

CREDIT UNION MEMBER BUSINESS LENDING



UNITED STATES DEPARTMENT OF THE TREASURY

January 2001

The Honorable Paul S. Sarbanes
Chairman
Committee on Banking, Housing,
and Urban Affairs
U.S. Senate
Washington, D.C. 20510-6075

Dear Mr. Chairman:

I am pleased to transmit the Department of the Treasury's report on credit union member business lending. We prepared this report as required by section 203 of the Credit Union Membership Access Act of 1998.

In preparing this report, we directly surveyed all 1,514 credit unions that carried member business loans on their books as of June 30, 1999. The survey produced detailed information on credit union member business lending, including the types and sizes of businesses that receive such loans, and the collateral used to secure those loans. The survey data reported here fills an information void about credit union member business lending and should inform any future policy discussions about such lending.

We also report our findings as to the effectiveness and enforcement of the National Credit Union Administration's regulations applicable to member business lending; whether business lending could affect credit unions' safety and soundness; the extent to which member business lending assists low- and moderate-income individuals; whether credit unions have a competitive advantage in making business loans; and the effect of the Credit Union Membership Access Act on the future growth of credit union member business lending.

Sincerely,

Lawrence H. Summers

Enclosure

[Identical letter sent to the Honorable Phil Gramm]

The Honorable Michael G. Oxley
Chairman
Committee on Financial Services
U.S. House of Representatives
Washington, D.C. 20515-6050

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Enclosure

[Identical letter sent to the Honorable John LaFalce]

EXECUTIVE SUMMARY

As depository institutions, most credit unions are small, retail-oriented operations that focus primarily on providing consumer credit to their members. However, credit unions may also make business loans to their members. As of June 30, 2000, federally insured credit unions had \$4.3 billion in member business loans outstanding. About 14 percent of federally insured credit unions had member business loans outstanding on that date.

The NCUA defines a credit union member business loan as any loan, line of credit, or letter of credit (including any unfunded commitments) where the borrower uses the proceeds for the following purposes: commercial, corporate, other business investment property or venture, or agricultural. The NCUA further exempts certain loans, including loans fully secured by a primary, 1-4 family residence and loans the total of which to an individual is less than \$50,000. In 1998 Congress codified the definition and limited a credit union's member business lending to the lesser of either 1.75 times net worth or 12.25 percent of total assets. The NCUA subsequently incorporated these limits and certain exceptions into their member business lending regulations.

Larger credit unions are more likely to offer member business loans than are smaller institutions. As of mid-year 2000, over half (53 percent) of the 338 federally insured credit unions with more than \$250 million in total assets offered member business loans. At the same time, less than five percent of the smallest credit unions (under \$10 million in total assets) offered this product.

Few credit unions are active business lenders. As of June 30, 2000, only 92 of 10,477 credit unions had total member business loans outstanding exceeding their net worth. While this group comprises less than one percent of all credit unions, they account for over 46 percent of total member business loans outstanding.

Four characteristics distinguish credit union member business loans from commercial lending done by banks:

- the loans can only be made to credit union members;
- the loans generally require the personal guarantee of the borrower;
- the loans generally must be fully collateralized; and
- total member business lending is generally subject to a portfolio limitation of 12.25 percent of total assets.

We prepared this study pursuant to section 203 of the Credit Union Membership Access Act of 1998. Congress directed us to investigate six specific issues pertaining to credit union member business lending. Our findings with respect to each of these issues are summarized below.

The Effectiveness and Enforcement of NCUA's Member Business Lending Regulations

Congress asked us to study the effectiveness and enforcement of the National Credit Union Administration's (NCUA) regulations applicable to member business lending.

Part 723 of the NCUA's regulations sets forth the written policies a credit union must have in place in order to make member business loans, and it establishes additional limitations and requirements on these loans. These limitations and requirements are intended to limit excessive risk taking in credit unions' member business lending portfolios. Overall, the regulations appear to be quite effective at limiting the credit risk associated with member business loans. The requirements for formal board policies, portfolio limits, and collateral requirements are much more stringent than those faced by banks and thrifts.

We reviewed the NCUA's enforcement of its member business lending regulations by looking at recent examination reports of credit unions that are actively engaged in this type of lending. Overall, we found it difficult to determine whether credit unions were in full, partial, or non-compliance with Part 723 because the information contained in the examination reports did not consistently show whether the examiners tested for compliance. NCUA staff told us that examiners need not document an area of review where no specific and material concerns were identified. We also had difficulty assessing the degree of compliance-testing undertaken in state-chartered credit unions. We identified several steps that the NCUA might take to improve its enforcement of Part 723, including monitoring Call Report data for credit unions that exceed the statutory limits; ensuring that credit unions are in compliance with other applicable regulatory requirements before granting a waiver to a member business lending limit; and updating its examination reports to reflect the current regulatory requirements.

Member Business Lending over \$500,000 and Under \$50,000

Congress asked us to examine member business lending over \$500,000 and under \$50,000, and to break down the data by types and sizes of businesses that received member business loans.

To collect the data requested by Congress on member business loans, we directly surveyed all 1,514 federally insured credit unions reporting member business loans outstanding on their June 30, 1999 Call Report. The survey asked credit unions to provide detailed information about their member business loan portfolio, including:

- the size of member business loans;
- the types of collateral used to secure member business loans;
- the types and sizes of businesses that receive member business loans; and
- the household income of members receiving member business loans.

A copy of the survey and the aggregated responses are provided in the Appendix. After

inputting and error-checking the data, we had 1,030 survey responses -- 68 percent of all credit unions reporting member business loans -- that could be used in our analysis.

The survey data showed that 59 percent of member business loans had balances less than \$50,000 and 2 percent had balances greater than \$500,000. These loans amounted to 14 percent and 17 percent, respectively, of the total outstanding principal balance of all the loans reported to us by survey respondents. For all reported loans, over half were collateralized with non-agricultural real estate, and another 23 percent were collateralized with taxicab medallions. Agricultural collateral backed 12 percent of the loans.

Over 50 percent of the loans reported to us by survey respondents were made for businesses with assets under \$100,000 and about 86 percent of those made were to businesses with total assets less than \$500,000. Loans to service-oriented businesses and for rental property made up nearly 55 percent of the total number of loans. In addition, 29 percent of member business loans were to agriculture-related business and 12 percent to “other business type.”

Looking at the total dollar value of member business loans outstanding, the survey showed that over 70 percent went either to service providers (38.8 percent) or for rental properties (32.9 percent). It appears that the figures for service providers largely reflect the loans made for taxicab medallions. Nearly half of the unpaid principal balance of member business loans outstanding was to businesses with total assets between \$100,000 and \$500,000. Cumulatively, almost 70 percent of the value of member business loans was made to businesses with total assets less than \$500,000.

Meeting the Needs of Low- and Moderate-Income Individuals

Congress asked us to study the extent to which member business lending helps to meet the financial services needs of low- and moderate-income individuals within the field of membership of insured credit unions.

We solicited information from credit unions about the member household income level for each of their member business loans based on several income categories. Overall, these data were difficult to obtain and the information that we did receive may suffer from accuracy problems. Thus, our survey data should be interpreted cautiously.

Our survey results showed 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.

The Effect of the Act on the Number of Credit Unions Engaged in Member Business Lending and the Overall Amount of this Lending

Congress asked us to study the effect of the 1998 Act on the number of insured credit unions involved in member business lending and the overall amount of commercial lending.

Overall, we expect the volume of credit union business lending to continue to increase. Certain provisions in the Credit Union Membership Access Act will tend to aid this growth, while others will serve to hinder it.

We expect that changes to the credit union membership restrictions in the Act will increase member business lending for two reasons. First, the expanded membership opportunities established in the Act will likely spur credit union growth, and larger credit unions tend to be more active member business lenders. Second, more credit unions are converting to community charters, which allow businesses to be credit union members.

On the other hand, the member business lending restrictions contained in the Act, coupled with risk-based net worth requirements issued by the NCUA, should temper this expected growth. The statutory limit on member business loans to 12.25 percent of assets serves as a binding constraint on long-term growth in this product market for credit unions not otherwise exempt from this limit. Also, marginal net worth requirements on member business loans that do exceed the 12.25 percent limit could also temper loan growth.

As for the competitive implications of the Act's membership and business lending provisions, it is reasonable to expect that some of these additional business loans will be new, while others will have been competed away from other depository institutions. Over the next few years, the total effect on other depository institutions should be modest -- especially given credit unions' relatively minor role in serving commercial borrowers. At the same time, there likely will be an increasing incidence of credit unions competing commercial loans away from other depositories in specific local markets.

Member Business Lending and the Safety and Soundness of Credit Unions and the Share Insurance Fund

Congress asked us whether member business lending by credit unions could affect the safety and soundness of credit unions or the National Credit Union Share Insurance Fund.

In the 1980s and early 1990s, member business lending was a factor in a number of credit union failures, and it contributed to losses to the Share Insurance Fund. In response, the NCUA established regulations governing member business loans in 1987, and strengthened those regulations in 1991.

Today, member business loans are generally less risky than commercial loans made by

banks and thrifts because they generally require the personal guarantee of the borrower and the loans generally must be fully collateralized. Ongoing delinquencies -- for credit unions, loans more than 60 days past due, and for banks and thrifts, loans more than 90 days past due -- are lower for credit unions than for banks and thrifts. Credit unions' mid-year 2000 loan charge-off rate of 0.03 percent was much lower than that for either commercial banks (0.60 percent) or savings institutions (0.58 percent).

We assessed the risk to the Share Insurance Fund from member business lending by running several simple stress tests whereby some portion of credit unions' outstanding member business loans were assumed to default at a total loss to the credit unions. No other sources of loss were included in the tests. *These stress tests are hypothetical and do not represent a judgement that the outcomes are likely. Rather, the tests seek to gauge the Share Insurance Fund's ability to withstand a negative shock to credit unions' member business loan portfolios.* If every credit union member business loan outstanding as of December 31, 1999, defaulted at a total loss to the credit union, and the credit unions suffered no other losses, the Share Insurance Fund would have remained solvent by \$3.1 billion. We conclude that, at this time, member business lending alone does not pose material risk to the Share Insurance Fund.

Do Credit Unions Have a Competitive Advantage? Could this Advantage Affect the Viability and Profitability of Other Federally Insured Depository Institutions?

Congress asked us to study whether credit unions that engage in member business lending have a competitive advantage over other insured depository institutions, and if any such advantage could affect the viability and profitability of such other insured depository institutions.

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.

Business lending is a niche market for credit unions. Overall, credit unions are not a threat to the viability and profitability of other insured depository institutions. In certain instances, however, credit unions that engage in member business lending may be an important source of competition for small banks and thrifts operating in the same geographic areas.

MEMBER BUSINESS LENDING

I. Introduction

Credit unions are depository institutions. Most are small, retail-oriented operations that focus primarily on providing consumer credit to their members. However, credit unions may also make business loans to their members. Credit unions are generally not active commercial lenders, but certain credit unions serve as an exception to this rule. As of June 30, 2000, federally insured credit unions had \$4.3 billion in member business loans outstanding.

