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AN ANALYSIS OF THE IMPACT OF EXPANDING THE ABILITY OF CREDIT UNIONS TO INCREASE COMMERCIAL LOANS

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Executive Summary

Credit union advocates are supporting controversial legislation that would increase the ability of credit unions to make business loans, which the law currently caps (in most instances) at 12.25 percent of the credit union's total assets. The legislation increases this to 27.5 percent.

They assert that increasing the cap would not only be good for credit unions but also a positive development for the economy as a whole, contending that it would provide a spark in the credit market, with more companies being able to obtain loans. As a result, they aver, an expansion of the cap would lead to greater economic growth and more tax revenue for the government

However, upon closer scrutiny, the claims made by credit union advocates regarding job creation and economic growth as a result of an increase in the business loan cap are highly questionable. Among the key findings in this paper are:

- As it currently stands, the vast majority of credit unions are nowhere near their credit limit: Only 1.6 percent of credit unions are at or above the 12.5 percent cap, and over 70 percent of credit unions have no member business loans at all, which calls into question the need for to push for such controversial legislation.
- Before the cap was first instituted in 1998, MBLs as a percentage of total assets for the entire credit union history was less than 1 percent. But today, that number has more than tripled to 3.4 percent. And compared to 1998, the total amount of MBLs outstanding is ten times higher today than it was immediately before the cap was instituted. This calls into serious question the claims made by CUNA and NAFCU that the existing cap is in any way stifling the small number of credit unions that wish to engage in business lending;
- Job growth forecasts offered by proponents of a higher MBL cap are highly suspect, are based on assumptions that make little economic sense, and are far rosier than real world data observed over the last three years suggest they should be. For example, if actual jobs data are used to predict new jobs per dollar spent, then the $14 billion in new lending predicted by proponents of a higher MBL cap would actually decrease employment by

more than 152,000 jobs.

- Existing law provides credit unions a variety of ways to make commercial loans without impinging on their statutory MBL cap , such as any loan under $50,000, loans guaranteed by the SBA or a residential mortgage, or any loan offered in part by another credit union. As such, increasing a statutory cap that currently does little to constrain business lending among credit unions is not going to have a significant impact on commercial lending.

- Any additional commercial lending by credit unions – as a result of a new law, regulatory fiat, or otherwise – will result in a net loss of tax revenues to the federal government as taxes that would otherwise have been paid by commercial banks making those loans are not paid by tax-exempt credit unions. The most recent estimate by the Congressional Budget Office pegs the lost revenue at nearly $16 billion.

- An analysis of failed credit unions shows that those with high MBL-to-asset ratios comprise a disproportionate share of failed credit unions since 2008. While credit unions with MBLs-to-asset ratios of 10% or higher comprise only 2.7% of all credit unions, they were responsible for 14.7% of all credit union failures. Credit unions with an MBL-to-asset ratio of 27.5% or higher (more than double the current cap), comprise only 1.5% of all credit unions, they were responsible for 11% of credit failures.

- Given this, one possible result of the statutory cap being lifted would be a marked increase in credit union failures. This begs the question as to what operational advantage do credit unions have over banks in this market that allows them to make more loans, other than an increased appetite for risk.

We anticipate that an increase in the lending cap would result in little or no boost to the economy while costing the government billions of dollars of revenue and also leaving it on the hook for potentially much larger costs in the future, should credit unions embrace the amount of risk in their loan portfolio expansion that's implicitly implied by the legislation's advocates.

INTRODUCTION

The two largest associations representing credit unions in the U.S., the National Association of Federal Credit Unions (NAFCU) and the Credit Union National Association (CUNA), have made increasing the cap on member business lending for credit unions one of their top legislative priorities for 2012. A member business loan, or MBL, is a loan given by a credit union to one of its members for a commercial purpose. Under current law, with certain exceptions, the dollar amount of MBLs on a credit union's balance sheet may not exceed the lesser of 12.25 percent of the credit union's total assets or 1.75 times the credit union's net worth.[1]

1 Code of Federal Regulations, Title 12, Volume 6, Section 723.16

NAFCU and CUNA are currently lobbying Congress to pass the Small Business Lending Enhancement Act of 2012 (S. 2231 in the U.S. Senate and H.R. 1418 in the U.S.), which would increase the cap on MBLs to 27.5 percent of total assets for credit unions that meet certain criteria. Both organizations have argued that the legislation is necessary to supply loans to businesses that are not being adequately served by traditional banks, thereby increasing economic growth and creating jobs.

