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STATEMENT

OF

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"CREDIT UNIONS: MEMBER BUSINESS LENDING"

BEFORE THE

SENATE COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS

THURSDAY, JUNE 16, 2011

I. Introduction

The National Credit Union Administration (NCUA) appreciates the opportunity to provide views on credit unions and member business lending. This hearing is an opportunity to consider legislation that would help small businesses grow, create new jobs, provide needed community services, and bolster the U.S. economy.

Specifically, the Committee has asked NCUA to comment on the agency's experience with member business loans (MBLs), the agency's views on legislative proposals to increase the MBL limit, and any recommendations NCUA has to ensure safe and sound member business lending.

This written testimony will provide a general background and history of credit union member business lending, including the reasons why statutory MBL limits often inhibit credit unions from meeting the financing needs of creditworthy members who are self-employed or small business owners. It will highlight current MBL trends as credit unions continue to rebound from the largest financial crisis since the Great Depression. And most importantly, it will demonstrate how prudently raising the MBL cap would benefit small businesses, local communities, and the U.S. economy.

II. About NCUA

NCUA's primary mission is to ensure the safety and soundness of federally insured credit unions. It performs this important public function by examining all federal credit unions, participating in the supervision of federally insured state-chartered credit unions in coordination with state regulators, and insuring federally insured credit union members' accounts. In its statutory role as the administrator for the National Credit Union Share Insurance Fund (NCUSIF),[1] NCUA provides oversight and supervision to 7,292 federally insured credit unions, representing 98 percent of all credit unions and 90.8 million members.[2]

III. Importance of Small Businesses Having Access to Credit

Many businesses, especially small businesses, count on credit to finance their operations, such as inventories, and to meet weekly payrolls. Disruptions in the availability of credit have been associated with particularly painful downturns. Our most recent contraction, dubbed by some as the "Great Recession," is no exception. In the last six months of 2008, more than 70 percent of banks were tightening standards on commercial and industrial loans to borrowers of all sizes, and more than 80 percent were tightening standards on commercial real estate loans. Credit contracted sharply. Bank loans to non-farm, non-corporate businesses (outside of mortgages) fell almost 20 percent from the end of 2008 to the end of 2009.

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[1] The NCUSIF was created in 1970 by Public Law 91-468 (Title II of the Federal Credit Union Act), which was amended in 1984 by Public Law 98-369. The Fund was established as a revolving fund in the United States Treasury under the NCUA Board for the purpose of insuring member share deposits in all federal credit unions and in qualifying state credit unions that request insurance.

[2] Approximately 150 state-chartered credit unions are privately insured and are not subject to NCUA oversight. The term "credit union" is used throughout this statement to refer to federally insured credit unions.

The economic consequences of the credit contraction that began in the fall of 2008 were immediate and severe. Businesses liquidated inventories, consumer demand disappeared, and worker layoffs surged. From December 2007 to the low point in February 2010, the economy lost 8.7 million jobs, and despite recent improvements, overall, U.S. payrolls have lost 6.9 million jobs from December 2007.

Impact on Small Businesses

The recession hit small businesses harder than larger firms, and small businesses have been slow to rebound. Recent research indicates that employment at firms with fewer than 50 employees—accounting for about 40 percent of private sector employment—fell more than 8 percent from December 2007 through June 2009, while employment at all other businesses fell by 4.5 percent. During the early stages of the recovery (July 2009 through November 2010), employment at firms with fewer than 50 employees declined roughly another 3 percent, while employment at larger firms rose.

While conditions in financial markets have improved, access to credit remains difficult for many small businesses and entrepreneurs that depend on financial institutions for such funding. According to the FDIC Statistics on Depository Institutions, net loans and leases by all FDIC-insured institutions fell by nearly 9 percent between year-end 2008 and the first quarter of 2011, including a decline of 1.6 percent so far in 2011. Starting in the first quarter of 2010, information became available on "small business" loans (defined as loans less than $1 million) in several categories. Between the first quarter of 2010 and the first quarter of 2011, total small business loans secured by non-farm, non-residential properties fell by 7 percent, and loans less than $100,000 fell by 14 percent. Small business commercial and industrial loans fell by 10.3 percent over the same period.

Clearly, the contraction in credit represents declines in both demand and supply, particularly in commercial real estate and construction and land development. Nevertheless, research indicates access to credit is a concern for small business owners. A recent survey shows that the net percent of respondents indicating that credit was harder to get more than tripled (from 5 percent to 16 percent) to the highest share on record between early 2007 and early 2009 (May 2009).[3] While the situation has improved, concerns about difficulty accessing credit remain elevated.