This section defines member business lending, sets forth the statutory requirements for this study, describes the methodology used, and outlines the structure of the study.

A. Member Business Lending is Distinct and Limited

A member business loan is a commercial loan, like those made by banks. However, four legal constraints on credit union member business loans distinguish them from commercial lending by banks:

- the loans can only be made to credit union members;
- the loans generally require the personal guarantee of the borrower;
- the loans generally must be fully collateralized; and
- total member business lending is generally subject to a portfolio limitation of 12.25 percent of total assets.

Relative to other depository institutions, credit unions are not active commercial lenders. Federally insured credit unions reported \$4.3 billion in member business loans outstanding as of mid-year 2000, or about one percent of their total assets. Moreover, only about 14 percent of federally insured credit unions had any member business loans outstanding on that date. In contrast, banks and thrifts reported \$1 trillion in commercial loans outstanding as of mid-year 2000, or about 15 percent of their total assets.

Larger credit unions are more likely to offer member business loans than are smaller institutions. As of mid-year 2000, over half (53 percent) of the 338 federally insured credit unions with more than \$250 million in total assets offered member business loans. At the same time, less than five percent of the smallest credit unions (under \$10 million in total assets) offered this product.

Few credit unions are active business lenders. As of June 30, 2000, only 92 of 10,477 credit unions had total member business loans outstanding exceeding their net worth. While this group comprises less than one percent of credit unions, they account for over 46 percent of the unpaid principal balance of all member business loans. These credit unions may provide important competition for the small banks and thrifts that operate in the same geographic areas.

B. Study Requirements, Methodology, and Design

1. Requirements

The Treasury performed this study pursuant to section 203 of the Credit Union Membership Access Act of 1998, which President Clinton signed into law on August 7, 1998.¹ That section required the Treasury to conduct a study of member business lending by federally insured credit unions, including:

- an examination of member business lending over \$500,000 and under \$50,000, and a breakdown of the types and sizes of businesses that receive member business loans;
- a review of the effectiveness and enforcement of regulations applicable to member business lending;
- whether member business lending could affect the safety and soundness of credit unions and the National Credit Union Share Insurance Fund;
- the extent to which member business lending helps to meet the financial services needs of low- and moderate-income individuals within the field of membership of insured credit unions;
- whether insured credit unions that engage in member business lending have a competitive advantage over other insured depository institutions, and if any such advantage could affect the viability and profitability of such other insured depository institutions; and
- the effect of enactment of the Credit Union Membership Access Act on the number of credit unions involved in member business lending and the overall amount of commercial lending.

2. Methodology

Because of the paucity of data on credit union member business lending, the Treasury Department directly surveyed individual credit unions to gather information on the types and sizes of businesses receiving member business loans, the collateral used to secure such loans, and the household income levels of the borrowers. The survey was sent to all 1,514 federally insured credit unions reporting member business loans outstanding on their June 30, 1999 Call Report.² Some 1,030 credit unions -- an unusually large response rate of 68 percent -- submitted usable responses.

¹ Pub. L. No. 105-219, § 203, 112 Stat. 913, 922.

² The NCUA's Call Report is a financial disclosure report filed by each credit union. Specifically, the Call Report includes information about the credit union's balance sheet (assets, liabilities, and equity) and income statement (revenues and expenses). The Call Report is filed quarterly by large credit unions (those with greater than \$50 million in total assets) and semi-annually by small credit unions (those with less than \$50 million in total assets).

Before issuing the member business lending survey, we met with the National Credit Union Administration (NCUA) and representatives of credit union and bank trade associations. These parties assisted in the construction of the survey by providing insight into appropriate categories, terminology, phrasing, and formatting. The NCUA also provided sampling services based on our specifications and generated an electronic mailing list and labels for us. Three credit union organizations (Credit Union National Association, National Association of Federal Credit Unions, and National Association of State Credit Union Supervisors) all pre-tested the survey instrument with certain members and publicized the survey on their respective web-sites.

To review the NCUA's enforcement of its member business lending regulations, we analyzed appropriate portions of NCUA examination reports on credit unions actively engaged in member business lending and we conferred with NCUA staff about the structure of their member business lending reviews.

3. Overview

Section II outlines the legal framework under which credit unions engage in member business lending – including an analysis of the effectiveness and enforcement of federal regulations. Section III provides comprehensive data on the types and sizes of businesses and the income characteristics of credit union members that receive member business loans. Section IV assesses the effect of the Credit Union Membership Access Act on the number of credit unions engaged in member business lending and the overall amount of commercial lending. Section V examines the effect of member business lending on credit union safety and soundness and on the Share Insurance Fund. Section VI considers whether credit unions have a competitive advantage in making business loans. Section VII summarizes the report's findings.

II. Legal Framework for Member Business Lending

Some credit unions have always made commercial credit available to their members. However, not until 1987 were credit unions subject to federal member business lending regulations. Overall, these regulations appear to be quite effective at limiting the risks associated with member business lending. We identified a few steps that the NCUA could take to strengthen its enforcement of these regulations.

A. Brief History of Credit Union Business Lending

Since their inception, credit unions have offered business-related loans to their members. It was not until 1987, however, following several credit union failures due to business lending, that the NCUA promulgated regulations specifically targeted at this type of lending. At that time, the NCUA reported that half of the losses accruing to the National Credit Union Share

Insurance Fund (\$20-\$30 million) in the two previous years (1985 and 1986) were directly or indirectly the result of member business lending.³

Even after the NCUA issued its member business lending regulations in 1987, poorly managed business lending programs continued to result in credit union failures. The NCUA's analysis of the five largest failures in each of its six regions during the 1987-1991 period found that "commercial lending was a factor" in 16 of the 30 credit union failures. These 16 failures cost the Share Insurance Fund about \$100 million.⁴ The NCUA also found that problem credit unions in 1991 had a "disproportionately higher level of member business loans than other credit unions." The NCUA concluded that, at that time, "credit unions with the poorest overall condition and poorest ability to withstand losses tend to have the greatest involvement with member business loans."⁵ The NCUA responded by revising its member business lending regulations in September 1991.

Following the 1991 regulatory revisions and the vastly improved macroeconomic environment, the quality of credit unions' member business lending portfolios grew stronger through the 1990s. As of June 30, 2000, member business lending delinquencies stood at 1.84 percent -- compared to 8.20 percent as of year-end 1993.

B. Current NCUA Regulations

The NCUA defines a credit union member business loan as any loan, line of credit, or letter of credit (including any unfunded commitments) where the borrower uses the proceeds for the following purposes: commercial, corporate, other business investment property or venture, or agricultural.⁶ The NCUA further exempts loans having certain characteristics, even if the proceeds are used for commercial purposes. Exempt loans include those:

- fully secured by a primary, 1-4 family residence;
- fully secured by shares in the credit union making the loan or deposits in another financial institution;
- the total of which to an individual is less than \$50,000;
- fully insured, or fully guaranteed, or where there is an advance commitment to purchase in full by any agency of federal, state, or local government; or

³ 51 Fed. Reg. 23,234 (June 26, 1986).

⁴ 56 Fed. Reg. 2,723 (Jan. 24, 1991).

⁵ 56 Fed. Reg. 48,421 (Sept. 25, 1991).

⁶ 12 C.F.R. § 723.1(a).

- granted by a corporate credit union to another credit union.⁷

Congress codified the NCUA's member business lending definition, including the exemptions, in the Credit Union Membership Access Act of 1998.⁸ At that time, Congress also limited a credit union's member business lending to the lesser of either 1.75 times net worth or 12.25 percent of total assets.⁹ The NCUA subsequently incorporated these limits and certain exceptions into their member business lending regulations.¹⁰ (Section V discusses the effect of the Act on member business lending.)

Part 723 of the NCUA's regulations requires that credit unions engaging in member business lending must have written policies that address the following issues:

- the types of loans to be made;
- the trade area to be serviced;
- the maximum amount of assets (in relation to net worth) that will be invested in business loans;
- the maximum amount of assets (in relation to net worth) that will be invested in any category of business loans;
- the maximum amount of assets (in relation to net worth) that will be loaned to one member (or associated group of members);
- the qualifications and experience of the personnel involved in making these loans (these individuals are to have at least two years experience with this type of lending);
- a requirement to analyze and document the ability of the borrower to repay the loan;
- documentation supporting each loan application (i.e., balance sheet, income statement, cash flow, etc.);
- collateral requirements (including loan-to-value ratios, appraisals, title search and insurance requirements, marketability, etc.);
- appropriate interest rates and maturities;
- loan monitoring and servicing procedures; and
- identification of individuals ineligible to receive member business loans.¹¹

Part 723 also outlines the following minimum limits and policies:

⁷ 12 C.F.R. § 723.1(b).

⁸ 12 U.S.C. § 1757a(c)(1).

⁹ 12 U.S.C. §§ 1757a(a), 1790d.

¹⁰ 12 C.F.R. §§ 723.16, 723.17.

¹¹ 12 C.F.R. § 723.6.

- unless approved by the NCUA, member business loans may only be granted on a fully secured basis by second liens up to 80 percent loan-to-value (LTV) and first liens up to 80 percent LTV (first liens between 80-95 percent LTV may be acceptable when the amount exceeding 80 percent is fully insured by a private mortgage insurer);
- unless approved by the NCUA, loans may not be granted without the personal liability and guarantees of the principals (loans to non-profits are exempt from this requirement);
- unless approved by the NCUA, loans to one borrower (or group of associated borrowers) may not exceed 15 percent of a credit union's net worth or \$100,000 -- whichever is larger (any portion of such loans secured by government guarantees or shares in the credit union are not included in this calculation);
- member business loans should be granted for periods consistent with the purpose, security, creditworthiness of the borrower, and sound lending practices; and
- "allowance for loan losses" are to be reserved at 100 percent of the outstanding loan amount for actual losses, 50 percent for "doubtful loans," and 10 percent for "substandard loans."

Also, with regard to credit unions implementing a member business loan program, the credit union's board of directors must adopt specific business loan policies and review them at least annually.

Unless waived by the NCUA, construction and development loans are subject to the following additional requirements:

- the aggregate amount of these loans must not exceed 15 percent of net worth (net of any amounts guaranteed by the government or secured by shares);
- the borrower must have at least a 35 percent equity interest in the property; and
- on-site, written inspections must be prepared by qualified personnel prior to release of funds.

Part 723 is intended to limit excessive risk taking in credit unions' member business lending portfolios. The NCUA thus seeks to maintain the financial safety and soundness of credit unions and the Share Insurance Fund. In the next two sections, we analyze the effectiveness and enforcement of Part 723.

C. Effectiveness of NCUA's Member Business Lending Regulations

Congress asked us to determine the effectiveness of the NCUA's member business lending regulations. We understood this to mean determining how effective Part 723 is at reducing credit risk.

We focused on the regulatory definition of a business loan, the required written policies governing business lending, collateral and security requirements, and limitations on member business lending generally and construction and development lending in particular. We also compared Part 723 to commercial lending regulations applicable to federally chartered banks and

thrifts. Our analysis resulted in five principal findings.