However, our analysis shows that letting credit unions make more commercial loans would do little for the economy: the diminution of bank lending is not due to some sort of ineluctable reluctance on their part to distribute capital but rather a sensible, profit-maximizing reaction to the weak economy as well as the natural result of a newly aggressive regulatory environment, neither of which would be greatly different for credit unions.

But more important than that is that credit unions are not well-suited to operate in the commercial loan market, lacking a stringent regulatory apparatus, ownership oversight, and—for most credit unions—expertise in making commercial loans. Expanding their ability to operate in this market would bring few benefits to the economy while potentially leading to a marked increase in credit union defaults, with its own concomitant impact on the economy and the financial sector that would be anything but salutary.

It is also unclear as to how increasing this limit will increase commercial loans to the extent the supporters of this legislation claim, given that for the vast majority of all credit unions the current limits are not even close to binding, as well as the fact that there already exist a number of loopholes that allow aggressive credit unions to evade the current commercial loan limits. While we argue that such loopholes make little sense from a policy perspective, their existence negates any need for such as increase in the cap on business lending and also blunts the impact of such a change.

A BRIEF HISTORY OF U.S. CREDIT UNIONS

To understand why the major credit union trade associations are focused on increasing the MBL cap, it helps to first understand the legislative history of credit unions in the U.S. In 1909, St. Mary's Cooperative Credit Association of Manchester, New Hampshire – now St. Mary's Bank – became the first official credit union in the country after the state legislature approved its charter.[2] The purpose of this first official credit union was to provide limited banking services to a small and closely bonded group of French-speaking immigrants from Quebec who might otherwise have been unable to bank elsewhere.

Less than a month after St. Mary's charter was approved, Massachusetts became the first state to pass a general law allowing credit unions to incorporate.[3] This law – the Massachusetts Credit Union Act of 1909 – became the basis of the Federal Credit Union Act, the first federal credit union law passed by Congress in 1934.

2 St. Mary's Bank, "Our History"
3 CUNA, "History Highlights"

From their inception, credit unions have differed from banks in that they are owned entirely by their members, not via the purchase of shares of the institution's stocks, but through mere deposits with the credit union. And rather than distribute profits to owners through share price appreciation, credit unions generally retain these earnings to be used for future loans. Dividends operate in a similar fashion, flowing only to depositor-members instead of to shareholders who may have no deposits, as is typical of traditional banks. In a credit union, each depositor effectively owns an equal share of the retained earnings generated by the credit union's lending activities: one depositor receives one vote.

Because of the unique structure of credit unions, whereby profits are re-invested instead of being paid out to stockholders, credit union proponents argue that the institutions should be treated the same as other not-for-profit organizations – namely, that they should be free from paying federal income taxes on earnings. Proponents also argue that the close member bonds and local community focus of credit unions, exemplified by St. Mary's Bank in 1909, make the financial institutions more akin to non-taxable community service organizations than traditional banks.

Although credit unions are currently exempt from most federal and state taxes, they were not originally created as tax-free financial institutions. In fact, the original 1934 law stated that federal credit unions were to be created as taxable entities with a tax burden "not to exceed the rate imposed upon domestic banking corporations."[4] It was not until the passage of the so-called Credit Union Omnibus Bill in 1937 that credit unions were granted a blanket exemption from paying federal income taxes. Only real property and tangible personal property of federal credit unions are currently subject to federal taxation.[5]

The 1934 law that created the federal credit union system limited membership in a credit union to "groups having a common bond of occupation or association, or to groups within a well-defined neighborhood, community or rural district."[6] The common bond requirement was no accident. One of the major features of the credit union model was the closely knit relationship between its members. By requiring credit unions to serve only groups with pre-existing associations or relationships, Congress effectively tapped the members of the credit union to monitor each other. It is no accident that most credit unions are "generally managed by volunteer boards of directors."[7]

The logic behind the common bond requirement was both simple and elegant: if the credit union's members knew and associated with each other, they would be less likely to default on their obligations knowing that their friends, neighbors, and co-workers would end up paying the price. The same logic can be seen from the lender's side of the table as well. The numbers and data from a credit history can be invaluable, but so too is personal knowledge, forged through a common bond, of how a potential borrower conducts himself day in and day out.

