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National Association of Federally-Insured Credit Unions

B. Dan Berger
President & Chief Executive Officer

January 25, 2023

The Honorable Todd M. Harper, Chairman
The Honorable Kyle S. Hauptman, Vice Chairman
The Honorable Rodney E. Hood, Board Member
National Credit Union Administration
1775 Duke Street
Alexandria, VA 22314

RE: Permissible Interest Rate Ceiling

Dear Chairman Harper, Vice Chairman Hauptman, and Board Member Hood:

On behalf of the National Association of Federally-Insured Credit Unions (NAFCU), I am writing to you regarding the permissible interest rate ceiling. NAFCU advocates for all federally-insured not-for-profit credit unions that, in turn, serve over 134 million consumers with personal and small business financial services products. NAFCU urges the National Credit Union Administration (NCUA) Board to immediately establish a 21 percent permissible interest rate ceiling to mitigate federal credit unions' (FCU) substantial interest-rate-related risks and to enable all FCUs to fairly and more fully serve their communities. In the alternative, NAFCU recommends that the NCUA Board immediately extend the current 18 percent permissible interest rate ceiling (18 percent rate) for 18 months. NAFCU firmly believes that the NCUA Board can permanently resolve the intractable issues posed by the Federal Credit Union Act's (FCU Act) 15 percent permissible interest rate ceiling only by establishing a floating permissible interest rate ceiling. Therefore, NAFCU also strongly encourages the NCUA Board to undertake whatever legal and economic research it believes is necessary to properly evaluate the propriety of a floating permissible interest rate ceiling.

General Comments

FCUs generally may not, irrespective of contemporary economic conditions, extend credit to members at rates exceeding 15 percent per year, inclusive of all finance charges.[1] However, the NCUA Board may establish a higher permissible interest rate ceiling for a period of up to 18 months if, after consulting with certain congressional committees, the United States Department of the Treasury, and other federal agencies, the NCUA Board determines 12 CFR §701.21(c)(7)(ii)(A)'s two-pronged test is satisfied. Section 701.21(c)(7)(ii)(A) requires that (1) money market rates have risen over the preceding six-month period; and (2) prevailing interest rate levels threaten the safety and soundness of individual FCUs, as evidenced by adverse trends

[1] 12 CFR §701.21(c)(7)(i)

in liquidity, capital, earnings, and growth. Similarly, the NCUA Board may, at any time, raise the permissible interest rate ceiling again or extend the expiration of a previously established permissible interest rate ceiling for a period of up to 18 months.

The NCUA Board most recently approved the 18 percent rate at its June 24, 2021, open meeting and thereby extended the 18 percent rate's expiration from September 10, 2021, to March 10, 2023. The NCUA Board has continuously maintained the 18 percent rate in this way for the better part of the last four decades.

Section 701.21(c)(7)(ii)(A)'s Two-Pronged Test is Satisfied

Neither the FCU Act nor Part 701 of the NCUA's regulations specifies which money market rates must have risen over the preceding six-month period for the first prong of §701.21(c)(7)(ii)(A)'s two-pronged test to be satisfied. Money market rates reported by various federal and state agencies and banking industry participants tend to move together but are not perfectly correlated. During periods in which the Federal Reserve System's (Federal Reserve) Federal Open Market Committee (FOMC) has either held the Federal Funds Rate (FFR) steady or within a relatively narrow range over the preceding six months, it may be unclear whether money market rates have risen. However, the FOMC has been remarkably active over the last year, and all money market rates have clearly risen in the preceding six months.

On July 25, 2022, the effective federal funds rate (EFFR), a volume-weighted median of overnight federal funds transactions reported in the FR2420 Report of Selected Money Market Rates, stood at 1.58 percent.[2] The FOMC raised the FFR by 75 basis points (bps) on July 27, 2022, another 75 bps on September 21, 2022, another 75 bps on November 2, 2022, and 50 bps on December 14, 2022.[3] By December 15, 2022, the EFFR had jumped a corresponding 275 basis points, or 174 percent, to its current level of 4.33 percent. Over the same period, monthly rate cap information released by the Federal Deposit Insurance Corporation shows that national deposit rates for retail money market products jumped 32 basis points, or 266 percent, from an average of 0.12 percent as of July 18, 2022, to an average of 0.44 percent as of January 17, 2023.[4] Over the preceding six months, other benchmark money market rates have increased by similar or greater margins.

