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Introduction to Financial Services: Credit Unions

Background

Credit unions are nonprofit financial *cooperatives*, meaning that these depository institutions are owned and operated entirely by their members. The concept of the modern credit union stems from small group cooperatives that emerged in financially underserved localities (dating as least as far back as U.S. colonial times) where residents pooled their funds and subsequently provided unsecured small-dollar loans to members. Following the Great Depression, Congress passed the Federal Credit Union Act of 1934 (FCU Act; 48 Stat. 1216) to create a class of federally chartered financial cooperative institutions for the purpose of "promoting thrift among its members and creating a source of credit for provident or productive purposes." Modern retail (natural person) credit unions still hold member deposits, which are referred to as *shares*; the interest earned by members is referred to as *dividends*; and the shares are used to provide low-cost loans to members, other credit unions, and credit union organizations.

Credit unions have various distinguishing traits from their primary competitors, commercial banks. As member-owned cooperatives, federal- or state-chartered credit unions are based on a *common bond*, which establishes the membership eligibility requirements. There are three types of charters: (1) a single common bond (occupation or association based), (2) a multiple common bond (more than one group each having a common bond of occupation or association), and (3) a community-based (geographically defined) common bond. As nonprofit institutions, credit unions are exempt from paying federal income tax at the corporate level. Individual members are taxed on their dividends. (By contrast, commercial banks are for-profit institutions that are owned by equity shareholders. With the exception of some small institutions, most banks pay corporate taxes. Individual depositors and shareholders pay individual taxes on interest and dividend income, respectively.)

The National Credit Union Administration (NCUA), an independent federal agency, charters and supervises national-chartered credit unions for safety and soundness and insures members' share deposits. The NCUA collects insurance assessments from member credit unions and then places the proceeds in the National Credit Union Share Insurance Fund (NCUSIF) to reimburse a credit union's share depositors were it to suffer large losses or become insolvent. The NCUA manages the NCUSIF to ensure that the statutory minimum requirement of funds is maintained. In addition, the NCUA provides lender-of-last-resort liquidity to solvent credit unions via its Central Liquidity Facility discount window. (This facility, which is itself a cooperative capitalized by its member credit unions, provides loans to its members.)

Permissible Lending Activities

By amending the FCU Act several times over the past decades, Congress has expanded the permissible lending activities of credit unions, thus allowing them to evolve into a more sophisticated financial intermediation system. Although credit unions and banks provide many similar types of financial services, credit unions face more statutory restrictions on their lending activities relative to banks. Some of the restrictions include the following:

- Credit unions can make loans only to their members, to other credit unions, and to credit union organizations.
- Credit unions face a 15% statutory loan interest rate ceiling, with some authority to operate above the cap under certain circumstances. The NCUA is allowed to set a ceiling above the 15% cap for up to an 18-month period after consulting with Congress, the U.S. Department of the Treasury, and other federal financial agencies. The credit union interest rate ceiling is currently set at 18% (extended through September 10, 2021). Credit card loans, for example, are likely to be offered to a consumer with an interest rate closer to the ceiling.
- Credit unions generally offer loans with a 15-year statutory maturity limit with some exceptions, such as loans for residential mortgages.
- Credit unions' *member business loans (MBLs)* are limited by statute. The aggregate amount of outstanding loans, lines of credit, or letters of credit used for an agricultural purpose or for a commercial, corporate, or other business investment property or venture to one member or group of associated members may not exceed 15% of the credit union's net worth or $100,000, whichever is greater. Statute also limits an MBL's aggregate amount to the lesser of 1.75 times the credit union's net worth or 12.25% of the credit union's total assets with three exceptions. The exceptions were authorized for credit unions with low-income designations, which are chartered for the purpose of making business loans, and with a history of primarily making such loans. When establishing the statutory cap on MBLs (along with their net worth supervisory framework, discussed in the next section), Congress emphasized concerns for the prudential safety and soundness of the credit union system.

Credit union industry advocates argue that lifting lending restrictions to make the system more comparable with the banking system would increase borrowers' access to credit. Community or small banks (e.g., banks with $10 billion or less in total assets), which often compete directly with credit unions, argue that policies such as raising the business lending cap, for example, would allow credit unions to expand beyond their congressionally mandated mission and could pose a threat to financial stability.