First, our survey results show that a large percentage of member business loans are financing 1-4 family residential rental properties (see Section III for details). According to the NCUA, these often are second or third homes that a credit union member rents to others. Rental properties typically have greater credit risk than owner-occupied properties. The Federal Credit Union Act requires that a non-owner occupied 1-4 family residential mortgage be classified as a member business loan unless it is the borrower's future primary residence. We believe that these loans should be reported as a subset of member business lending and identified as “non-owner occupied 1-4 family mortgages.”

Second, the NCUA requires the boards of directors of credit unions engaged in commercial lending to meet certain requirements that are not applicable to national banks or federal savings associations. Specifically, credit union boards must establish a member business loan policy identifying the types of business loans it will make, its trade area, the qualifications and experience of its business lending personnel, and those individuals ineligible to receive such loans.¹² In addition, the credit union must limit the amount it will dedicate to aggregate member business lending, as well as to any given type of member business lending.¹³

Third, NCUA collateral and security requirements serve to differentiate credit union member business lending from commercial lending by other depository institutions. Except for commercial credit card programs, the NCUA requires collateral for all credit union member business loans. By contrast, banks and thrifts generally are not required to take a security interest in a commercial loan borrower's assets.¹⁴ Because collateral serves to better align the incentives of the borrower with the lender, collateral requirements generally result in smaller, less risky loans and hence less overall credit risk.

Fourth, the Credit Union Membership Access Act limits a credit union's business lending activity to the lesser of 1.75 times net worth or 12.25 percent of total assets.¹⁵ Similarly, federal savings associations are limited in their commercial lending to 20 percent of total assets, provided that any amount over 10 percent of total assets consists of small business loans.¹⁶

¹² 12 C.F.R. §§ 723.5, 723.6(a), (b), (f), and (m).

¹³ 12 C.F.R. § 723.6(c), (d).

¹⁴ All national banks and federal savings associations, however, must establish and maintain prudent underwriting practices. 12 C.F.R. § 30, Appendix A § II.D; 12 C.F.R. § 560.100 *et seq.*

¹⁵ 12 U.S.C. § 1757a(a); 12 C.F.R. § 723.16.

¹⁶ 12 U.S.C. § 1464(c)(2)(A); 12 C.F.R. 560.30.

National banks, by contrast, may make commercial loans without specific limitation.¹⁷

Fifth, limitations on credit union construction and development lending (i.e., 15 percent of net worth) are stricter than for banks and thrifts.¹⁸ For example, federal savings associations are limited in their unsecured construction lending to the greater of total capital or five percent of total assets.¹⁹ Federal savings associations are also limited in their lending secured by non-residential real estate up to 400 percent of capital.²⁰ National banks, by contrast, may make construction and development loans without specific limitation.²¹

Overall, the NCUA's member business lending regulations appear to be quite effective at limiting the credit risk associated with these loans. Indeed, the NCUA's formal board policy requirement, portfolio limits, and collateral requirements are much more stringent than those faced by banks and thrifts.

D. Enforcement of NCUA's Member Business Lending Regulations

We reviewed the NCUA's enforcement of its member business lending regulations by looking at recent examination reports of credit unions that are actively engaged in this type of lending.

1. Review of Examination Reports

We limited our review of examination reports to those credit unions that reported on their year-end 1999 Call Report having either member business loans exceeding the lesser of 1.75 times net worth or 12.25 percent of total assets, or construction and development loans outstanding exceeding 15 percent of net worth. This approach directed our review of NCUA's enforcement of Part 723 to those credit unions that, by their own reporting, exceeded the standard limits on member business lending. As a result, we established a sufficiently large sample from which to draw conclusions and we directed our resources to cases where we would expect to find that the NCUA had either taken enforcement action or granted waivers to its regulations.

¹⁷ 12 U.S.C. § 24(seventh).

¹⁸ 12 C.F.R. § 723.3(a).

¹⁹ 12 U.S.C. § 1464(c)(3)(C); 12 C.F.R. 560.30.

²⁰ 12 U.S.C. § 1464(c)(2)(B); 12 C.F.R. 560.30.

²¹ 12 U.S.C. § 371(a).

Looking at year-end 1999 Call Report data, we identified 90 credit unions with member business loans in excess of the regulatory ceilings.²² Of these, 78 credit unions had member business loans outstanding exceeding the aggregate member business lending limit and 15 credit unions exceeded the construction and development lending limit. Three credit unions exceeded both limits. Of these 90 credit unions, two had recently been liquidated and an examination report for another was not available. Consequently, we reviewed electronic examination reports for 87 credit unions using the NCUA's Automated Integrated Regulatory Examination System (AIRES) program.²³

2. Findings

In reviewing examination reports for the 87 credit unions, we evaluated whether:

- the credit union had obtained the appropriate waiver for the lending limits it exceeded;
- examiners systematically tested for compliance with the requirements of Part 723; and
- credit unions corrected compliance problems identified by examiners.

a. Waivers

As noted above, all 87 credit unions in our sample had member business loans in excess of the regulatory limits. The NCUA's regulations permit credit unions to exceed those limits if they meet certain criteria. Specifically, a credit union may exceed the aggregate limit on outstanding member business loans if it applies for and receives an exception to the limit, pursuant to the standards set forth in Part 723.²⁴ A credit union also may apply for a waiver of the aggregate limit on construction and development loans pursuant to procedures in Part 723.²⁵

Of the 78 credit unions that exceeded the aggregate member business lending limit, six did not have the appropriate exception. According to the NCUA, four of these credit unions are under moratoria to stop their member business lending production until they attain a level below 12.25 percent of total assets. One did not seek a waiver because it only temporarily exceeded the member business lending threshold, and one only appeared to exceed the limit because it had filed an incorrect Call Report.

²² As of June 30, 2000, 103 credit unions exceeded at least one of the regulatory ceilings.

²³ The AIRES program was designed by the NCUA and is now used by both them and state credit union supervisors. The NCUA provides AIRES (and laptop computers) to credit union examiners in 49 states (Utah excluded).

²⁴ 12 C.F.R. §§ 723.17, 723.18.

²⁵ 12 C.F.R. §§ 723.10(c); 723.11.

Of the 15 credit unions with construction and development loans exceeding 15 percent of their net worth, only two had the appropriate waiver. According to the NCUA, 10 of the 15 credit unions had filed incorrect Call Reports.

In 12 instances, we found that the NCUA had issued an exception or a waiver to a credit union that it found to be in noncompliance with other aspects of Part 723. It appears that the NCUA does not require that a credit union otherwise be in compliance with Part 723 before granting a waiver from the lending limits.

b. Compliance Testing

The NCUA's examiner guidance manual states that examiners should test every credit union with member business loans for compliance with Part 723. We assessed examiners' conformance with this requirement by reviewing the most recent two or three examination reports completed for each of the 87 credit unions in our sample. For state-chartered credit unions, we also looked at a checklist prepared by NCUA examiners that documents their own review of the state examination. Since all of the credit unions in our sample exceed certain regulatory limits for member business lending, they are all materially involved in such lending. Consequently, one would expect that the review of member business loan portfolios would be a material aspect of any full regulatory examination of these credit unions.

Overall, we found it difficult to determine whether any in our sample of 87 credit unions was in full, partial, or non-compliance with Part 723. As noted above, both NCUA and state credit union examiners use the AIRES program to document their on-site visits to credit unions. However, the member business lending questionnaire contained on AIRES is limited in that it focuses exclusively on board policies. Thus, it omits the other requirements under Part 723, such as loan-to-value ratios below 80 percent, personal guarantees, and loan loss reserving requirements. In short, the member business lending questionnaire in AIRES is not set up in a way that requires the examiner to attest to a credit union's compliance with all aspects of Part 723.

We tested whether examiners completed the limited member business lending questionnaire for the 87 credit unions in our sample. The information contained in the examination reports did not consistently show whether the examiners tested for compliance. NCUA staff told us that examiners need not document an area of review where no specific and material concerns were identified. We also had difficulty assessing the degree of compliance-testing undertaken in state-chartered credit unions.

In 19 cases (22 percent), examiners systematically reviewed (and documented their review of) credit union board policies regarding member business lending. In another 33 cases, examiners indicated in their work papers that they had looked at some aspect of the credit union's compliance with Part 723. These work paper comments were either that a credit union violated a regulatory provision concerning member business lending or that it had recently

corrected problems identified in previous examinations. Thus, in at least some of the cases where the examiner did not complete the member business lending questionnaire, the examiner did undertake some amount of review in this area. In the remaining 35 credit unions, however, we found no evidence that examiners tested for compliance with Part 723.

We had particular difficulty assessing the degree of compliance testing undertaken in state-chartered credit unions. NCUA examiners do not typically examine state-chartered credit unions. Instead, state examiners use the AIREs program and then forward their examinations to the NCUA. NCUA examiners then review this report and complete a checklist that assesses whether the state exam covered key risk areas. These reports, however, are not uniform across NCUA regions. For example, not all regions have a question concerning compliance with member business lending regulations and when they do, the question refers to Part 701.21(h) of NCUA's Rules and Regulations.²⁶ Also, NCUA examiners reviewing AIREs examination data submitted by state examiners face the same limitations we encountered and have noted above. Thus the NCUA has little direct knowledge, and only limited indirect knowledge, of the compliance of state-chartered credit unions with the requirements of Part 723.

The NCUA's policy is to conduct on-site safety and soundness examinations at state-chartered, federally insured credit unions only if the NCUA has an "insurance concern"²⁷ or observes negative trends in a state credit union or group of state credit unions. As a result, many years may pass in between examinations by the NCUA of a state-chartered credit union. The NCUA's approach differs from that taken by the federal banking agencies, which are required by law to examine state-chartered banks and thrifts under their jurisdiction at least every two years.²⁸

From our limited review, we could not attest to the NCUA's testing for compliance with restrictions on construction and development lending. For all construction and development loans, Part 723 requires that: (1) borrowers have at least a 35 percent equity stake in the properties (projects); and (2) on-site, written inspections by qualified personnel have been conducted prior to the release of the loan funds. For the 15 credit unions reporting construction and development lending exceeding 15 percent of net worth, none of the examination reports we reviewed documented whether those credit unions had been examined for compliance with these requirements.

²⁶ This section was replaced by Part 723 in May 1999. 64 Fed. Reg. 28721 (May 27, 1999).

²⁷ Determination that a state-chartered credit union is an "insurance concern" is a judgment left to each NCUA regional office and is not guided by a formal regulation or policy guidance.

²⁸ The federal banking agencies are the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, and the Office of Thrift Supervision.

c. Correcting Compliance Problems

We also reviewed past examination reports for the 87 credit unions in our sample to see whether compliance problems identified by an examiner were cured before the next examination. Specifically, we looked at cases in which an examination report recorded a formal agreement (such as a “Document of Resolution” or “Letter of Understanding and Agreement”) or an oral directive to a credit union to correct a lack of compliance with Part 723. Overall, based on the information available to us in the examination files, we could not usually determine a credit union's compliance with a “Document of Resolution” or “Letter of Understanding and Agreement.” We worked under the assumption that if the subsequent examination did not mention the earlier problems, the credit union had corrected them.