Credit Unions' Small But Important Role in Business Lending

Though making up only approximately 1 percent of total commercial loans in the United States,[4] credit unions serve an important role in lending to small businesses and continued to extend credit during the economic downturn. Today credit unions have more than 167,000 outstanding loans to businesses.

[3] National Federation of Independent Businesses' *Small Business Economic Trends*, May 2011.

[4] Mortgage Bankers Association Commercial and Multifamily Mortgage Debt Outstanding Report as of June 30, 2010. <http://www.mortgagebankers.org/NewsandMedia/PressCenter/74019.htm>

Small businesses rely on financing far more than larger businesses. Smaller financial institutions play a critical role in providing credit to small businesses.[5] Credit unions are well suited to prudently offer credit to small businesses, which in turn will help create jobs and spur economic growth.

Credit unions serve an important niche, typically making the smallest of the small business loans. The dollar-weighted average credit union MBL is $223,000,[6] indicating credit unions are predominantly serving the needs of small businesses. The two most common types of loans—non-farm residential property loans and commercial and industrial loans—average $160,000 and $127,000, respectively.[7]

Credit unions continued to serve as a source of credit for consumers and small businesses during the economic downturn and recovery. Over the period from year-end 2007 through the first quarter of 2011, credit union lending increased by nearly 6 percent. Total member business loans, in particular, increased by 41.4 percent during this timeframe. Member business loans with portions guaranteed by the Small Business Administration (SBA) grew by 81 percent.

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[5] Commercial banks with less than $10 billion in assets account for only 19 percent of assets, but 45 percent of small business commercial & industrial lending (using the FDIC definition). All but three credit unions have less than $10 billion in assets.
[6] The median of the average member business loan size by credit union lender is only $127,000.
[7] The average loan size of all commercial and industrial loans made by commercial banks is $643,000. Federal Reserve's *Survey of Terms of Business Lending* (Feb 2011).

IV. Credit Union Member Business Lending History

Credit unions have a long history of meeting the business lending needs of their members, dating back to the inception of our nation's credit union movement in 1908. From their roots, credit unions have played a small, yet crucial role in supplying credit to farmers, immigrants and small business owners. In fact, the first credit union ever chartered in the United States, St. Mary's Bank Credit Union, had as a primary lending focus to "establish neighborhood business." Over the last century, credit union business lending has evolved from providing mostly agricultural and farming loans to funding small business start-ups as well as contemporary commercial real estate projects.

Credit Unions Have a Successful Business Lending History

Many credit unions have successfully provided credit to meet the business needs of their members for decades. Congress recognized this fact in 1998 when enacting the Credit Union Membership Access Act (CUMAA) [Public Law 105-219]. CUMAA provided an exception to the business lending cap imposed on credit unions for those institutions with a "history of primarily making business loans."

Centris Federal Credit Union, chartered in 1934, is one of the institutions that met the criteria for this statutory exception. SBA recently recognized Centris Federal Credit Union "as a community lender having a significant impact on underserved markets in its area, as the number of loans approved for this segment increased by 83% from 2009 to 2010 and the gross dollar amount approved increased by 230.29%." SBA also stated that "while portfolio performance played a significant role in the awards, the institutions' continued support of small business, especially in underserved communities during challenging economic times was also a major factor."[8]

NCUA Regulated MBL Activity Prior to Statutory MBL Limits

During the late 1980s credit unions increasingly established and engaged in member business lending, but some lacked the necessary expertise in underwriting and servicing such loans. Given the lack of necessary expertise combined with the challenging macroeconomic conditions at the time, over a two-year period in the late 1980s, nearly half of the losses sustained by the NCUSIF directly or indirectly resulted from losses in business lending portfolios.

During this time period and since, NCUA increased supervisory oversight of credit unions involved in business lending, especially those in challenging markets. NCUA also began collecting more specific MBL data on credit union Call Reports.