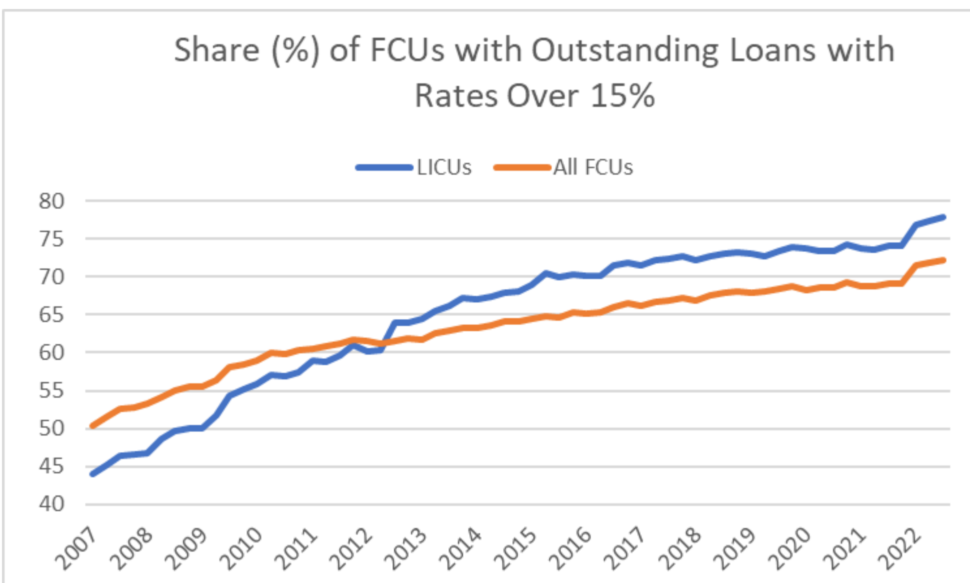
The second prong of §701.21(c)(7)(ii)(A)'s two-pronged test requires that the NCUA Board look to any adverse trends in liquidity, capital, earnings, and growth to determine whether prevailing interest rate levels threaten the safety and soundness of individual FCUs. Several Letters to Credit Unions extending the expiration of the 18 percent rate explore this requirement, but the NCUA's

[2] Federal Reserve Bank of New York, Effective Federal Funds Rate, https://www.newyorkfed.org/markets/reference-rates/effr.
[3] Board of Governors of the Federal Reserve System, Open Market Operations, https://www.federalreserve.gov/monetarypolicy/openmarket.htm.
[4] Federal Deposit Insurance Corporation, National Rates and Rate Caps, https://www.fdic.gov/resources/bankers/national-rates/index.html.

April 2011 Permissible Interest Rate Ceiling Letter to Credit Unions (2011 Letter) is particularly instructive.[5]

In its 2011 Letter, the NCUA Board explained that its failure to extend the 18 percent rate in a rising rate environment would impair the safety and soundness of individual FCUs and undermine access to fairly priced, high-quality credit for borrowers with low incomes and low credit scores. As the NCUA Board recognized, FCUs can fairly price riskier loans, particularly unsecured loans, at rates in excess of 15 percent, and the loans FCUs make available to borrowers with low incomes and low credit scores are typically much less expensive than loans made available by other lenders. Shortly after the NCUA issued its 2011 Letter, in June 2011, 59 percent of low-income FCUs and 61 percent of all FCUs reported making loans at rates between 15 and 18 percent.