Prudential Requirements Following the Financial Crisis of 2008

An established goal in NCUA's 2018-2022 Strategic Plan includes ensuring a safe and sound credit union system. In general, credit unions (and banks) must maintain buffers to absorb losses associated with loan defaults. A *buffer* is defined as the difference between assets (e.g., loans, bonds) and liabilities. A buffer can be used to absorb losses associated with loan defaults. (Banks maintain *capital* buffers; credit unions maintain *net worth* buffers. Although capital and net worth buffers are analogous concepts, the terminology differences are because bank capital consists of both retained earnings and equity stock shares. Credit unions, however, do not issue equity stock shares, so their net worth consists primarily of retained earnings. Despite these particulars, capital and net worth have been used interchangeably when referring to prudential buffer requirements.) The credit union and banking systems generally compute their buffer requirements differently. Even within each system, buffer computations differ by the overall asset size of each depository institution, the wide variation in the types of loans predominantly held in portfolios, and associated credit risks linked to their borrowers. Consequently, determining whether credit unions and banks hold comparable buffer amounts is difficult given the variety of factors at play.

Corporate credit unions provide retail credit unions with liquidity, investment, and clearing services, thus reducing the costs that smaller credit unions would bear individually to perform various financial transactions for members. In 2008, corporate credit unions—facing increasing liquidity pressures after a significant portion of their mortgage-related assets lost value following a deterioration of the underlying real estate collateral—were downgraded below investment grade. By 2010, five financially distressed corporate credit unions, which are cooperatively owned by their federally insured retail credit union members, could not maintain their buffers and threatened NCUSIF's solvency. At that time, the five corporates represented approximately 70% of the entire corporate system's assets and 98.6% of the credit union system's investment losses, and they were liquidated by the NCUA. Rather than deplete the NCUSIF, Congress in May 2009 established a Temporary Corporate Credit Union Stabilization Fund (TCCUSF) to manage the losses from the corporates. The TCCUSF borrowed from Treasury to help cover losses. The NCUA also raised share deposit assessments on all federally insured credit unions to repay Treasury. After collecting sufficient funds from credit unions and recovering various debts and obligations that had been owed to the corporates, the TCCUSF was able to close officially on October 1, 2017.

The credit union system, along with numerous financial entities, experienced distress after a sharp rise in the percentage of seriously delinquent mortgage loans in the United States in 2008. By 2013, the federal bank prudential regulators (i.e., the Federal Reserve, the Office of the Comptroller of the Currency, and the Federal Deposit Insurance Corporation) had enhanced their prudential capital requirements to increase the U.S. banking system's resilience to systemic risk events. Likewise, the NCUA in 2014 proposed increasing, thus strengthening, net worth buffer requirements, particularly for large credit unions. The proposal, however, has been revised and delayed.

- In 2015, NCUA amended the definition of *complex credit union* as one having at least $100 million in assets. The NCUA also finalized a new risk-based capital rule for complex credit unions, which was designed to be more consistent with the capital adequacy requirements commonly applied to banks.
- In 2019, the NCUA issued a final rule that delayed the effective date of the 2015 final rule. The NCUA also amended the complex credit union definition by increasing the asset threshold level from $100 million to $500 million. This final rule would make the risk-based capital requirements effective on January 1, 2022.
- On July 22, 2021, the NCUA released a proposed rule that would allow eligible complex credit unions to opt into a complex credit union leverage ratio (CCULR) framework, comparable to the optional community bank leverage ratio framework. Instead of calculating and meeting generally applicable risk-based capital requirements, the CCULR framework would require complex credit unions to meet a minimum net worth ratio initially established at 9% by January 1, 2022, that would gradually increase to 10% by January 1, 2024. The comment period for the proposed rule ended on October 15, 2021. On December 23, 2021, the *Federal Register* published a final rule requiring a complex credit union to have a CCULR of 9% or greater that became effective on January 1, 2022. However, NCUA did not adopt the transition provision to 10%.

The NCUA also implemented final rules and subsequently released proposed rules that would expand lending activities and increase financial transactions volumes (economies of scale) and potential revenues for the credit union system. For example, the NCUA has revised certain terms (e.g., local community, rural district, underserved area, multiple common-bond credit union) to broaden access to federal credit unions. Additionally, the NCUA implemented certain provisions from P.L. 115-174, such as the amendment to the statutory MBL definition to exclude nonowner-occupied real estate (e.g., rental property) loans from counting toward the aggregate MBL cap.

CRS Resources

CRS Report R46360, *The Credit Union System: Developments in Lending and Prudential Risk Management*, by Darryl E. Getter

CRS In Focus IF11048, *Introduction to Bank Regulation: Credit Unions and Community Banks: A Comparison*, by Darryl E. Getter

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