We found that when NCUA examiners identified compliance problems, the credit unions did not always correct all of the problems by the next examination. In six cases, we found at least one member business lending-related problem that still existed at the time of the next examination. Each of these six credit unions was located in NCUA Region 5 and participated in that region's special agricultural review program,²⁹ and five of these six credit unions were state chartered.

d. Farm Service Agency Guarantees for Agricultural Member Business Loans

NCUA Region 5 has encouraged some credit unions to seek federal loan guarantees provided by the Farm Service Agency (FSA) for troubled agricultural borrowers. Based on its agricultural review work papers, it seems that Region 5 encourages credit unions to obtain such guarantees for their agriculture loans. While this is not a problem *per se*, we identified two concerns with this policy. First, Region 5 was encouraging credit unions to seek guarantees on loans that were already not performing (thereby shifting the credit union's credit risk to a federal agency). Second, some credit unions had difficulty meeting the FSA servicing requirements – potentially resulting in loss of the FSA guarantee.

2. Improving the NCUA's Enforcement of Part 723

Based on our review, we believe that the NCUA can improve its enforcement of Part 723 in four ways:

²⁹ The NCUA established its agriculture review program to review the financial condition and administrative operations of credit unions engaged in agricultural lending. This program uses examiners that specialize in reviewing agricultural lending to tailor corrective actions in response to a credit union's operational and financial difficulties arising from agricultural lending.

- Regularly monitor Call Report data to identify those credit unions exceeding the member business lending limits. When those credit unions are identified, the NCUA should quickly determine whether the data are accurate and, if so, whether a credit union qualifies for a waiver or exception under Part 723 or whether other action is appropriate.
- Ensure that a credit union is in compliance with other applicable regulatory requirements before issuing a waiver to a member business lending limit.
- Update both the member business lending questionnaire and the Code 26 report (for reviewing the examinations of state-chartered credit unions) to reflect the current requirements of Part 723. In addition, the NCUA examiners should ensure that examiners follow the examiner’s guidance in reviewing compliance with Part 723 and properly documenting that review.
- Test for compliance with the 35 percent equity requirement and the on-site inspection requirement for construction and development lending in Part 723.

III. Member Business Lending Survey

Congress asked us to provide it with detailed information about: (1) credit union member business lending over \$500,000 and under \$50,000; (2) the types and sizes of businesses that receive member business loans; and (3) the extent to which member business lending helps to meet the financial services needs of low- and moderate-income individuals. Because neither the NCUA nor national credit union trade associations had previously collected this information, we constructed a survey to obtain these data.

A. Survey Methodology and Response

1. Member Business Loans and Business Purpose Loans

When the NCUA first promulgated its member business lending regulations in 1987, it required credit unions to report all business loans on their Call Reports. At the same time, however, only loans to a single borrower with aggregate original amounts greater than \$25,000 were subject to the member business lending regulation. In an effort to reduce regulatory burden, in 1993 the NCUA raised the regulatory threshold to \$50,000 and eliminated the reporting requirement for loans under this amount.³⁰ Since then, credit union business loans made for business purposes, but that *aggregate* to less than \$50,000 for a particular borrower have generally been reported as either consumer loans, mortgage loans, or “other” loans. NCUA

³⁰ 58 Fed. Reg. 40,040 (July 27, 1993).

refers to these as “business purpose loans” but does not require credit unions to report them in a separate category. Nor do credit unions have to adhere to any of the NCUA’s member business lending requirements in making business purpose loans.

Since Congress asked us to provide data on “member business lending over \$500,000 and under \$50,000” the distinction between member business loans and business purpose loans is an important one. In order to avoid confusion among credit unions in collecting the data requested by Congress, we followed the NCUA’s conventions and terminology. There are two ways in which a credit union may have a member business loan less than \$50,000. First, the loan is one of a group of business loans to a single borrower that, when added together, amount to more than \$50,000. Second, the original principal amount of the member business loan exceeded \$50,000 but enough of the principal had been repaid so as to make the remaining principal balance less than \$50,000.

Since Congress asked for data on member business loans less than \$50,000, we took the additional step of asking credit unions for data on their business purpose loans. While these loans do not meet the NCUA's definition of a member business loan, they are loans less than \$50,000 where the loan proceeds went to finance a business, rather than a consumer, purpose.

Thus, in our survey we separately asked credit unions about their member business loans and their business purpose loans. Based on current regulations and on our discussions with the NCUA, credit union trade associations, and individual credit union managers prior to issuing our survey, we understood that there was no reason for credit unions to maintain readily identifiable loan files on business purpose loans. Nor was there any reason to expect that they maintained the sort of detailed data on these loans that they must have for their member business loans. Consequently, we asked credit unions to estimate the number and dollar value of business purpose loans on their books, but we did not ask them to provide more detailed data on these loans. As described below, we found that some credit unions are not clear about the distinction between business purpose loans and member business loans.

2. Survey Design and Response Rate

To collect the data requested by Congress on member business loans, we directly surveyed all 1,514 federally insured credit unions reporting member business loans outstanding on their June 30, 1999 Call Report. The survey asked credit unions to provide detailed information about their member business loan portfolio, including:

- the size of member business loans;
- the types of collateral used to secure member business loans;
- the types and sizes of businesses that receive member business loans;
- the household income of members receiving member business loans;
- the size and duration of loan delinquencies; and
- the extent to which loan participations were used to share the credit risk associated with

member business loans.

A copy of the survey and the aggregated responses are provided in the Appendix.

We received 1,118 survey responses (73.8 percent). After inputting and error-checking the data, we found that 88 of these credit unions reported on their survey that they had no member business loans. Because these responses directly conflicted with their mid-year 1999 Call Report filings, we removed these credit unions from the analysis. As a result, we received 1,030 surveys -- 68 percent of all credit unions reporting member business loans -- that could be used in our analysis.

In order to gather information about business purpose loans, we elected to survey both credit unions that did and did not have member business loans. Specifically, we asked a stratified random sample of 811 credit unions that did *not* report member business loans outstanding as of June 30, 1999 about any business purpose loans they may have.³¹ This survey asked the respondents to estimate the number and unpaid principal balances of any business purpose loans that they may have had on their books as of June 30, 1999. Overall, we received 648 responses to this survey (80.0 percent). Five of these contained incomplete data, resulting in 643 responses in our analysis. We also asked all of the credit unions that *did* report having member business loans to separately provide us with an estimate of the number and unpaid principal balances of any business purpose loans that they may have had on their books as of June 30, 1999. A copy of the survey on business purpose loans and the aggregated responses are also provided in the Appendix.

B. Data Limitations

In order to ensure that the 1,030 credit unions that returned completed member business loan surveys were representative of all 1,514 credit unions with member business loans, we conducted a statistical test.³² The results indicated that the total assets and the ratio of member business loans-to-total assets of the responding credit unions were not statistically different from those of the non-responding credit unions.

To test the accuracy of the survey responses, we compared the total dollar volume of member business lending for each credit union as reported on both the Call Report and our

³¹ The sample was stratified based on total assets. The stratification categories were: under \$2 million, \$2-10 million, \$10-50 million, \$50-250 million, and over \$250 million. Sample sizes in each strata were determined assuming a 50 percent response rate and 90 percent confidence interval.

³² We conducted t-tests of the differences in the means of both total assets and the ratio of member business loans to total assets based on Call Report data as of June 30, 1999. Both tests accepted the null hypothesis of no statistical difference between responding and non-responding credit unions.

survey for June 30, 1999. Even after allowing for errors up to \$1,000, we found that 194 of the credit unions responding to our survey (19 percent) had reporting discrepancies. These discrepancies arose despite the explicit guidance on the survey form that the total loan volume reported on the survey should be identical to the total reported on the Call Report.³³

In an attempt to resolve these discrepancies, we contacted more than 100 survey respondents. Based on our review of the surveys and the numerous discussions we had with survey respondents, we believe that some credit unions were confused about the NCUA's definition of a member business loan. This confusion sometimes caused credit unions to report business purpose loans as being member business loans on their Call Report or on our survey. The confusion among some credit unions as to what constitutes a member business loan raises some question as to the reliability of Call Report data on member business loans.

C. Survey Results

1. Member Business Loans

The following data on credit union member business loans are from the 1,030 usable responses to the Treasury survey. The data are as of June 30, 1999.

Our survey results show that member business loans served as financing primarily for service businesses, agricultural businesses, and rental properties. Furthermore, borrowers collateralized most member business loans with non-agricultural real estate. Credit unions also reported that 25 percent of member business loans were issued to members of low- and moderate-income households. As described below, the survey results are limited in that: (1) some credit unions appear to be confused about the definition of member business loans; and (2) borrower information, such as business size and household income, often reflected information from the time of loan origination, which could have been several years or more in the past.

a. Collateral Type

As previously noted, NCUA regulations require that almost all member business loans be fully collateralized. Table 1 shows that non-agricultural real estate (55.7 percent) and taxicab medallions (22.7 percent) collateralized most of the unpaid principal balance of member business loans. Agricultural-related assets (real estate, equipment, crops, or livestock) secured another 12.4 percent of member business loan balances. Together, these three types collateral backed 91 percent of the unpaid principal balance of all member business loans.

Loans under \$100,000 constituted about one-third of the outstanding unpaid principal

³³ The survey included specific schedule and line number information indicating what data on the credit union's June 30, 1999 Call Report should match what data reported in the survey.

balance of member business loans. While non-agricultural real estate collateralized 16 percent of these loan balances, the remainder was tied to a variety of assets (e.g., inventory and equipment). Another one-half of the unpaid principal balances on member business loans were for loans between \$100,000 and \$500,000. Non-agricultural real estate and taxicab medallions (i.e., higher value assets) primarily backed these loans. Another 17 percent of unpaid principal balances on member business loans were for loans over \$500,000. These loans were (almost exclusively) secured by non-agricultural real estate.

Table 1: Distribution of Unpaid Principal Balance of Member Business Loans
By Collateral Type and Loan Size
(As of June 30, 1999)

Collateral Type	Loan Size				Total
	Under \$50,000	\$50,000 – \$100,000	\$100,001- \$500,000	Over \$500,000	
Agricultural Real Estate	1.0%	1.5%	2.7%	0.1%	5.2%
Agricultural Equipment	1.9%	1.0%	0.9%	0.0%	3.8%
Crops and Livestock	1.2%	1.0%	1.1%	0.0%	3.4%
Non-Ag Real Estate	5.6%	10.5%	23.5%	16.1%	55.7%
Non-Ag Equipment	1.6%	1.2%	1.6%	0.4%	4.7%
Accounts Receivable	0.1%	0.0%	0.1%	0.0%	0.2%
Inventory	0.1%	0.1%	0.3%	0.0%	0.5%
Taxicab Medallions	1.3%	2.4%	18.7%	0.3%	22.7%
Other Collateral	1.2%	1.0%	0.9%	0.1%	3.1%
No Collateral	0.3%	0.1%	0.1%	0.0%	0.6%
Total	14.3%	18.8%	49.9%	17.0%	100.0%

For the number of loans by collateral type and loan size, Table 2 shows that non-agricultural real estate and taxicab medallions secured 47.5 percent of all member business loans. The fact that loans secured by such collateral account for 78.4 percent of the total unpaid principal balance reported in Table 1 indicates that these loans tend to be larger than member business loans secured with other collateral. The remainder of the member business loan portfolio generally included much smaller loans that were secured by a variety of collateral types. Nearly 60 percent of member business loans had remaining unpaid principal balances less than \$50,000 and almost 78 percent were less than \$100,000. Fewer than 2 percent of member business loans outstanding were for more than \$500,000.