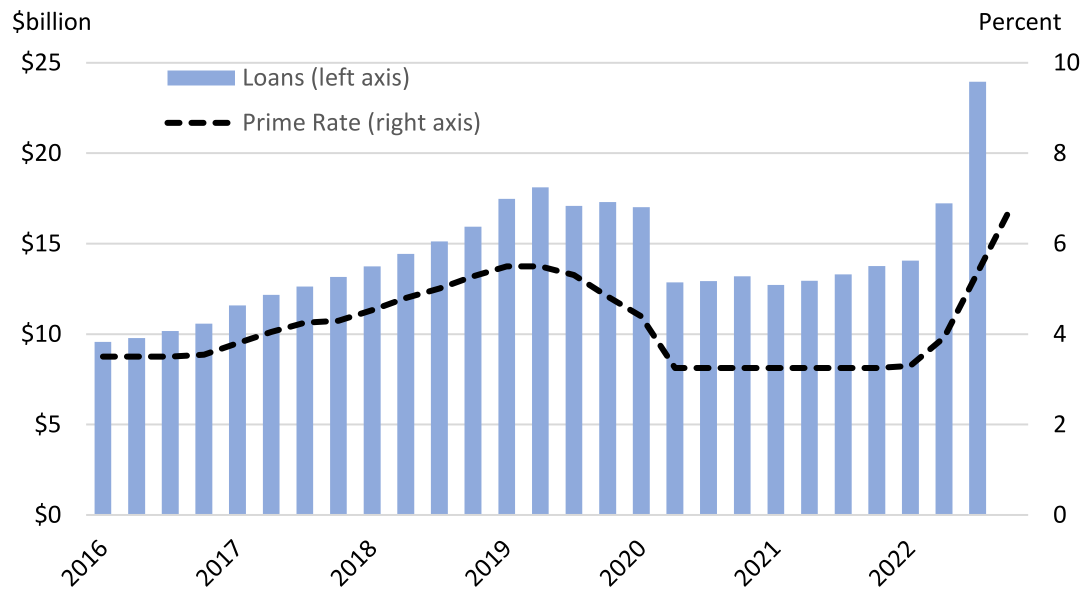
Today, as compared to 2011, FCUs face even more extraordinary earnings and growth pressures from big, for-profit banks and largely unregulated non-depository financial technology (fintech) lenders that are not subject to similarly constraining permissible interest rate ceilings. The rapid introduction of massive online-only banks, non-depository payment systems, new types of unsecured lending, and regulatory efforts around data portability have all fed expanding consumer expectations and the accelerating commoditization of financial services. To remain competitive, most every FCU now offers a broader suite of products than it did in 2011, including more unsecured loan products. As the below graph shows, the share of FCUs with outstanding loans with rates in excess of 15 percent has climbed steadily since 2007. In September 2022, 78 percent of low-income FCUs and 72 percent of all FCUs reported making loans at rates between 15 and 18 percent.



[5] NCUA, Letter to Credit Unions: Permissible Interest Rate Ceiling (April 2011).

Not only are more FCUs making loans at rates between 15 and 18 percent, but outstanding FCU loans made at rates exceeding 15 percent have increased significantly in recent years in terms of total value and as a percentage of all outstanding FCU loans. After nearly four years of steadily growing both in terms of total value and as a percentage of outstanding FCU loans, FCU loans made at rates exceeding 15 percent fell sharply early in the COVID-19 pandemic. However, as benchmark interest rates have risen rapidly over the past year, FCU loans made at rates in excess of 15 percent rose in total value from $14.1 billion in 2022 Q1 to $17.2 billion in 2022 Q2 to $24 billion in 2022 Q3. The NCUA Board was absolutely right in 2011 that effectively reverting to the FCU Act's 15 percent rate would have been disastrous for FCUs and their communities. Today, it would be catastrophic.

Federal Credit Union Loans Exceeding 15%



Sources: NCUA 5300 call report data, Federal Reserve *H.15 Selected Interest Rates*

Establishing a 21 Percent Permissible Interest Rate Ceiling

NAFCU urges the NCUA Board to immediately establish a 21 percent permissible interest rate ceiling. Section 701.21(c)(7)(ii)(A)'s two-pronged test is clearly satisfied, and the NCUA Board has a fiduciary responsibility to protect and support the credit union system's safety and soundness by remaining responsive to contemporary economic conditions. Today, the 18 percent rate constrains FCUs' capacity to fairly, more fully serve their members and the underserved and unserved in their communities, and likely upcoming additional FOMC FFR hikes will exacerbate the problem.

Permissible interest rate ceilings tend to reduce the overall availability of fairly-priced, high-quality credit, especially for those with the fewest financial resources and least access to regulated financial services – in other words, those who need it the most. Basic economic theory tells us that artificially constraining the supply of almost any good or service leads to something less than the natural rate of consumption. And the World Bank has exhaustively researched the negative impacts of permissible interest rate ceilings in 76 economies around the world.[6]

Various data shows that state-chartered financial institutions subject to even lower permissible interest rate ceilings, such as Arkansas's 17% interest rate ceiling,[7] have been slower than others to raise their rates as benchmark interest rates pushed higher over the past year. And it can be enticing to conclude from these data, that those financial institutions' borrowers are better off than they otherwise would be. However, during this period, most financial institutions subject to even lower permissible interest rate ceilings grew their unsecured lending portfolios at below-average rates. These financial institutions' most well-qualified borrowers did, in fact, likely enjoy lower rates than they would have otherwise. On the other hand, these financial institutions' inability to grow their unsecured lending portfolios during a time of the year when consumer credit card spending is particularly intense strongly suggests less fortunate consumers and small businesses likely went without much-needed credit or, more likely, secured credit on much less favorable terms from other lenders. Unfortunately, because we know average commercial bank credit card interest rates generally climbed above 18 percent in 2022 Q4 and remain on an upward trajectory, we can expect 2022 Q4 and 2023 Q1 FCU data to show many, if not most, FCUs have also curtailed their unsecured lending in recent months.