In 1987 the agency adopted its first Rule and Regulation specifically devoted to member business lending. This regulation (what is now encompassed by Part 723 of NCUA's Rules and Regulations) provided a more robust prudential regulatory framework to

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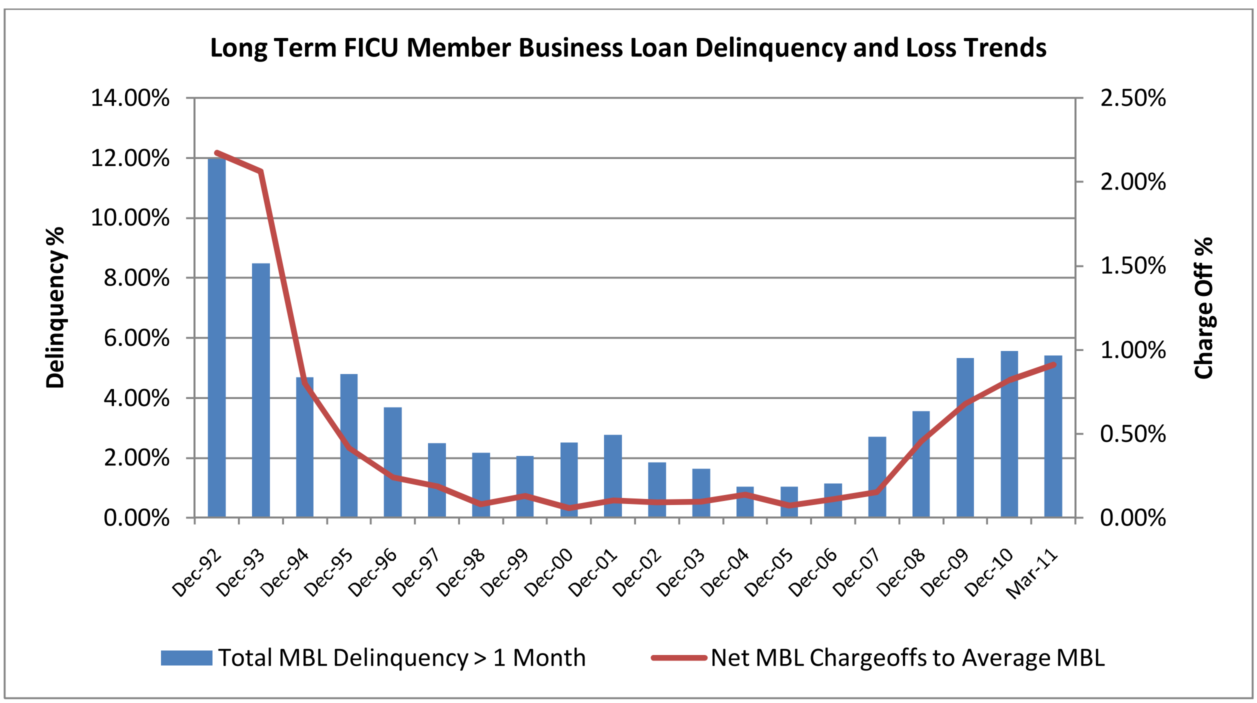
[8] *Six Lenders and Two Investment Companies Receive Top SBA Recognition at National Small Business Week*, SBA Press Release, May 20, 2011.

better manage the risks business lending activity posed to credit unions and the Share Insurance Fund.[9]

NCUA has periodically made various enhancements to the MBL rule since adoption in 1987. Over the years NCUA has increased underwriting standards, collateral requirements, and management qualifications. On the whole, NCUA's regulatory and supervisory efforts have proven successful in mitigating losses from member business lending. These rules also set a solid foundation for this form of credit to be extended in a safe-and-sound manner during the 1990s, without any aggregate cap on member business lending prior to 1998 (see Figure 1 below).

Figure 1



[9] NCUA's MBL rule is applicable to all federal credit unions (FCUs) and the vast majority of federally insured state-chartered credit unions (FISCUs), except for those FISCUs in six states that maintain their own MBL rule with NCUA's approval. These six states are Connecticut, Maryland, Oregon, Texas, Washington and Wisconsin.

Member Business Lending Statutory Cap

In 1998, CUMAA codified in the Federal Credit Union Act the definition of an MBL[10] and established a statutory aggregate limit on outstanding MBLs credit unions could hold. CUMAA set the aggregate limit on a credit union's net member business loan balances as the lesser of 1.75 times the credit union's net worth or 12.25 percent of the credit union's total assets. Certain loans, including loans less than $50,000 or portions of loans guaranteed by a governmental agency, are not counted for the purpose of the aggregate loan limit.