4 Thomas Jefferson Institute for Public Policy, "An Assessment of the Competitive Environment Between Credit Unions and Banks"

5 U.S. Code, Title 12, Chapter 14, Subchapter I, Section 1768

6 Social Security Administration, "The Federal Credit Union System: A Legislative History"

7 CUNA, "What Is The Credit Union Difference?"

But in 1982, in what it said was a necessary response to the fragile economic and banking environment at the time, the National Credit Union Administration (NCUA) – the independent government agency that oversees and regulates the U.S. credit union industry – began to permit federal credit unions to be composed of "multiple, unrelated employer groups," thereby eviscerating the single common bond requirement included in the 1934 law.[8]

After several years of legal wrangling, the Supreme Court ruled in 1997 that NCUA's actions were "impermissible" given the clear common bond requirement spelled out in statute. According to the Supreme Court, NCUA's misinterpretation of the law "would allow the chartering of a conglomerate credit union whose members included the employees of every company in the United States."

In response to the Supreme Court decision, Congress passed the Credit Union Membership Access Act (CUMAA) of 1998 to explicitly allow for the creation of the same types of multiple common bond credit unions chartered by NCUA beginning in 1982.

Congress affirmed the unique history and mission of credit unions and included the following findings in the 1998 law:[9]

1. The American credit union movement began as a cooperative effort to serve the productive and provident credit needs of individuals of modest means.

2. Credit unions continue to fulfill this public purpose, and current members and membership groups should not face divestiture from the financial services institution of their choice as a result of recent court action.

3. To promote thrift and credit extension, a meaningful affinity and bond among members, manifested by a commonality of routine interaction, shared and related work experiences, interests, or activities, or the maintenance of an otherwise well-understood sense of cohesion or identity is essential to the fulfillment of the public mission of credit unions.

4. Credit unions, unlike many other participants in the financial services market, are exempt from Federal and most State taxes because they are member-owned, democratically operated, not-for-profit organizations generally managed by volunteer boards of directors and because they have the specified mission of meeting the credit and savings needs of consumers, especially persons of modest means.

5. Improved unions, unlike many other participants in the financial services market, are exempt from Federal and most State taxes because they are member-owned, democratically operated, not-for-profit organizations generally managed by volunteer boards of directors and because they have the specified mission of meeting the credit and savings needs of consumers, especially persons of modest means.

8 U.S. Supreme Court, [Bench Opinion, National Credit Union Administration v. First National Bank & Trust Co. et. al.]

9 Public Law 105-219, [Credit Union Membership Access Act]

In addition to allowing credit unions to form on the basis of multiple common bonds, as opposed to the single common bond that formed the foundation of federal credit union policy for more than 50 years, CUMAA also instituted a cap on the amount of member business loans (MBLs) that could be granted. The legislation defined a member business loan as any loan that "will be used for a commercial, corporate or other business investment property or venture, or agricultural purpose[.]"

Under CUMAA, the MBL balance of a credit union cannot exceed the lesser of 12.25 percent of the credit union's assets or 1.75 times the credit union's net worth. Business loans under $50,000 are not counted toward the MBL cap, which also allows for several other exceptions that have allowed a number of credit unions – including a handful that have failed – to significantly exceed the MBL cap.

OVERVIEW OF PROPOSED BUSINESS LENDING LEGISLATION

Today, the major trade associations representing credit unions assert that the cap created by Congress is both unfair and arbitrary and that it should be increased to 27.5 percent of total assets for credit unions that meet certain criteria.

The main legislative vehicle for the increased cap on business lending is the Small Business Lending Enhancement Act of 2012 (S. 2231 in the U.S. Senate and H.R. 1418 in the U.S. House). For example, in order to qualify for the increased cap on member business lending afforded by S.2231 and H.R. 1418, a credit union must:[10]

1. Be well-capitalized (i.e., have a net worth ratio of at least 7 percent);[11]
2. Have business loans outstanding equal to at least the lesser of 9.8% of total assets or 1.4 times net worth for four consecutive quarters preceding its request for an increased cap;
3. Demonstrate that it has the policies, experience, and standards required to effectively administer and oversee the increased business loan volume.