Table 2: Distribution of Member Business Loans by Collateral Type and Loan Size
(As of June 30, 1999)

Collateral Type	Loan Size				Total
	Under \$50,000	\$50,000 – \$100,000	\$100,000- \$500,000	Over \$500,000	
Agricultural Real Estate	2.6%	1.5%	1.1%	0.0%	5.2%
Agricultural Equipment	10.7%	1.1%	0.4%	0.0%	12.3%
Crops and Livestock	6.9%	1.3%	0.7%	0.0%	9.0%
Non-Ag Real Estate	13.6%	9.6%	8.7%	1.7%	33.5%
Non-Ag Equipment	6.8%	1.4%	1.2%	0.1%	9.6%
Accounts Receivable	0.5%	0.1%	0.0%	0.0%	0.6%
Inventory	0.4%	0.1%	0.2%	0.2%	0.9%
Taxicab Medallions	4.3%	2.4%	7.3%	0.0%	14.0%
Other Collateral	4.8%	1.3%	0.4%	0.0%	6.6%
No Collateral	8.0%	0.2%	0.1%	0.0%	8.3%
Total	58.6%	19.0%	20.2%	2.2%	100.0%

b. Business Type and Size³⁴

Looking at the distribution of member business loans by business type, we once again found that the data were clustered into two groups. Table 3 shows that, based on the total dollar value of loans outstanding, over 70 percent of member business loans were made to either service providers (38.8 percent) or for rental properties (32.9 percent). Given that Table 1 shows that 22.7 percent of the value of member business loans was secured by taxicab medallions, it would seem that the figures for service providers largely reflect the loans made for taxicab medallions.

Table 3 also shows that nearly half of the unpaid principal balance of member business loans outstanding is to businesses with total assets between \$100,000 and \$500,000. Cumulatively, almost 70 percent of the value of member business loans is made to businesses with total assets less than \$500,000.

³⁴ Some credit unions reporting information about the collateral type used to secure their loans did not provide complete information for the subsequent tables. We found that 42 credit unions provided no subsequent information, while another 76 provided limited amounts (e.g., provided information about half of their member business loans). Therefore, the total dollar amount of member business loans used for our analysis of “business type” was about \$551 million lower than the amount used for collateral type -- reflecting a lack of data on about 3,700 loans.

Table 3: Distribution of Unpaid Principal Balance of Member Business Loans by Business Type and Size
(As of June 30, 1999)

Business Type	Business Size (As Measured by Total Assets)				Total
	Under \$100,000	\$100,000 \$500,000	\$500,001 \$1 Million	Over \$1 Million	
Manufacturing	0.3%	0.4%	0.2%	0.2%	1.2%
Service	3.6%	18.8%	14.9%	1.4%	38.8%
Agriculture	6.6%	5.5%	1.4%	0.7%	14.3%
Real Estate Construction and Development	0.4%	2.0%	0.8%	1.2%	4.3%
Rental Property	10.1%	14.8%	5.0%	3.0%	32.9%
Religious Organization	0.1%	0.5%	0.6%	0.5%	1.7%
Other Fraternal Org	0.1%	0.1%	0.0%	0.0%	0.2%
Other Business Type	2.2%	2.5%	0.9%	1.1%	6.7%
Total	23.5%	44.6%	23.9%	8.0%	100.0%

Table 4 shows that the distribution of the number of loans by business type and size is different from the distribution of unpaid principal balances. Over 50 percent of the number of loans made are for businesses with assets under \$100,000 and about 86 percent of those made are to businesses with total assets less than \$500,000. Loans to service-oriented businesses and for rental property make up nearly 55 percent of the total number of loans. In addition, 29 percent of member business loans were to agriculture-related business and 12 percent to “other business type.”

Table 4: Distribution of Member Business Loans by Business Type and Size
(As of June 30, 1999)

Business Type	Business Size (Measured by Total Assets)				Total
	Under \$100,000	\$100,000 \$500,000	\$500,001 \$1 Million	Over \$1 Million	
Manufacturing	0.7%	0.2%	0.1%	0.2%	1.3%
Service	9.1%	14.0%	5.8%	1.1%	29.9%
Agriculture	19.5%	7.1%	1.4%	0.5%	28.6%
Real Estate Construction and Development	0.4%	0.7%	0.2%	0.3%	1.6%
Rental Property	14.7%	7.9%	1.4%	0.8%	24.9%
Religious Organization	0.2%	0.3%	0.1%	0.9%	1.4%
Other Fraternal Org	0.1%	0.1%	0.0%	0.0%	0.2%
Other Business Type	8.7%	2.1%	0.9%	0.5%	12.2%
Total	53.5%	32.3%	9.9%	4.3%	100.0%

c. Household Income

Congress asked us to study the extent to which member business lending helps to meet the financial services needs of low- and moderate-income individuals. To this end, we asked credit unions to report the member household income level of their member business loan borrowers. We defined the following income categories: under \$30,000, \$30,000-50,000, \$50,000-100,000, \$100,000-250,000, and over \$250,000. Credit unions also had the option to classify the loan as being made directly to a business.

Overall, we had difficulty obtaining the household income data from credit unions and the information that we did receive may be inaccurate. First, 80 credit unions (7.8 percent of those responding to the survey) did not provide any data at all. Since these credit unions tended to have the largest member business loan portfolios, the survey produced household income data on only 65.4 percent of all the member business loans reported in the survey. Second, credit unions may have had only dated information about the borrower's household income that did not reflect the borrowers current income situation.³⁵ Third, some credit unions may not have

³⁵ For example, as noted above, many member business loans are for non-owner occupied rental properties with long-term mortgages. In this case, the credit union may have only had income data (household or personal) as of loan origination, which could have been years before the time of our survey.

reported household income, but rather borrower income, on the survey. As a result of the latter two reporting problems, reported household income may tend to be below actual household income. Consequently, we believe that the results reported below should be interpreted cautiously.

Table 5 shows the number and outstanding balance of loans made to borrowers in the various household income categories for those credit unions that provided these data. The survey results show that 25.3 percent of member business loans were made to members with household income of less than \$30,000. These loans totaled 13.2 percent of the outstanding member business lending balances. Another 20 percent of the loans (with 15 percent of the outstanding loan balances) went to households with incomes reported to be between \$30,000 and \$50,000.

Credit unions reported that 21.4 percent of their member business loans -- amounting to 23.5 percent of unpaid principal balances -- were made directly to businesses. Follow-up conversations with credit unions suggest that many institutions reported "borrower is a business" because they either thought of these loans that way (even though they are truly made to the member) or because they didn't have the household income data available. However, only not-for-profits and business members of community credit unions are eligible to directly receive member business loans. Thus, we question whether these survey results are reliable.

As an alternative measure of member business lending to low- and moderate-income households, we examined Call Report data for the 541 "low-income" credit unions operating as of year-end 1999. These credit unions had \$293 million in member business loans outstanding as of that date. Of course, the Call Report does not distinguish member business loans by household income. Some low-income credit unions may make loans to non-low-income households, and non-low-income credit unions may make loans to low-income households.

Table 5: Distribution of Member Business Loans by Member Household Income
(As of June 30, 1999)

Member Household Income	Distribution of Dollar Value of Loans Outstanding	Distribution of Number of Loans Outstanding
Under \$30,000	13.2%	25.3%
\$30,001-\$50,000	15.1%	20.1%
\$50,001-\$100,000	26.3%	23.6%
\$100,001-\$250,000	16.1%	8.4%
Over \$250,000	5.8%	1.3%
Borrower is Business	23.5%	21.4%
Total	100.0%	100.0%

d. Additional Analysis

For each of the credit unions that responded to our survey, we identified its NCUA region, and its common bond and charter type.³⁶ This subsection provides additional details on the survey results to show how member business lending varied by region, common bond, and charter of the responding credit unions.

Table 6 reports the survey results for member business loans by collateral type and NCUA Region. The geographical differences are pronounced. First, taxicab medallions secured 64 percent of the member business loans in the Albany region, whereas non-agricultural real estate secured 85 percent or more of the member business loans in the Atlanta, Capital, and Pacific districts. The remaining two districts -- Austin and Chicago -- make almost all of the credit union member business loans backed by some type of agricultural collateral, either real estate, equipment, or crops and livestock.

³⁶ The six NCUA Regions are: Albany NY, Atlanta GA, Chicago (Lisle, IL), Pacific (Concord, CA), Capital (Alexandria, VA), and Austin TX.

Table 6: Distribution of Member Business Loans by Collateral Type and NCUA Region
(As of June 30, 1999)

Collateral Type	NCUA Region					
	Albany	Atlanta	Austin	Capital	Chicago	Pacific
Agricultural Real Estate	0.1%	0.8%	20.7%	3.4%	12.4%	0.62%
Agricultural Equipment	0.0%	0.9%	16.9%	0.7%	7.6%	0.17%
Crops and Livestock	0.0%	0.0%	19.1%	0.1%	1.3%	0.80%
Non-Ag Real Estate	28.8%	92.3%	27.2%	84.9%	62.8%	92.28%
Non-Ag Equipment	2.2%	2.1%	10.3%	3.0%	10.2%	3.07%
Accounts Receivable	0.1%	0.0%	0.9%	0.7%	0.2%	0.08%
Inventory	0.3%	0.3%	1.3%	0.2%	0.5%	0.24%
Taxicab Medallions	64.4%	0.0%	0.0%	2.6%	0.0%	0.03%
Other Collateral	3.9%	3.1%	3.3%	2.2%	3.5%	1.96%
No Collateral	0.1%	0.4%	0.3%	2.2%	1.6%	0.76%
Total	100.0%	100.0%	100.0%	100.0%	100.0%	100.00%

Table 7 reports survey results on the differences in member business loans among the various common bond types: occupational, association, community, or other.³⁷ Community credit unions had the most diversity in collateral backing member business loans. Associational credit unions, by contrast, used non-agricultural real estate as collateral for over 90 percent of their member business loans. Taxicab medallions secured nearly half of the member business loans made to individuals in occupational credit unions.³⁸ Another 41 percent of member business loans made by occupational credit unions was secured by non-agricultural real estate.

³⁷ In our analysis, “occupational” credit unions include both those identified as single-common-bond occupational credit unions and multiple common bond credit unions where the primary membership group was an occupation or employer. We defined associational and community common bond credit unions to have a single membership group. Credit unions in the “other” common bond category include: (1) a small number of single-common bond credit unions not otherwise defined; and (2) a larger collection of multiple common bond credit unions that have no primary occupational group, have multiple associational groups, or have both occupational and associational groups in their field of membership.

³⁸ According to the NCUA, eight credit unions -- three federal credit unions and five state credit unions -- have been chartered for the principal purpose of making loans to taxi drivers.