The statute exempts from the aggregate MBL cap credit unions meeting any of the following criteria:

> (1) credit unions with a low-income designation or participating in the Community Development Financial Institutions Program;[11]
>
> (2) credit unions chartered for the purpose of making member business loans; and
>
> (3) credit unions that had a history of primarily making member business loans when the statute was enacted.[12]

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[10] The Federal Credit Union Act's definition of a member business loan is incorporated in Part 723 of the NCUA Rules and Regulations. A member business loan is defined as any loan, line of credit, or letter of credit, where the proceeds will be used for a commercial, corporate, other business investment property or venture or agricultural purpose. [12 CFR 723.1(b) and (c)]

[11] There are 1,116 credit unions that are low-income designated and/or participate in the CDFI. The median asset size for these credit unions is $8.5 million. Twenty-five percent of these credit unions grant MBLs.

[12] There are 120 credit unions, with $24 billion in assets, which were either chartered for the purpose of making MBLs, or have a history of primarily making MBLs. This small subset of credit unions accounts for over one-third of all credit union agricultural lending. Fifty-nine of these 120 credit unions are also low-income designated and counted in the footnote above. Thus a total of 1,177 credit unions are not subject to the cap.

Collectively, 1,177 credit unions qualify for these exemptions. Thus, the other 6,115 credit unions—about 85 percent of all credit unions, representing 94 percent of assets and 75 percent of current member business lending—are subject to the statutory cap.

Effective member business lending requires the creation of internal policies and procedures to engage safely and soundly in this activity. It also requires the hiring of professionals with sufficient knowledge of business lending to judge the quality of the loan applications and to monitor the performance of the loans once made—especially cash flow, portfolio management, and liability issues.

The low statutory cap also acts as a deterrent, keeping many credit unions out of member business lending entirely. With the cap, it is difficult to achieve the necessary economies of scale in terms of personnel and systems to make this type of program cost-effective. As a result, some credit unions that would otherwise elect to meet their member business financing needs do not offer member business loans.

Figure 2 shows the share of credit unions subject to the cap participating in member business lending and the extent of their participation relative to the asset-based cap. For example, approximately 70 percent of credit unions subject to the cap do not offer MBLs, and nearly one-quarter of credit unions subject to the cap with more than $100 million in assets do not offer MBLs. As of March 2011, 289 credit unions (including those with grandfathered regulatory waivers) are at or near the current statutory MBL cap.

Figure 2

Member Business Lending Compared to Current Statutory Limit: First Quarter 2011

Credit Unions Subject to the Statutory Cap

				MBL Share of Assets Relative to 12.25% Cap			
Asset Class	**Credit Unions**	**Total Assets ($B)**	**Total MBL ($B)**	**No MBL**	**Less than 50%**	**50% to 80%**	**80%+**
				(% of CUs)			
<$10M	2,106	8.59	0.01	97.63	2.14	0.14	0.09
$10M to $50M	2,057	49.97	0.39	76.52	20.42	1.70	1.36
$50M to $100M	700	49.24	0.67	54.00	39.14	3.86	3.00
$100M to $500M	891	196.99	5.60	29.18	53.20	10.55	7.07
$500M to $1B	195	136.59	6.25	11.28	56.41	17.95	14.36
$1B+	166	437.37	15.09	9.64	56.63	21.69	12.05
Total	6,115	878.75	28.02	70.42	23.17	3.76	2.65

Notes: Excludes the 1,177 credit unions that are not subject to the statutory cap based on either low-income credit union status or a charter exclusion. There are 1,116 credit unions with low-Income status and 120 credit unions with charter exemptions. Fifty-nine credit unions are exempted from the caps by both low-Income status and charter exemptions.

As credit unions continue to offer MBL services to their members, more credit unions will approach the statutory limit, thus limiting the avenues of credit available to small businesses.

Legislation proposed by Senator Mark Udall (S. 509) would allow well capitalized and well managed credit unions with a proven track record of member business lending to grow their MBL portfolios—in small, manageable increments—to as much 27.5 percent of total assets.[13]

This statutory change would allow credit unions with well managed MBL programs to provide additional funding to meet the financial needs of their members and their communities, thereby contributing to the economic recovery and job growth. Further, the provisions of S. 509 requiring a tiered implementation of a higher cap are appropriate safeguards to ensure this authority is exercised only after credit unions offering MBLs have demonstrated proper controls.[14]

The potential to reach a higher cap could lead more credit unions to make the economic decision to invest in the infrastructure, develop the policies, and hire the expertise needed to engage in an effective, prudent member business lending program. NCUA projects that credit unions could extend several billion more dollars in member business loans in the first few years after passage and implementation of S. 509. If each credit union most likely to qualify immediately for higher MBL limits under the bill increased

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[13] Under S. 509, experienced credit unions operating in the second tier (above the current statutory cap) could not immediately increase their levels of MBLs. Subject to supervisory considerations, these credit unions could only increase their MBL portfolios on a gradual basis, by no more than 30 percent annually. Additionally, the legislation would prevent credit unions operating in the second tier that subsequently fall below a well capitalized level from underwriting new MBLs until such time as the credit union becomes well capitalized. Also, the legislation would establish safeguards to ensure that NCUA has the powers needed to protect the safety and soundness of credit unions engaging in increased levels of member business lending.