Bending the Rules: Current Law Allows Credit Unions to make MBL in Excess of the Cap

While the credit union lobby is strongly pushing Congress to allow credit unions to expand their member business lending cap, currently set at 12.25 percent of assets, there remains a number of ways for credit unions to get around the cap. For instance, a credit union at the current cap may still make the following types of loans:

- Any loan under $50,000
- Any loan guaranteed by the Small Business Administration
- Any loan secured by a residential mortgage
- Any loan that is offered in part by another credit union
- Any loan made by a designated Low Income Credit Union

10 S.2231 (112th Congress), Small Business Lending Enhancement Act of 2012
11 NCUA, Examiners Guide, Chapter 17

Proponents of this legislation and its increased caps on member business loans have made several assertions about the effects of the proposed law which are discussed later in this paper.

THE EFFECTS OF THE FEDERAL TAX EXEMPTION FOR CREDIT UNIONS

The credit union exemption from paying federal income taxes on earnings has been a contentious issue ever since it was first implemented in 1937, several years after the enactment of legislation that created the federal credit union system. Whereas a traditional corporation must pay taxes first on its earnings before distributing taxable dividends or capital gains to its shareholders – which are also taxed – credit union earnings are never taxed by the federal government.

Proponents of the exemption argue that it is justified due to the community service aspects and not-for-profit nature of credit unions. Critics of the exemption believe that it provides an unfair competitive advantage for credit unions relative to traditional banks and that the modern credit union system no longer resembles the closely held, community-focused model that was recognized by state and federal governments in the early 20th century.

Although proponents of the federal tax exemption for credit unions are loath to admit that the special tax treatment provides the credit unions with a competitive advantage relative to traditional banks, third-party research on the subject – including research conducted by the federal government – is relatively unambiguous on the significant advantage that comes with a federal tax exemption.

In August of 2010, an economic recovery advisory board appointed by the President submitted its comprehensive report on tax reform options.[12] The report included a section discussing the effects of the federal income tax exemption for credit unions. "Unlike other financial institutions like banks and thrifts, credit unions do not pay corporate taxes on their income," the report stated. "This puts them at a competitive advantage relative to other financial institutions for tax reasons." The report's section on the special tax treatment for credit unions concluded by noting that eliminating the tax exemption would "level the playing field[.]"

The non-partisan Congressional Budget Office (CBO) also examined the credit union tax exemption in a 2009 report on ways to reduce the federal deficit.[13] According to CBO, "With their current tax advantage, credit unions can use their retained earnings to expand thus displace the services of other thrift institutions, even though the latter may provide those services more efficiently."

The U.S. Treasury Department issued an extensive report in January of 2001 that analyzed the dynamics of business lending by credit unions as well as the credit

12 President's Economic Recovery Advisory Board, "The Report on Tax Reform Options: Simplification, Compliance, and Corporate Taxation – August 2010"

13 Congressional Budget Office, "Budget Options, Volume 2 – August 2009"

unions' preferential tax treatment.[14] While credit unions face some constraints not faced by other financial institutions, Treasury found that the tax exemption provides a clear competitive advantage. "This exemption may allow credit unions to offer more competitive deposit and loan rates," the report wrote under a section entitled "Credit Unions Have Certain Competitive Advantages."

Several studies have also shown that not all of the benefits of the tax exemption flow to depositors. A 2010 study that examined the performance of credit unions and banks in Georgia found that "credit unions have a higher after tax [return on assets] than banks due to their tax exemption."[15] And a 2005 study by the Tax Foundation found evidence that "part of the tax advantage [provided to credit unions] is absorbed by costs that are higher than they would have been in a taxed, or more competitive, environment."

A 2003 study co-authored by a researcher at the Federal Reserve Bank of Atlanta and published in the Review of Financial Economics journal reported similar dynamics within single common bond residential credit unions.[16] "[R]esidential credit unions do appear to engage in expense preference behavior and misuse some portion of their tax exemption," the study reported.