Table 7: Distribution of Member Business Loans by Collateral Type and Common Bond Type
(As of June 30, 1999)

Collateral Type	Common Bond Type			
	Community	Association	Occupational	Other
Agricultural Real Estate	8.1%	3.8%	1.9%	11.1%
Agricultural Equipment	5.4%	1.0%	1.8%	9.2%
Crops and Livestock	2.4%	0.1%	2.1%	9.9%
Non-Ag Real Estate	65.7%	90.2%	40.6%	51.4%
Non-Ag Equipment	10.5%	2.0%	2.1%	7.9%
Accounts Receivable	0.2%	0.1%	0.1%	0.6%
Inventory	1.0%	0.0%	0.2%	1.0%
Taxicab Medallions	0.4%	0.0%	47.6%	6.2%
Other Collateral	5.1%	1.6%	3.3%	2.5%
No Collateral	1.2%	1.1%	0.3%	0.2%
Total	100.0%	100.0%	100.0%	100.0%

Finally, we measured the differences in our survey results between federally chartered credit unions and state chartered credit unions. While 55 percent of our survey respondents had federal charters, state-chartered credit unions accounted for 74 percent of the member business loans reported in response to our survey. Table 8 shows that federally chartered credit unions relied on non-agricultural real estate as collateral for more than half of their member business loans, while state-chartered credit unions relied more on agriculture-related collateral and taxicab medallions.

Table 8: Distribution of Member Business Loans by Collateral Type and Charter Type (As of June 30, 1999)

Collateral Type	Charter Type	
	Federal	State
Agricultural Real Estate	2.3%	6.2%
Agricultural Equipment	8.1%	13.7%
Crops and Livestock	4.9%	10.4%
Non-Ag Real Estate	55.2%	25.8%
Non-Ag Equipment	10.6%	9.3%
Accounts Receivable	0.4%	0.7%
Inventory	0.8%	1.0%
Taxicab Medallions	4.7%	17.3%
Other Collateral	8.5%	5.9%
No Collateral	4.5%	9.6%
Total	100.0%	100.0%

2. Business Purpose Loans

As noted in the earlier section on survey methodology and response, we chose to ask credit unions about their business purpose loans. As previously noted, business purpose loans do not meet the NCUA's definition of a member business loan but they are loans of less than \$50,000 made to a credit union member for a business purpose. We asked credit unions to estimate the number and dollar value of their business purpose loans.

For those credit unions that make member business loans, we found that many were confused by the difference between business purpose loans and member business loans. While we were careful in the survey structure and survey instructions to differentiate between these two categories of loans, 35 percent of the credit unions responding to our member business lending survey reported the same dollar amount for both categories. Consequently, we believe that the distinction between the two concepts is not clear and that our survey results on business purpose loans should be interpreted with caution.

For the 658 credit unions that did not report the same figure for both business purpose loans and member business loans, 394 (60 percent) reported having business purpose loans on their books. These 394 credit unions estimated that they had 20,863 business purpose loans outstanding -- an average of 53 per institution. These credit unions further estimated that the dollar value of these loans was \$362 million -- or \$17,362 per loan.

For those credit unions that do not make member business loans, we found that only 103 of the 643 credit unions (16 percent) that provided usable responses to our survey reported having any business purpose loans outstanding. These credit unions estimated that they had a total of 3,031 business purpose loans outstanding as of June 30, 1999 -- or approximately 30 per institution. The respondents estimated that the total dollar value of these loans was roughly \$27 million, or \$8,850 per loan.

We compared these two sets of survey results -- those from credit unions that also made member business loans and those from credit unions that did not. The results of a statistical test indicate a statistically significant difference in business purpose lending between the group of credit unions that makes member business loans and the group that does not.³⁹ Credit unions that also make member business loans make more, and larger, business purpose loans than those that do not make member business loans.

IV. The Credit Union Membership Access Act and Member Business Lending

The Credit Union Membership Access Act of 1998 imposed aggregate limits on member business lending with some exceptions. Still, we expect the volume of member business lending to continue to grow because of the expanded membership opportunities provided for in the Act.

A. Business Lending Restrictions

The Act limited a credit union's business lending activity to the lesser of either 1.75 times actual net worth or 12.25 percent of total assets (i.e., 1.75 times the minimum net worth requirement for a credit union to be deemed "well capitalized.")⁴⁰ However, there are several exceptions to these limits. A credit union may be exempt from the member business lending limits if the NCUA Board determines either that the credit union was chartered for the purpose of making, or that it has a history of primarily making, such loans.⁴¹ The Act also provides exceptions for credit unions that serve predominately low-income members (i.e., low-income credit unions) and those that are Community Development Financial Institutions (CDFIs).⁴²

³⁹ We conducted a test of the differences in the means of both total number of business purpose loans and the total dollar value of these same loans based on the survey data. Both tests rejected the null hypothesis of no statistical difference between credit unions with member business loans and those without member business loans.

⁴⁰ 12 U.S.C. § 1757a(a). The Act specifies that a credit union is "well capitalized" if it has a net worth ratio of not less than 7 percent and it meets any applicable risk-based net worth requirement. 12 U.S.C. § 1790d(c)(1)(A).

⁴¹ 12 U.S.C. § 1757a(b)(1).

⁴² 12 U.S.C. § 1757a(b)(2).

The NCUA issued a final rule in May 1999 instituting these statutory exceptions and outlining the criteria by which they will be granted.⁴³ Part 723 now offers two different methods for determining whether a credit union has a history of making business loans.⁴⁴ First, credit unions with member business loans that totaled at least 25 percent of total loans on any Call Report between January 1995 and September 1998 are deemed to have such a history. Second, institutions with member business loans that comprised their largest loan category on any of these same Call Reports are also eligible for the exception.

For credit unions seeking an exception based on the fact that they were “chartered for the purpose of ... primarily making business loans,” the NCUA seeks sufficient documentation.⁴⁵ Such evidence may include the original charter, original bylaws, original business plan, original field of membership, board minutes, or loan portfolio.⁴⁶

Exceptions for low-income credit unions and those that are certified as CDFIs are covered by separate guidelines. NCUA regulations provide generally that a low-income credit union is one in which the majority of members either:

- earn less than 80 percent of the average for all wage earners in the given area;
- earn at or below 80 percent of the median household income for the nation; or
- are otherwise determined to be low-income members by the NCUA Board.⁴⁷

CDFI status, on the other hand, is certified by the Community Development Financial Institutions Fund, a component of the Department of the Treasury.⁴⁸

As of year-end 1999, the NCUA had granted 90 exceptions to the aggregate member business lending limits.

⁴³ 64 Fed. Reg. 28,721 (May 27, 1999).

⁴⁴ 12 C.F.R. § 723.17(c).

⁴⁵ 12 U.S.C. § 1757a(b)(1)

⁴⁶ 12 C.F.R. § 723.17(b)

⁴⁷ 12 C.F.R. § 701.34.

⁴⁸ 12 C.F.R. § 1805, subpart B

B. The Effect of the Credit Union Membership Access Act on Credit Union Member Business Lending

Credit union member business lending steadily increased during the 1990s. Aggregate member business lending went from \$2.0 billion as of year-end 1993 to \$4.3 billion as of mid-year 2000 – an increase of 115 percent. However, member business lending has remained relatively stable at about one percent of total credit union assets. The number of credit unions with outstanding member business loans went from 1,390 in 1993 to 1,493 in 1999, a 7 percent increase.

Table 9 compares the overall volume and growth of credit union member business lending with bank and thrift commercial lending between 1993 and 1999. Credit unions' \$3.9 billion in member business loans as of year-end 1999 is significantly less than banks' \$824.7 billion or thrifts' \$20.3 billion. While the growth in credit union business lending (97.5 percent) over this period exceeds that of banks (84.2 percent), it falls significantly short of thrifts (240.0 percent).

Table 9: Federally Insured Depository Institution Commercial Loan Growth: 1993-1999

Year	Credit Unions		Banks		Thrifts	
	(\$ billions)	(% Chg.)	(\$ billions)	(% Chg.)	(\$ billions)	(% Chg.)
1993	\$2.0	---	\$447.8	---	\$6.0	---
1994	\$2.9	46.2%	\$488.7	9.1%	\$5.2	-12.4%
1995	\$2.4	-18.9%	\$540.4	10.6%	\$7.2	37.4%
1996	\$2.7	14.0%	\$575.8	6.5%	\$9.4	30.4%
1997	\$2.9	8.2%	\$643.2	11.7%	\$11.5	22.6%
1998	\$3.3	14.4%	\$735.7	14.4%	\$15.6	35.3%
1999	\$3.9	18.0%	\$824.7	12.1%	\$20.3	30.6%
1993-1999	---	97.5%	---	84.2%	---	240.0%

Source: Sheshunoff Information Services, Inc., *BankSearch*.

Note: Credit union data is total member business loans. Bank and thrift data is total commercial and industrial lending by domestic bank offices.

Overall, we expect the volume of credit union business lending to continue to increase. Certain provisions in the Credit Union Membership Access Act will tend to aid this growth, while others will serve to hinder it.

We expect that changes to the credit union membership restrictions in the Act will increase member business lending for two reasons. First, by expanding membership opportunities, the Act should serve to increase overall credit union membership and asset growth. Moreover, Call Report data indicate that the credit unions that offer business loans tend to be the larger institutions.⁴⁹ Therefore, we expect as credit unions grow, their propensity to make member business loans will increase. Second, more credit unions have adopted community charters in recent years. Community credit unions can accept businesses as members.⁵⁰ As a result, we expect to see a greater number of credit unions engaged in member business lending in the future.

On the other hand, the member business lending restrictions contained in the Act, coupled with risk-based net worth requirements issued by the NCUA, should temper this expected growth. First, the statutory limit on member business loans to 12.25 percent of assets serves as a binding constraint on long-term growth in this product market. Credit unions that are active business lenders qualify for an exception to this limit. Still, those credit unions are subject to a marginal net worth requirement of 14 percent on member business loans exceeding the statutory limit.⁵¹ This regulation could temper the future growth of member business lending by those credit unions that exceed the 12.25 percent limit.

As for the competitive implications of the Act's membership and business lending provisions, it is reasonable to expect that some of these additional business loans will be new, while others will have been competed away from other depository institutions. Over the next few years, the total effect on other depository institutions should be modest -- especially given credit unions' relatively minor role in serving commercial borrowers. At the same time, there likely will be an increasing incidence of credit unions competing commercial loans away from other depositories in specific local markets.⁵²

⁴⁹ Federally insured credit unions with member business loans averaged \$114 million in total assets, while those without such loans averaged \$26 million.

⁵⁰ 63 Fed. Reg. 71,998, 72,037 (Dec. 30, 1998) (Chartering Manual).

⁵¹ 65 Fed. Reg. 44,950, 44,968 (July 20, 2000) (to be codified at 12 C.F.R. § 702.106(b)(2)).