[14] For credit unions meeting certain criteria, S. 509 would permit the NCUA Board to approve applications to operate in a second tier above the first tier for member business lending. Among others, these criteria would require the applying credit union to be well capitalized and well managed, have at least five years of experience in member business lending, and operate near the first-tier MBL cap for at least four consecutive quarters. Credit unions receiving approval from the NCUA Board to operate in this second tier would have the ability to underwrite MBLs up to 27.5 percent of total assets.

member business lending by 30 percent, more than $2 billion in credit would be extended.

In addition, some credit unions that are not presently near the cap, including some that do not make MBLs, are likely to increase their MBL activity because they could achieve appropriate economies over the long term with the higher cap.

How quickly and to what degree credit unions would respond remains uncertain. Using conservative assumptions, over the next few years, it is possible that an additional $2 billion to $3 billion in credit could be made available through these channels.

However, the current cap limits credit unions' abilities to diversify their loan portfolios. At this time, the portfolios of many credit unions are invested heavily in long-term, fixed-rate mortgages. Such assets have greater exposure to interest-rate risk. Although it may seem counter-intuitive, allowing credit unions to engage in more member business lending is another way in which to prudently manage risk. An increase in the member business lending cap could allow credit unions to diversify the risk of their loan portfolio, with member business lending typically involving less interest-rate risk than long-term, fixed-rate mortgages.

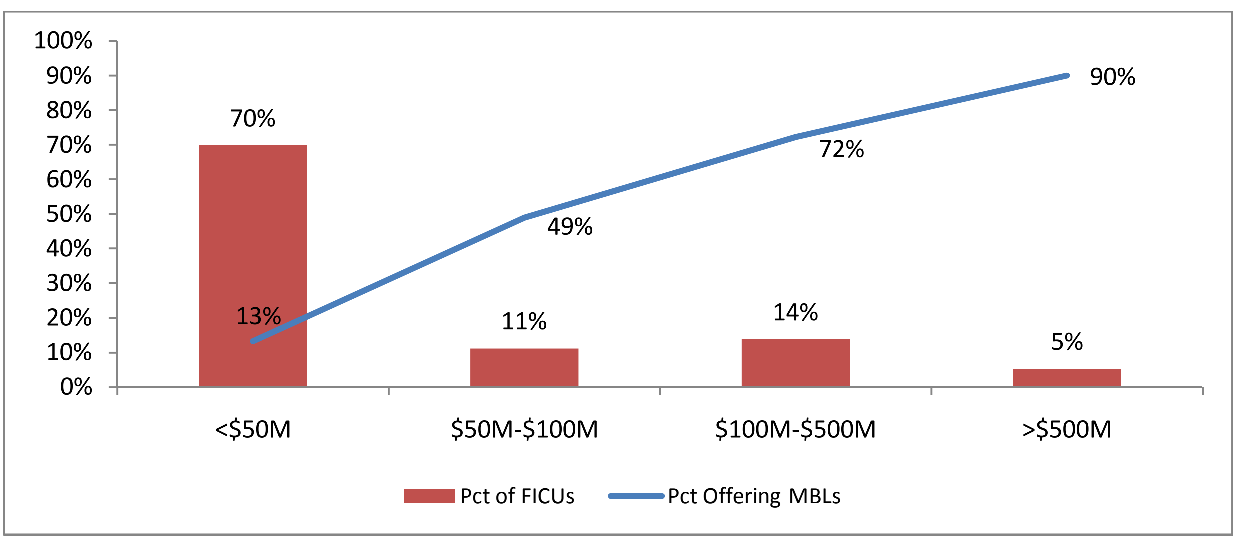
V. Member Business Lending in Credit Unions Today

Within the constraints of the statutory cap on MBLs, many credit unions are striving to provide the credit needed by self-employed persons and small businesses. Such loans can have far-reaching and positive impacts throughout a community by creating jobs and promoting local commerce.