In addition to providing a clear competitive advantage to credit unions even if its benefits do not flow entirely to a credit union's membership, the federal tax exemption also increases the federal budget deficit. Government and third-party estimates have consistently shown the cost of the federal income tax exemption for credit union earnings to be in the billions of dollars.

As shown in Table 1 below, independent analyses of the credit union tax exemption consistently peg its cost at more than $10 billion over ten years. Since 2001, the U.S. Treasury Department has twice estimated the cost of the tax exemption as exceeding $10 billion over a ten-year period.[17,18] More importantly, each estimate was released under the direction of a presidential administration that supported preserving the tax exemption.[19]

The Congressional Budget Office also estimated the cost of the exemption in its semi-regular report listing revenue and spending options to reduce the federal budget deficit. Its most recent estimate, released in August of 2009, pegged the ten-year cost of the exemption at $12.6 billion.

14 U.S. Treasury Department, "Credit Union Member Business Lending – January 2001"

15 Thomas G. Noland and Edward H. Sibbald, "100 Years of Credit Unions: Impact of Tax Exempt Status – The Case for Georgia"

16 W. Scott Frame, Gordon V. Karels, Christine A. McClatchey, "Do credit unions use their tax advantage to benefit members? Evidence from a cost function"

17 U.S. Treasury Department, "Comparing Credit Unions With Other Depository Institutions – January 2001"

18 U.S. Treasury Department, "Treasury Conference on Business Taxation and Global Competitiveness – Background Paper, July 23, 2007"

19 NAFCU, "NAFCU Applauds Presidential Candidates for Supporting Credit Union Tax Exemption"

The two most recent JCT estimates are on the low end compared to other estimates, while the 2005 Tax Foundation cost estimate of $31.3 billion represents the highest recent estimate. It is difficult, however, to square the January 2012 and December 2012 estimates from JCT with the same organization's January 2010 estimate. In a span of less than twelve months in 2010, the tax scoring agency radically revised its credit union tax exemption cost estimate without explanation, slashing it by over 70 percent.

When averaged together, the nine separate estimates of the federal revenue loss from the credit union tax exemption suggest a ten-year cost and equivalent credit union equity contribution of $15.9 billion.

Legislation that were to increase the ability of credit unions to make business loans that came by taking away market share of banks and other for-profit, tax-paying entities would act to reduce tax revenue as well. Any legislation that was to increase the lending ability of credit unions should be scored as costing the Treasury.

TABLE 1. SUMMARY OF COST ESTIMATES OF CREDIT UNION FEDERAL INCOME TAX EXEMPTION

Source	Estimated Cost	Applicable Years	Date Published
Joint Committee on Taxation	$2.8 billion	2011-2015	January 2012
Joint Committee on Taxation	$2.3 billion	2010-2014	December 2010
Joint Committee on Taxation	$8.2 billion	2009-2013	January 2010
Congressional Budget Office	$12.6 billion	2010-2019	August 2009
U.S. Treasury Department	$19 billion	2008-2017	July 2007
Congressional Budget Office	$21.1 billion	2008-2017	February 2007
Tax Foundation	$31.3 billion	2004-2013	February 2005
Chmura Economics	$1.89 billion	2002	May 2004
U.S. Treasury Department	$13.7 billion	2000-2009	January 2001
Average 10-Year Cost Estimate	**$15.9 billion**	**Over 10 Years**	

PROMISED EFFECTS OF PROPOSED BUSINESS LENDING LEGISLATION

Proponents of increasing the MBL cap for credit unions have made several claims about the economic effects of an increased cap. The trade associations representing the credit unions have couched their support for the Small Business Lending Enhancement Act in terms of its effects on job growth and the unemployment rate.

First, proponents of an increased cap argue that increasing the cap will immediately result in new MBLs being issued. For example, CUNA estimates that at least $14 billion worth of new MBLs will be issued in the year following enactment of an increased cap. Second, proponents argue that the $14 billion worth of new MBLs will lead to the creation of thousands of new jobs. One group estimates that over 150,000 new jobs will be created by increasing the MBL cap. Third, proponents argue that credit unions not currently issuing MBLs will significantly increase their MBL activity if the cap is increased. Fourth, proponents of an increased MBL cap argue that the bulk of the credit union beneficiaries of the increased cap will be small institutions. Finally, credit union proponents argue that an increase in the cap will not lead to higher risk or a greater likelihood of credit union failures.