It is imperative that FCUs remain competitive and able to offer their communities a responsible, in-community alternative to loans and lines of credit pushed by profit-hungry, often predatory lenders. To do that, FCUs must be able to fairly serve their communities with the full suite of financial services products and services consumers need and demand. No individual or small business should be forced to seek desperately-needed credit on patently unfair terms from big banks, fintech lenders, and unscrupulous, poorly regulated short-term-only lenders. However, this is the real-world effect of the 18 percent rate. It prevents those most in need of access to high-quality credit from getting fairly priced FCU loans and lines of credit – the very harm the NCUA Board has worked so diligently to avoid throughout the COVID-19 pandemic and economic recovery.

In April 2011, during which the EFFR was never higher than 0.12 percent, the NCUA Board recognized that unsecured FCU loans and lines of credit could be fairly priced above 15 percent. Today, the EFFR stands at 4.33 percent and is poised to move higher by at least 50 bps within weeks. Certainly, in our contemporary economic conditions, unsecured FCU loans and lines of credit can be fairly priced above 18 percent, and a 21 percent rate is more appropriate than the current 18 percent cap. It is imperative that the NCUA Board not maintain a permissible interest rate ceiling or any other regulation that stands in the way of FCUs fairly, more fully serving their communities.

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[6] Ferrari, Aurora, Oliver Masetti, and Jiemin Ren, Interest Rate Caps: The Theory and the Practice, Policy Research Working Paper 8398 (2018).

[7] Arkansas Const. Art. XIX §13

Establishing a Floating Permissible Interest Rate Ceiling

Absent the Board immediately establishing a 21 percent permissible interest rate ceiling, FCUs' interest-rate-related risks will continue to rise alongside benchmark interest rates, and FCUs will be able to fairly serve fewer and fewer consumers and small businesses in their communities. However, there is no reasonable fixed permissible interest rate ceiling the NCUA could establish that would permanently resolve the issues unnecessarily imposed on FCUs and their communities by the FCU Act's arbitrarily low 15 percent rate.

The NCUA Board can permanently resolve these issues only by establishing a floating permissible interest rate ceiling. NAFCU strongly encourages the NCUA Board to undertake whatever legal and economic research it believes is necessary to properly evaluate the propriety of a floating permissible interest rate ceiling equal to a 15 percent or greater spread above the Prime Rate. The intractable defect of the FCU Act's 15 percent rate, that it prevents FCUs from fairly, more fully serving their communities, is painfully obvious. In fact, the defect is so painfully obvious that, over the better part of the last four decades, the NCUA Board has approved the 18 percent rate nearly two dozen times in a row. As the developing Arkansas experiment shows, every basis point above the FCU Act's 15 percent rate helps FCUs fairly, more fully serve their communities. However, every fixed permissible interest rate ceiling invites all too obvious, avoidable interest-rate-related risks during periods when benchmark interest rates rise sharply quarter after quarter.

When the NCUA Board approved the Derivatives Final Rule in May 2021, it expressly acknowledged its continued, intentional shift to principles-based regulation.[8] The NCUA Board recognized and again embraced this shift as recently as December 15, 2022, with the issuance of the Financial Innovation: Loan Participations, Eligible Obligations, and Notes of Liquidating Credit Unions proposed rule.[9] At the heart of the NCUA Board's reasoning in these rulemakings is a simple principle: FCUs capable of prudently using tailored interest rate risk management tools should be permitted to use those tools to protect and grow their balance sheets and, in the process, help reduce overall risks to the credit union system. NAFCU strongly supports the Derivatives Final Rule and other NCUA rulemakings that do away with unnecessarily prescriptive regulation and return key risk-management decisions to FCUs. But not every FCU benefits equally from this kind of regulatory flexibility because not every FCU has the requisite resources to prudently engage in more complicated risk management activities. In contrast, FCUs with even the most modest resources have continuously tracked the Prime Rate for decades to ensure their loans and lines of credit are fairly priced. By establishing a floating permissible interest rate ceiling, the NCUA Board would ensure FCUs of all sizes and resource levels have an effective interest rate risk management tool in all economic environments.