Credit Union MBL Statistics

As of March 31, 2011, 30 percent (2,148) of credit unions provide credit to businesses.[15] Figure 3 shows the size distribution of credit unions engaged in member business lending compared to the population of all federally insured credit unions. In brief, this chart shows that the smaller a credit union's size, the less likely it is to engage in member business lending.

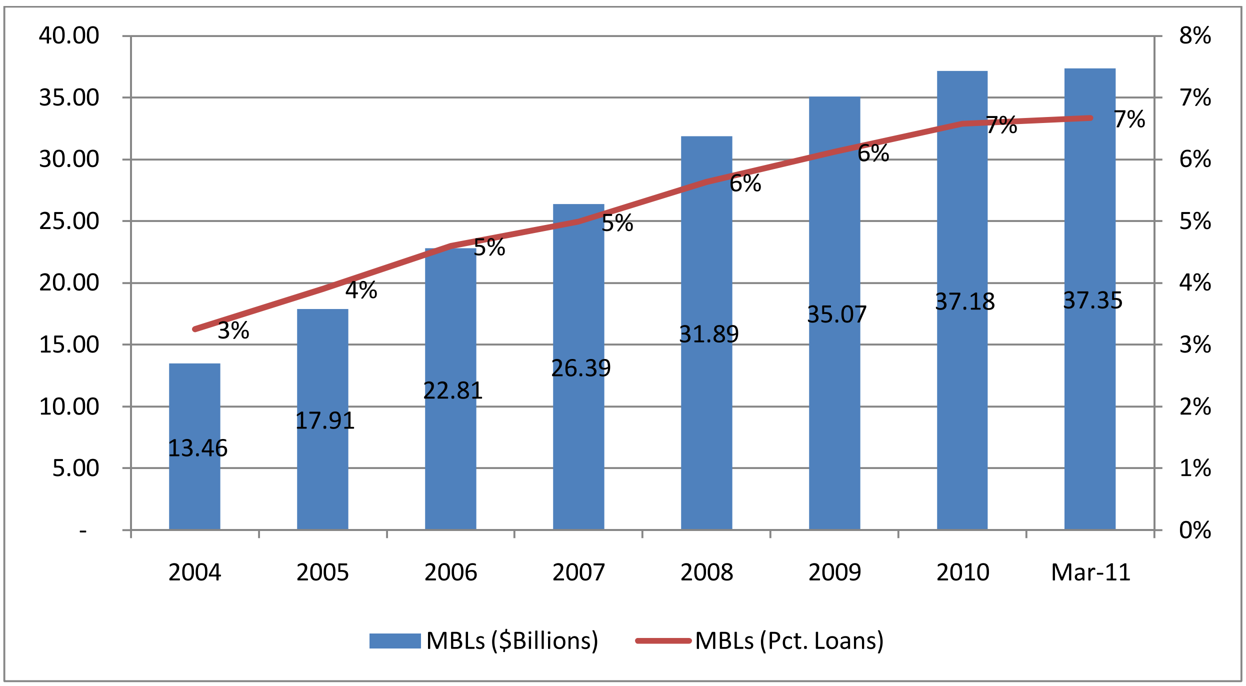
Figure 3



[15] Unless otherwise indicated, all data provided is as of March 31, 2011.