⁵² For example, in 1999, three Wisconsin credit unions formed a for-profit (and taxable) service corporation known as Business Lending Group to offer commercial loans up to \$1 million. According to *Credit Union Times*, as of October 2000, Business Lending Group had closed \$30 million in loans averaging \$400,000 (Elaine Kingoff, *Credit Union Times*, November 29, 2000, p. 1,14).

V. RISKS ASSOCIATED WITH CREDIT UNION MEMBER BUSINESS LENDING

While commercial loans are generally riskier than consumer loans, credit union member business lending tends to be less risky than business lending by banks and thrifts. A simple stress test of the effect of credit union failures precipitated by member business lending on the National Credit Union Share Insurance Fund indicates that the insurance fund would remain solvent if every member business loan defaulted at a loss of 100 percent, assuming no other losses at those credit unions.

A. Commercial Loans are Generally Riskier than Consumer Loans

Banks and thrifts broadly delineate their loan portfolios into consumer and commercial lending. The principal reason for this distinction stems from the personal responsibility for debt repayment assumed with consumer credit. By contrast, when commercial enterprises borrow, firm shareholders generally assume limited liability for the debt.

Consumer lending tends to be less risky than commercial lending for at least three additional reasons:

- original amounts on consumer loans are usually smaller than those on commercial loans;
- consumer loans are often secured by readily marketable collateral such as a house or car; and
- borrower riskiness is more easily determined through the use of consumer credit reports and credit scoring models.

B. Member Business Loans are Generally Less Risky than Commercial Loans Made by Banks and Thrifts

Credit union member business loans are generally loans to individuals for business purposes. Because an individual (or group of individuals) is personally liable for the debt, member business loans tend to be smaller and less risky than typical business loans made by banks and thrifts. Indeed, credit union member business loans share many characteristics of consumer loans. That is, these loans are generally smaller and fully collateralized, and borrower risk profiles are more easily determined. As a result, the credit risk associated with member business loans may be less than that for most bank and thrift commercial loans.

There are some exceptions to this general rule. First, community credit unions can directly take in businesses as members. (A loan in this case would be made to the business, but would still require a personal guarantee.) Second, loans to non-profit entities do not require personal guarantees. Third, credit card line-of-credit programs offered to businesses are unsecured. Lastly, NCUA Regional Directors have authority to waive security and collateral requirements. Each of these exceptions provides for a possible increase in the credit risk

associated with a particular loan.

Table 10 provides information on business loan delinquencies and charge-offs for credit unions, banks, and thrifts. Credit unions define loan delinquency somewhat differently than do banks and thrifts so comparisons of delinquency rates should be interpreted cautiously.⁵³ Ongoing delinquencies -- for credit unions, loans more than 60 days past due, and for banks and thrifts, loans more than 90 days past due -- are lower for credit unions than for banks and thrifts. Credit unions' mid-year 2000 loan charge-off rate of 0.03 percent was much lower than that for either commercial banks (0.60 percent) or savings institutions (0.58 percent).

⁵³ Term of delinquency categories vary between credit unions, on one hand, and banks and thrifts on the other due to differences in reporting. Credit unions report recently delinquent loans as those 60 days or less past due; banks and thrifts report recent delinquencies as 90 days or less past due. Credit unions report ongoing delinquencies as more than 60 days past due whereas banks and thrifts report such delinquencies as more than 90 days past due.

Table 10: Business Loan Delinquencies and Charge-Offs as a Percent of Total Business Loans
(As of June 30, 2000)

	Recent Delinquencies ⁴	Ongoing Delinquencies ⁵	Net Charge-offs ⁶
All Credit Unions ¹	1.52%	0.32%	0.03%
All Commercial Banks ²	0.85%	1.41%	0.60%
Banks with total assets less than \$100 million	1.43%	1.33%	0.36%
Banks with total assets between \$100 million and \$1 billion	1.25%	1.19%	0.36%
All Savings Institutions ³	1.42%	1.25%	0.58%
Thrifts with total assets less than \$100 million	1.79%	1.94%	0.44%
Thrifts with total assets between \$100 million and \$1 billion	1.31%	0.90%	0.56%

¹ Credit union business loans are defined as total member business loans.

² Commercial bank business loans are defined as total commercial and industrial loans. It also includes "all other loans" for institutions with fewer than \$1 billion in total assets.

³ Savings institutions include both savings associations and savings banks. For savings institutions, business loans are defined as total commercial and industrial loans.

⁴ Recent delinquencies are defined as those less than 60 days past due for a credit union loan and less than 90 days past due for bank and thrifts loans.

⁵ Ongoing delinquencies are defined as those more than 60 days past due for a credit union loan and more than 90 days past due for bank and thrifts loans.

⁶ Charge-offs less recoveries.

Source: Sheshunoff Information Services, Inc., *BankSearch* and FDIC *Quarterly Banking Profile*, 2nd Quarter, 2000.

C. Risk to the Share Insurance Fund

In order to assess the current risk exposure of the Share Insurance Fund to member business lending, we ran a series of simple stress tests. Using year-end 1999 Call Report data, we alternately assumed that 25 percent, 50 percent, 75 percent, and 100 percent of credit union member business loans defaulted -- with total loss. To the extent that these losses resulted in

credit union failures -- that is, left a credit union with negative net worth -- we then charged those losses in excess of a credit union's net worth to the Share Insurance Fund. *We emphasize that these stress tests are hypothetical and do not represent a judgement that the outcomes are likely. Rather, the tests seek to gauge the Share Insurance Fund's ability to withstand a negative shock to credit unions' member business loan portfolios.*

As of December 31, 1999 the Share Insurance Fund reported total equity of \$4.2 billion. The Share Insurance Fund's reserve ratio -- the ratio of its total reserves to total insured deposits -- was 1.24 percent at that time.

Table 11 presents the results of our four stress scenarios. If every credit union member business loan outstanding as of December 31, 1999, defaulted at a total loss to the credit union, and the credit unions suffered no other losses, the Share Insurance Fund would have remained solvent by \$3.1 billion. We conclude that, at this time, member business lending alone does not pose material risk to the Share Insurance Fund.

Table 11: Results of Member Business Lending Stress Tests on the Share Insurance Fund
(As of December 31, 1999)

Percent of Member Business Loans that Completely Fail	Number of Credit Unions Projected to Fail	Loss to the Share Insurance Fund (in million of dollars)	Share Insurance Fund Reserve Ratio After Losses
0%	0	\$0	1.24
25%	18	\$51	1.22
50%	48	\$272	1.16
75%	67	\$667	1.04
100%	91	\$1,097	0.92

VI. COMPETITION BETWEEN CREDIT UNIONS AND OTHER DEPOSITORY INSTITUTIONS IN BUSINESS LENDING

Congress asked whether credit unions have a competitive advantage in business lending over other depository institutions. While credit unions have certain competitive advantages, such as sponsor subsidies and federal income tax exemption, they also face constraints not faced by other depository institutions. These constraints include limitations on eligibility for member business loans and the restrictions placed on credit unions in making member business loans.

A. Credit Unions Have Certain Competitive Advantages

Relative to banks and thrifts, credit unions have an inherent cost advantage in at least two

areas. Specifically, some credit unions are sponsor-subsidized and all of these institutions are exempt from federal income taxation.

First, many occupational and associational credit unions receive sponsor subsidies such as free or reduced-cost operating facilities and equipment. These credit unions may also economize on marketing costs through the simple use of posters and advertisements stuffed in employee paychecks or association newsletters to reach their membership.

Second, credit unions are exempt from federal corporate income taxes. This exemption may allow credit unions to offer more competitive deposit and loan rates, other things being equal. This exemption also aids credit unions in building their net worth, which can only be accomplished through retained earnings.

B. Restrictions on Credit Unions

Credit unions face certain legal restrictions on their business lending that are not applicable to other depository institutions. These limitations are in the form of limitations on the eligibility to receive such loans and on the loans themselves.

First, individuals sharing common bonds of association, occupation, or geographic area define a federal credit union's field of membership. As a result, credit unions may only accept deposits from, and make loans to, eligible members. Such membership limitations are a distinct characteristic of credit unions. However, the Act's allowance for multiple common bond credit unions and the increased popularity of community credit unions make the membership restrictions less binding than in the past.

Second, as described earlier in this report, credit unions face greater constraints in making business loans than do banks and thrifts. For instance, credit union member business lending is generally constrained by the fact that these loans:

- can only be made to credit union members;
- generally require the personal guarantee of the borrower;
- generally require full collateralization; and
- are subject to a portfolio limitation of 12.25 percent of total assets.

C. Balancing Advantages and Disadvantages

It is not possible to quantify the value of credit unions' advantages, and the costs of credit unions' added constraints, in making member business loans. Thus, we cannot discern whether or not credit unions have a competitive advantage. It seems reasonable, however, that in some particular situations a credit union may have a competitive advantage, but in other cases not. In any event, credit union membership restrictions and the general requirements for personal guarantees and full collateralization limit the universe of business loans for which credit unions

and other depository institutions directly compete.

Two trends point to an increase in credit union member business lending in the future. First, as credit unions continue to increase in size, while decreasing in number, a greater proportion of credit unions will likely pursue this business line. These credit unions will have larger and more diverse memberships and will have the capital and managerial sophistication necessary to compete vigorously in this market. Second, an increasing movement to community credit unions opens the door to more businesses becoming credit union members and hence eligible for member business loans.

Congress also asked us whether credit unions' competitive advantage – if it exists – could affect the viability and profitability of other insured depository institutions. At this time, member business lending is a relatively small product line for credit unions and credit unions are unlikely to have a systematic competitive advantage relative to other depository institutions in making these loans. Based on these findings, we conclude that today credit unions' member business lending has no material affect on the viability and profitability of other insured depository institutions. Indeed, all types of depository institutions have been very profitable in recent years. As of year-end 1999, credit unions' combined return-on-assets was 0.91 percent compared to 1.24 percent for banks and 0.94 percent for thrifts.

VII. Summary

Treasury prepared this study pursuant to section 203 of the Credit Union Membership Access Act of 1998. The study mandate directed us to investigate six specific issues pertaining to credit union member business lending.

We found that credit unions are generally not active commercial lenders, as member business lending remained at about one percent of total credit union assets during the 1990s. As of June 30, 2000, only 92 of 10,477 credit unions had total member business loans outstanding exceeding their net worth. These credit unions accounted for 46 percent of the unpaid principal balance of member business loans at that time.

We found that most member business loans are for modest amounts. Our survey results showed that three-quarters of member business loans had balances less than \$100,000, and that about three-quarters were collateralized by non-agricultural real estate, taxicab medallions, and agricultural-related assets. Service businesses, rental property, and agriculture were the three most frequent types of businesses receiving member business loans, both in terms of the number of loans and the unpaid principal balances.

We found that the NCUA's member business lending regulations should be quite effective at limiting the credit risk associated with these loans. Their specific requirements concerning personal guarantees, portfolio limits, and collateral are much more stringent than those faced by banks and thrifts. Still, we found that the NCUA's enforcement of its member

business lending regulations falls short of the requirements set forth by examiner guidance. This was evident in the NCUA's approach to granting waivers from the regulatory limits, our difficulty ascertaining regulatory compliance from examination reports, and the NCUA's follow-up on compliance problems.