NCUA, the credit union industry's federal regulator, also recently announced that it would allow over 1,000 credit unions to qualify as LICUs, a move which would make them exempt from the statutory 12.25 percent cap on member business loans. NCUA asserted that its move to exempt these credit unions from the MBL cap would give small businesses "the money needed to open their doors, create jobs, or expand operations" to help the country's economy.[20]

EXPECTED EFFECTS OF PROPOSED BUSINESS LENDING LEGISLATION

An analysis of the balance sheets and business loan portfolios of the over 7,000 credit unions that have filed 2012 call reports with NCUA makes it difficult to believe that an increased cap on business loans will create the results promised by its proponents.

Most Credit Unions Are Nowhere Near the Current MBL Cap. At least one estimate provided by increased MBL cap proponents assumes that total member business lending will increase by $14.1 billion – over 34 percent – in the first year alone due to an increase in the cap on member business loans from 12.25 percent to 27.5 percent of total credit union assets. This assumption is highly problematic for several reasons.

First, as shown below in Table 2, the vast majority of credit unions – over 70 percent – make no business loans to members at all. And only a tiny minority of credit unions – 85 out of a total of 7,165, or 1.2 percent – find themselves bumping up against the current cap on member business loans.

TABLE 2. DISTRIBUTION OF U.S. CREDIT UNIONS BY MBLS AS A % OF ASSETS

MBL-to-Asset % Interval	No. of Credit Unions	Avg. MBL-to-Asset %	% of Credit Unions
No Member Business Loans	5,045	0.0%	70.4%
Between 0% and 5%	1,616	1.5%	22.6%
Between 5% and 7.5%	179	6.1%	2.5%
Between 7.5% and 10%	131	8.9%	1.8%
Between 10% and 12.25%	85	11.0%	1.2%
Between 12.25% and 27.5%	63	18.0%	0.9%
Above 27.5%	46	48.2%	0.6%
Total	**7,165**	**3.4%**	**100.0%**

Source: NCUA call reports (quarter ending in March of 2012)

20 Credit Union Times, "NCUA Launches Low-Income Credit Union Blitz in MBL Boost"

In both a letter it sent to the chairman and ranking member of the Senate Banking Committee in March of 2012 and a detailed document posted on its website, CUNA listed several assumptions it made in estimating the new loans and jobs it expected to see one year after the enactment of the Small Business Lending Enhancement Act:

1. Only credit unions with net worth-to-asset ratios of at least 6 percent would increase their MBL holdings.

2. Credit unions with net worth-to-asset ratios between 6 and 7 percent would not exceed the MBL cap of 12.25 percent relative to total assets as a result of increased MBL lending.

3. Well-capitalized credit unions with a net-worth-to-asset ratio of at least 7 percent could increase their MBL holdings above the 12.25 percent cap.

4. Credit unions that did not currently issue business loans would issue MBLs equal to 0.4 percent of total assets one year following enactment of the legislation.

5. Institutions with MBL-to-asset ratios currently in excess of 12.25 percent would not increase MBL lending.

6. Credit unions with MBL-to-asset ratios above 0 percent but below 10 percent would increase MBL holdings by 40 percent in the first year, while those between 10 percent and 12.25 percent would increase MBL holdings by 30 percent.

By using data culled from call reports submitted to NCUA for the first quarter of 2012, it is possible to reconstruct the increased lending estimates released by CUNA. Because CUNA used data in addition to that provided in the call reports submitted to NCUA by the credit unions, the reconstructed estimate will not perfectly mirror CUNA's original estimates. The data produced by the reconstructed estimate is not an endorsement of the assumptions made by CUNA. However, it is necessary to conduct an independent analysis of the assumptions in order to determine which credit unions will be responsible for the bulk of the increased MBL activity promised by CUNA.

Table 3 below shows, using CUNA's assumptions about business loan growth based on March 2012 NCUA call report data submitted by 7,615 credit unions, which types of credit unions will be responsible for the bulk of the increased MBL activity. This distributional analysis provides a strong rejoinder to the claims of CUNA and NAFCU that increasing the MBL cap is necessary to spur new lending.