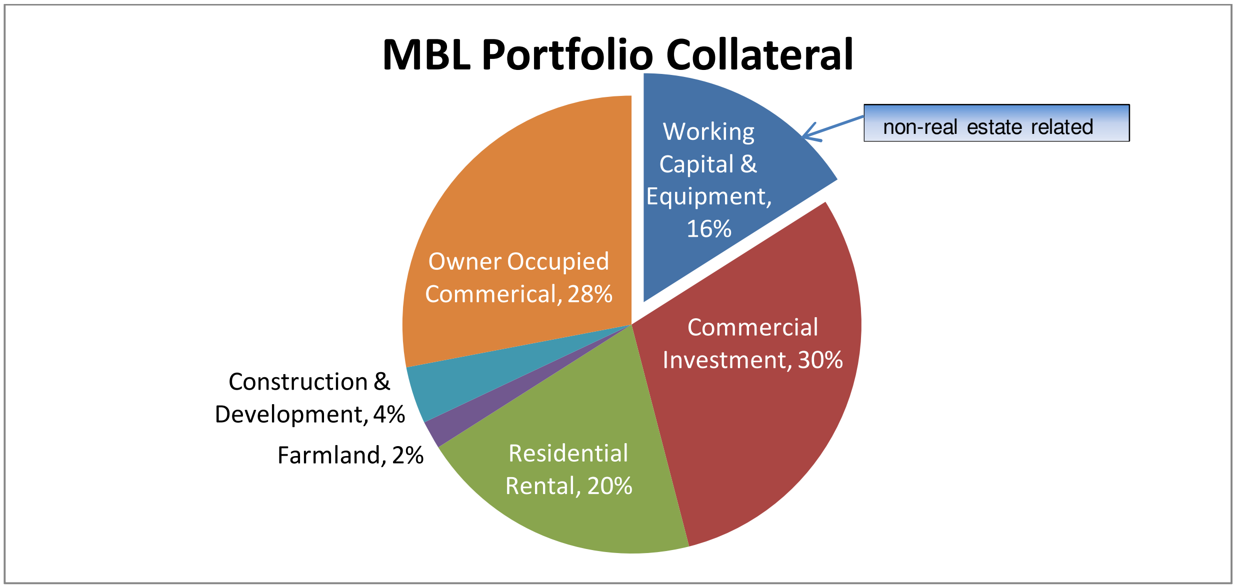
In 2010, credit unions originated or purchased $12.1 billion in MBLs. Another $3.1 billion were added in the first quarter of 2011. Outstanding balances of MBLs as of March 31, 2011, total $35.7 billion (without unfunded commitments) and comprise 6.4 percent of total loans and 4 percent of total credit union industry assets. (Figure 4 includes unfunded commitments).

Figure 4



The majority of MBLs, $31.4 billion or 84 percent, are secured by real estate. Agricultural-related MBLs have steadily grown to $1.4 billion, representing approximately 4 percent of total MBLs (see Figure 5 below). Construction and development MBLs declined in both 2009 and 2010; however, an increase of $146.6 million, or 10.3 percent, to $1.6 billion was noted in March 2011.

Figure 5



More than one-third of all MBLs ($14 billion) are held by credit unions in three states. California credit unions account for the largest percentage of total MBLs (20 percent or $7.5 billion), followed by New York credit unions (11 percent or $4.2 billion), then Wisconsin credit unions (6 percent or $2.3 billion).

Credit unions in North Dakota, Minnesota, and Wisconsin continue to have the largest concentrations in agricultural MBLs, each with more than $100 million. For example, North Dakota credit unions report $497 million in agricultural MBLs, representing 74 percent of the state's total MBLs, with a portfolio delinquency rate of 0.53 percent—very low compared to credit unions nationwide.

Recent Stresses on MBL Performance

Like other types of loans, MBLs perform in a cyclical manner. Understandably, the MBL portion of credit unions' loan portfolios has suffered from the adverse effects of the protracted economic downturn. The level of delinquent member business loans has increased from 0.53 percent at year-end 2006, to a high of 3.93 percent as of December 2010, moderating somewhat to 3.76 percent as of March 2011. The average MBL delinquency ratio by credit union, however, is 2.60 percent, indicating a few outliers are increasing the dollar-weighted delinquency level as they work through the impact of the economic downturn.

Credit unions located in states hit the hardest by the economic distress of the last few years hold a disproportionate amount of the delinquent MBLs. Most notably, the 328 credit unions located in the "sand states" account for 40 percent of all delinquent MBLs, but only represent 15 percent of credit unions offering MBLs.[16] Losses on MBLs increased from 0.11 percent in 2006 to 0.91 percent (last 12 months as of March 2011). The credit unions located in the sand states account for 49 percent of losses on MBLs. As Figure 6 illustrates, despite the recent increase during the economic downturn, current credit union MBL delinquency levels remain lower than other federally insured financial institutions.