We found that member business loans are generally less risky than commercial loans made by banks and thrifts because they generally require the personal guarantee of the borrower and generally must be fully collateralized. Data on member business loan charge-offs for credit unions, compared to charge-off rates for commercial loans made by banks and thrifts, support this conclusion.

Our survey results suggested that 25.3 percent of member business loans were made to members with household income of less than \$30,000. These loans totaled 13.2 percent of the outstanding member business lending balances reported by our survey respondents. The survey results showed that another 20 percent of the loans (with 15 percent of the outstanding loan balances) went to households with incomes reported to be between \$30,000 and \$50,000. Because of data collection problems described in the report, however, we believe these figures should be interpreted with a great deal of caution.

Credit unions do have advantages over banks and thrifts in making business loans in that some credit unions receive sponsor subsidies, and all are exempt from the federal corporate income tax. However, credit unions do face certain constraints in the form of limitations on membership, and stricter rules governing business lending.

We found that credit union's business lending currently has no effect on the viability and profitability of other insured depository institutions. In certain instances, however, credit unions that are particularly active business lenders may be a source of competition for small banks and thrifts operating in the same geographic areas.

We found that the relaxation of membership restrictions in the Act should serve to further increase member business lending by spurring credit union growth. However, the member business lending limitations in the Act, coupled with risk-based net worth requirements, should temper this growth.

APPENDIX

We conducted two surveys to determine the scope of credit union business lending. The first was a comprehensive survey of all credit unions that reported member business loans on their June 30, 1999 Call Report. In this case, we asked credit unions to complete seven tables of information about their member business loans outstanding. We also asked these credit unions whether they had any business purpose loans outstanding. Both the credit unions that reported making member business loans and a stratified sample of other credit unions were asked about business purpose loans. This appendix presents the survey questions and aggregates the credit unions responses.

All credit unions received the following questions about business purpose loans.

Small Loans for Business Purposes

Under NCUA regulations, loans, lines of credit, and letters of credit are generally classified as member business loans if they are made for commercial, corporate, business, or agricultural purposes. However, loans for these purposes are not counted as “member business loans” if, when added to all other such loans to one borrower, the sum is less than \$50,000. These smaller credits are referred to more broadly as “business purpose” loans and recorded as consumer loans. (An example might be a new vehicle loan to a member that purchases a pickup truck for his/her construction business.)

Does your credit union have any “business purpose” loans outstanding? Yes No

If so, for loans outstanding as of June 30, 1999 please estimate:

(1) The number of such loans used for business purposes: _____

(2) The aggregate dollar value of these business purpose loans: \$_____

Member Business Loans

Did your credit union have any member business loans outstanding as of June 30, 1999?

Yes: No:

If so, please check **Yes** and continue. If not, please check **No** and return the survey to the Treasury Department.

Note: The following data represent the 68% of credit unions that responded to the survey (1,030 of the 1,516 credit unions that make member business loans). Also, some credit unions were not

able to provide data for all tables. Therefore, some tables may reflect data from fewer than the 1,030 respondent credit unions.

Table A-1: Total Dollar Volume of Business Loans (By Collateral Type and Loan Size)

Collateral Type	Loan Size				
	Under \$50,000	\$50,000 - \$100,000	\$100,001-\$500,000	Over \$500,000	Total
Agricultural Real Estate	\$26,164,054	\$40,213,000	\$71,331,085	\$1,907,489	\$139,615,627
Agricultural Equipment	\$50,948,446	\$26,438,997	\$24,736,864	\$0	\$102,124,307
Crops and Livestock	\$33,046,261	\$28,131,185	\$30,448,396	\$1,032,899	\$92,658,741
Non-Agricultural Real Estate	\$150,519,347	\$282,501,938	\$630,987,317	\$433,546,385	\$1,497,554,987
Non-Agricultural Equipment	\$42,178,949	\$33,094,328	\$41,889,438	\$9,596,946	\$126,759,661
Accounts Receivable	\$2,694,263	\$1,124,787	\$2,264,947	\$0	\$6,083,997
Inventory	\$2,693,957	\$2,285,839	\$6,777,091	\$762,725	\$12,519,612
Taxicab Medallions	\$34,915,277	\$63,310,263	\$503,124,408	\$8,185,679	\$609,535,627
Other Collateral	\$31,714,862	\$25,827,662	\$24,526,154	\$2,245,989	\$84,314,667
No Collateral	\$9,308,446	\$2,768,182	\$3,787,327	\$0	\$15,863,955
Total	\$384,183,861	\$505,696,181	\$1,339,873,027	\$457,278,112	\$2,687,031,182

Table A-2: Number of Business Loans Outstanding (By Collateral Type and Loan Size)

Collateral Type	Loan Size				
	Under \$50,000	\$50,000 - \$100,000	\$100,001- \$500,000	Over \$500,000	Total
Agricultural Real Estate	998	564	432	12	2,006
Agricultural Equipment	4,142	441	157	0	4,740
Crops and Livestock	2,685	513	273	2	3,473
Non-Agricultural Real Estate	5,241	3,709	3,359	649	12,958
Non-Agricultural Equipment	2,646	546	474	58	3,724
Accounts Receivable	188	23	18	0	229
Inventory	146	51	75	95	367
Taxicab Medallions	1,652	915	2,834	14	5,415
Other Collateral	1,868	508	173	2	2,551
No Collateral	3,110	75	21	0	3,206
Total	22,676	7,345	7,816	832	38,669

The Types and Sizes of Businesses Served

Similar to above, please complete the following two tables relating business type and business sizes. Please classify each loan only once -- choosing the business type that best describes the loan. The information included in these tables should reflect the position of your credit union as of June 30, 1999.

Business types are delineated as:

- manufacturing;
- taxicabs;
- service (other than taxicabs);
- agriculture (including fishing);
- real estate construction and development (including shopping centers and apartment complexes)
- rental property (including second homes, vacation property, small office buildings, and small apartment buildings);
- religious organizations;
- other fraternal organizations; or
- other business type.

The size of the businesses (as measured by total assets) are categorized as:

- under \$100,000;
- \$100,000-500,000;
- \$500,001-\$1 million; and
- over \$1 million.

In the first table, present your credit union's total dollar amount of member business loans within the appropriate cell. In the second table, record the number of member business loans within the appropriate cell.

Table A-3: Total Dollar Volume of Business Loans (By Business Type and Size)

Business Type	Business Size (Total Assets)				
	Under \$100,000	\$100,000 - \$500,000	\$500,001 - \$1 Million	Over \$1 Million	Total
Manufacturing	\$6,950,659	\$8,905,738	\$5,176,694	\$3,971,027	\$25,004,117
Service	\$77,549,532	\$400,679,408	\$318,475,648	\$30,627,444	\$827,332,031
Agriculture	\$141,540,748	\$117,934,755	\$30,422,080	\$14,906,124	\$304,803,706
Real Estate Construction and Development	\$7,872,364	\$42,595,616	\$16,210,151	\$25,075,992	\$91,754,123
Rental Property	\$215,298,894	\$315,708,080	\$107,033,648	\$63,135,650	\$701,176,273
Religious Organization	\$2,666,316	\$10,328,274	\$12,332,122	\$10,762,271	\$36,088,983
Other Fraternal Organization	\$1,290,581	\$2,804,256	\$143,776	\$337,844	\$4,576,457
Other Business Type	\$47,392,925	\$52,907,311	\$19,046,093	\$22,853,272	\$142,199,601
Total	\$500,562,020	\$951,863,438	\$508,840,210	\$171,669,623	\$2,132,935,291

Table A-4: Number of Business Loans Outstanding (By Business Type and Size)

Business Type	Business Size (Total Assets)				
	Under \$100,000	\$100,000 - \$500,000	\$500,001 - \$1 Million	Over \$1 Million	Total
Manufacturing	251	82	45	62	440
Service	3,177	4,881	2,011	382	10,451
Agriculture	6,830	2,474	496	184	9,984
Real Estate Construction and Development	156	230	70	93	549
Rental Property	5,149	2,779	497	279	8,704
Religious Organization	70	89	19	320	498
Other Fraternal Organization	31	22	5	1	59
Other Business Type	3,051	727	322	175	4,275
Total	18,715	11,284	3,465	1,496	34,960

Business Loans by Member Household Income

Congress directed the Treasury to determine the extent to which member business lending by insured credit unions helps to meet financial services needs of low- and moderate-income individuals within the field of membership of insured credit unions.

To that end, please report the distribution of your credit union's member business loans according to the borrowing members' income category. The information included in these tables should reflect the position of your credit union as of June 30, 1999.

Table A-5: Total Member Lending (By Member Total Household Income)

Member Household Income	Number of MBLs Outstanding	Total Dollar Amount of MBLs Outstanding
Under \$30,000	6,393	\$167,742,300
\$30,000 - \$50,000	5,094	\$192,921,579
\$50,001 - \$100,000	5,959	\$335,485,386
\$100,001 - \$250,000	2,122	\$205,830,572
Over \$250,000	328	\$73,640,279
Borrower is a Business	5,401	\$298,890,777
Total	25,297	\$1,274,510,893

Business Loan Delinquencies

Please complete the following tables relating total business loan delinquencies and loan size. The information included in these tables should reflect the position of your credit union as of June 30, 1998.

As on the call report, delinquencies are delineated as:

- 1-less than 2 months;
- 2-6 months;
- 6-12 months; and
- over 12 months.

Loan sizes are categorized as:

- \$50,000-100,000;
- \$100,001-500,000; and
- over \$500,000.

In the first table, present your credit union's total dollar amount of member business loans within the appropriate cell. In the second table, record the number of member business loans within the appropriate cell.

Table A-6: Total Dollar Volume of Delinquent Business Loans (By Length of Time and Loan Size)

Delinquency Period	Loan Size				
	Under \$50,000	\$50,000 - \$100,000	\$100,001 - \$500,000	Over \$500,000	Total
1 - less than 2 Months	\$4,739,161	\$4,923,935	\$16,520,002	\$1,342,556	\$27,633,444
2-6 Months	\$3,951,261	\$3,848,765	\$5,234,381	\$16,804	\$13,169,167
6-12 Months	\$1,055,589	\$1,550,168	\$1,741,407	\$1,982,036	\$6,640,195
Over 12 Months	\$754,065	\$1,067,521	\$1,430,065	\$0	\$3,634,515
Total	\$10,500,076	\$11,390,389	\$24,925,855	\$3,341,396	\$51,077,271

Table A-7: Number of Delinquent Business Loans Outstanding (By Length of Time and Loan Size)

Delinquency Period	Loan Size				Total
	Under \$50,000	\$50,000 - \$100,000	\$100,001 - \$500,000	Over \$500,000	
1-less than 2 Months	279	69	98	16	463
2-6 Months	250	57	27	1	341
6-12 Months	63	11	11	1	96
Over 12 Months	56	14	9	0	88
Total	648	151	145	18	988

Business Loan Participations

Does your credit union have any member business loans outstanding that your credit union originated—a portion of which have been sold or participated with another financial institution?
36 Yes 994 No

If so, please estimate the total unpaid principal balance of the sold or participated portion of these member business loans. \$ 228,457,786.38