As Table 3 shows, nearly 80 percent of increased business loan volume will come from credit unions that are not even close to approaching the current cap on MBLs. In fact, even after accounting for the $8.1 billion worth of new loan activity projected using CUNA's assumptions about loan growth, the MBL-to-asset ratio for the 1,839 well-capitalized credit unions making those loans will be less than 4 percent. Only 83 credit unions that currently bump up against the cap – those with MBL-to-asset ratios between 10 percent and 12.25 percent – will increase MBL volume based on CUNA's assumptions. These 83 credit unions represent barely 1 percent of all credit unions that filed call reports for the first quarter of 2012.

TABLE 3. SOURCE OF INCREASED BUSINESS LOANS ONE YEAR AFTER MBL CAP INCREASE (CUNA ASSUMPTIONS)

Current Metrics	No. of CUs Increasing MBLs	New MBLs ($)	New MBL-to-Asset %
No Member Business Loans	4,956	$791,564,302	0.4%
Net Worth Ratio Btw. 6% and 7%			
0% and 10% MBL-to-Asset Ratio	51	$157,080,448	3.0%
10% and 12.25% MBL-to-Asset Ratio	4	$2,577,977	12.1%
Net Worth Ratio 7% or Higher			
0% and 10% MBL-to-Asset Ratio	1,839	$8,109,229,170	3.9%
10% and 12.25% MBL-to-Asset Ratio	79	$1,241,039,354	13.6%
Total	**6,929**	**$10,301,491,252**	**4.4%**

Source: Data from NCUA call reports, CUNA assumptions for first-year increased loan following increase in MBL cap

Credit Unions With No MBLs Are Unlikely to Initiate MBL Activity. While it does make intuitive sense that credit unions up against a lending cap might be constrained in their ability to make new loans, it makes far less sense to assume that firms that are nowhere near the 12.25 percent cap would suddenly be motivated to initiate or increase activity if a 27.5 percent cap were implemented. For example, CUNA assumes that 98.2 percent of firms that currently have no outstanding MBLs will suddenly initiate MBL programs if the MBL cap is increased.

Proponents of the increased cap argue that its mere existence serves as a deterrent to firms that might want to issue business loans. They assert that the up-front fixed costs of hiring, training, and retaining the right staff to evaluate and monitor credit risk do not outweigh the benefits of being in the MBL business if a cap on lending activity exists. The 14 years worth of data available following the original enactment of the MBL cap in 1998 show these concerns to be completely invalid.

Of the 11,249 credit unions that submitted call reports to NCUA before the MBL cap was enacted as part of CUMAA, 9,693 of them – over 86 percent – reported no business lending activity whatsoever. A mere 91 credit unions out of more than 11,000 – less than 1 percent – reported an MBL balance that exceeded 12.25 percent of total assets. Only 20 credit unions reported MBL-to-asset ratios between 10 and 12.25 percent. And the 3.4 percent MBL-to-assets ratio for the entire credit union industry today is nearly four times higher than the 0.9 percent reported 14 years ago, before the MBL cap was ever instituted. Over that time, the total amount of MBLs outstanding has increased by $31.1 billion, from $3.2 billion in June of 1998 to $34.4 billion.

If a cap on business loan activity does act as a deterrent to initiate those loans, then it is difficult to explain why the amount of MBLs issued by credit unions has increased by a factor of ten following the enactment of an MBL cap in August of 1998.

Understanding estimates of increased business loan activity offered by proponents of a higher MBL cap is crucial because the loan estimates form the foundation of the trade group's promises of job growth. For example, CUNA has repeatedly asserted that if the Small Business Lending Enhancement Act became law, "[C]redit unions could lend an additional $13 billion to small businesses, helping them create 140,000 new jobs in the first year after enactment[.]"[21] In a separate document breaking out new jobs by state, CUNA estimated that a total of 153,486 new jobs would be created by increasing the MBL cap.

Job Growth Estimates Are Not Credible. Job growth estimates provided by proponents of a higher MBL cap are highly questionable because they are based on a single assumption that has proven to be inaccurate. According to one estimate of state-by-state job growth resulting from a higher MBL cap, each $92,000 of increased MBL activity would create one new job.[22] The defense of the $92,000-per-job assumption is that the White House made the same job growth assumption when it predicted the effects of the American Recovery and Reinvestment Act, otherwise known as the 2009 stimulus bill.