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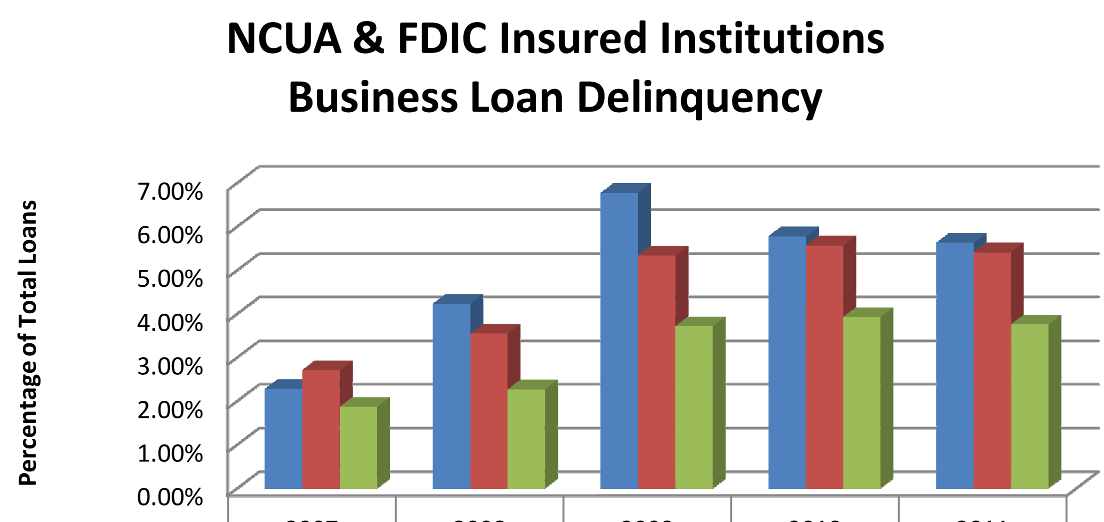
[16] NCUA uses the term "sand states" to collectively refer to Arizona, California, Florida, Nevada, and Utah.

Figure 6



	2007	2008	2009	2010	2011
FDIC >30 days	2.28%	4.23%	6.77%	5.78%	5.63%
NCUA >30 days	2.71%	3.55%	5.34%	5.57%	5.41%
NCUA >60 days	1.87%	2.27%	3.72%	3.93%	3.76%

While MBL delinquencies and losses increased significantly during the economic downturn, they did not have a major impact on the safety and soundness of the vast majority of credit unions. Of the 55 credit union failures in 2009 and 2010, only one failure was primarily related to MBLs. MBLs were one of several factors contributing to the failure of eight other credit unions. Thus, the vast majority (46) of credit union failures during this period were unrelated to member business lending. Losses to the NCUSIF for credit unions with MBLs as a contributing factor for 2009 and 2010 totaled $83.4 million, accounting for 20.5 percent of the $406 million in losses during that timeframe.

Reviews of the cause of each loss clearly point to individual credit union management deficiencies—not inherent flaws with member business lending in credit unions. Rather, managements' lack of planning, internal controls, and oversight of MBL programs, and inadequate third-party vendor due diligence played an integral part in the failure of these nine credit unions.[17]

An additional factor in several cases was the declining value of the underlying real estate serving as collateral on the MBLs. When real estate values declined to the point that credit lines were no longer supportable, the businesses defaulted.

While the nine failures illustrate some of the risks of member business lending if not well managed, member business lending can be conducted in a safe, sound and prudent manner with appropriate regulatory safeguards. Such lending activity by credit unions can be of significant benefit to the small business community that is too often limited in its access to credit.

VI. Conclusion

NCUA recognizes the importance of small businesses in our nation's economy. S. 509 has the potential to increase the access of small businesses to capital and to promote job growth. As such, NCUA supports efforts to allow credit unions to provide

[17] Sometimes credit unions use credit union service organizations (CUSOs) or other third-party vendors to engage in various activities, including member business lending. NCUA is the only Federal Financial Institutions Examination Council (FFIEC) agency that does not have examination and enforcement authority over vendors. It is important to have examination and enforcement authority over vendors to properly identify and mitigate risks inherent to, or introduced by, vendor products for federally insured institutions. NCUA believes the agency should be provided with this authority.

businesses additional avenues of credit when appropriate under a comprehensive regulatory framework, by increasing or eliminating the current statutory MBL limitation.

NCUA further believes that when regulated consistent with the principles of sound risk management and consistent with the capabilities of the credit union, increased business lending is good not only for the credit union, but also for its members and the communities in which the credit union operates.

NCUA has a long-standing history of effectively balancing the risks inherent in member business lending within an appropriate level of flexibility for credit unions to meet the business needs of their members. Over the two-and-a-half decades since NCUA issued its first MBL rule, the agency has made appropriate adjustments to keep pace with developments in this line of business.

NCUA is committed to remaining vigilant in carrying out its fiduciary responsibilities over the NCUSIF. Should Congress increase the MBL lending limit for credit unions, NCUA will ensure its prudential regulatory framework is further enhanced to manage the associated risks. In sum, NCUA will continue to fulfill its primary responsibilities: to protect the NCUSIF and the 90.8 million consumers who place their trust in federally insured credit unions.