When §701.21(c)(7)(ii)(A)'s two-pronged test is satisfied, the NCUA Board is bound by no statutory upper limit on the permissible interest rate ceiling's value nor any requirement that the

[8] 12 CFR Part 703, Subpart B

[9] NCUA, Financial Innovation: Loan Participations, Eligible Obligations, and Notes of Liquidating Credit Unions, 87 Fed. Reg. 80,479 (Dec. 30, 2022)(proposed to be codified at 12 CFR PARTS 701 and 714).

NCUA Board express the permissible interest rate ceiling as a fixed value. The NCUA Board's own prior actions highlight the NCUA Board's broad discretion to establish a floating permissible interest rate ceiling and the propriety of exercising such discretion. In October 2010, the NCUA Board formally recognized for the first time that the 18 percent permissible interest rate ceiling unnecessarily constrains FCUs' capacity to fairly, more fully serve their communities.[10] Today, when an FCU extends a payday alternative loan (PAL), the FCU may, under either the October 2010 PALs Final Rule or the September 2019 PALs II Final Rule[11], utilize fair, risk-based pricing up to a maximum interest rate that floats 10 percent above the otherwise permissible interest rate ceiling.

This is the type of interest rate pragmatism that the NCUA Board should apply to the permissible interest rate ceiling generally. A floating permissible interest rate ceiling equal to a 15 percent or greater spread above the Prime Rate would preserve the spirit of §701.21(c)(7)(i)'s general prohibition against FCUs extending credit at excessive rates and enable FCUs to fairly, more fully serve their communities in every interest rate environment and through every interval of the natural economic cycle.

A floating permissible interest rate ceiling would not undermine PALs' utility for FCU members or risk dangerously increasing the maximum interest rate at which FCUs may offer PALs. As the NCUA has repeatedly recognized, PALs represent a meaningful alternative to payday loans and other loans offered by largely unregulated, unscrupulous lenders that routinely charge rates in excess of 100 percent annual percentage yield. Though the rates at which PALs are sometimes offered are well above the 18 percent rate, given their small value, short maturities, and their disproportionately high underwriting expenses, PALs are often unprofitable for FCUs. That is not likely to change if the NCUA Board establishes a floating permissible interest rate ceiling as described because the corresponding maximum PALs interest rate would only rise if the Prime Rate rises, which would enable FCUs to expand access to other, less expensive, unsecured lending products.

Maintaining the 18 Percent Rate

Absent the NCUA Board immediately establishing a 21 percent permissible interest rate ceiling, NAFCU recommends that the NCUA Board immediately extend the 18 percent rate for 18 months. At a time when benchmark interest rates have risen so much so quickly, the NCUA Board simply cannot fail to at least extend the 18 percent rate. As the NCUA recognized in 2011, failing to at least extend the 18 percent rate would reduce FCUs' revenues without reducing their related credit risks and, thereby, undermine the safety and soundness of the credit union system. If the NCUA Board waits any longer to at least extend the 18 percent rate, the NCUA Board will inject even greater regulatory uncertainty into an economic environment already fraught with significant interest-rate-related headwinds.

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[10] 12 CFR § 701.21(c)(7)(iii)
[11] 12 CFR § 701.21(c)(7)(iv)

Conclusion

NAFCU always appreciates the opportunity to share our views and the views of our members on this perennially important issue. NAFCU urges the NCUA Board to continue to support FCUs' role in this ongoing, all-important economic recovery by immediately establishing a 21 percent permissible interest rate ceiling. In the alternative, NAFCU recommends that the NCUA Board immediately extend the 18 percent rate for 18 months. NAFCU also strongly encourages the NCUA Board to undertake whatever legal and economic research the NCUA Board believes is necessary to properly evaluate the propriety of a floating permissible interest rate ceiling. If you have any questions or concerns, please do not hesitate to contact me or Dale Baker, NAFCU Regulatory Affairs Counsel, at (703) 842-2803 or dbaker@nafcu.org.

Sincerely,

B. Dan Berger
President and CEO

cc: Mr. Larry Fazio, Executive Director
Mr. Frank Kressman, General Counsel
Mr. Eugene Schied, Chief Financial Officer