Yet even if the $92,000-per-job figure made sense in 2009 before the stimulus bill was enacted, it makes little sense now that more than three years have passed and its accuracy can be tested. At the time, the White House Council of Economic Advisers published a report predicting that enactment of the $787 billion stimulus bill would create 3.5 million new jobs by the fourth quarter of 2010 and 6.8 million new jobs by the end of 2012. If job growth can be predicted via something as simple as the amount of dollars expended, then it makes sense to update that job growth assumption using real jobs data going back to February of 2009 when the stimulus bill was enacted.

According to data from the U.S. Bureau of Labor Statistics, the level of non-farm payroll employment immediately prior to the enactment of the stimulus bill was 132.8 million. By the end of the fourth quarter of 2010, employment actually fell by nearly 2.5 million jobs. The $92,000-per-job assumption predicted growth of 3.5 million, an overestimation of roughly 6 million jobs. If the actual jobs data are used to predict new jobs per dollar spent, then the $14 billion in new lending predicted by proponents of a higher MBL cap would actually *decrease* employment by more than 152,000 jobs.

Using the same employment benchmark and comparing it to employment levels in July of 2012, the latest month for which data are available, total employment has increased by 408,000. If every single new job created since is attributed to the 2009 stimulus, then the most accurate job-per-dollar spent assumption would be $1.92 million per job, which suggests that the increased MBL activity predicted by the $92,000-per-job assumption would only increase total U.S. employment by 7,320 jobs.

21 CUNA, March 6, 2012 letter to the Senate Banking Committee

22 CUNA, "Estimated 1st-Year Increases in Member Business Lending at Credit Unions"

But what if February of 2009 is not the correct employment benchmark? What if the non-farm payroll employment trough of February of 2010 is used as the benchmark instead, and all jobs created since are assumed to have been created by the $787 billion stimulus bill? In February of 2010, employment bottomed out at 129.2 million. As of July of 2012, the latest month for which payroll data are available, the level of non-farm payroll employment was 133.2 million, an increase of 4 million jobs. Even using those incredibly generous (and unrealistic) assumptions – whereby every single job created is attributed to the 2009 stimulus bill – the new job per dollar figure would equal $196,700. That figure would cut CUNA's job growth estimates in half, from 153,486 to roughly 72,000.

Regardless of which month is used to evaluate the accuracy of the jobs-per-dollars estimate, the job growth forecasts offered by proponents of a higher MBL cap are highly suspect, based on assumptions that make little economic sense, and far rosier than real world data observed over the last three years suggest they should be.

A Handful of Large Credit Unions Will Benefit Disproportionately. Contrary to claims that small credit unions will be the biggest beneficiaries of an increase in the MBL cap, an analysis of NCUA call report data using CUNA's loan growth assumptions shows that larger credit unions will be responsible for the bulk of increased MBL volume if the MBL cap is increased. As Table 4 below shows, nearly 80 percent of the increased MBL dollar volume will come from credit unions with average assets that are 2.7 times higher than the average credit union.

CUNA rests its claim that small credit unions will benefit most from a higher cap on the assumption that credit unions with no current MBL activity will suddenly initiate MBL programs after the MBL cap is lifted. Even if this assumption is current, those credit unions – with average assets of $39.9 million – will be responsible for only 7.7 percent of additional MBL volume according to CUNA's own assumptions. The data clearly show that larger credit unions, with average assets approaching $400 million, will disproportionately benefit from the increased MBL cap.

TABLE 4. AVERAGE TOTAL ASSETS OF CREDIT UNIONS WITH INCREASED MBL ACTIVITY (CUNA ASSUMPTIONS)

Current Metrics	% of Increased MBL Activity	Avg. Assets	% of Industry Assets
No Member Business Loans	7.7%	$39,929,596	19.5%
Net Worth Ratio Btw. 6% and 7%			
0% and 10% MBL-to-Asset Ratio	1.5%	$365,926,744	1.8%
10% and 12.25% MBL-to-Asset Ratio	0.0%	$63,262,245	0.0%
Net Worth Ratio 7% or Higher			
0% and 10% MBL-to-Asset Ratio	78.7%	$394,171,798	71.4%
10% and 12.25% MBL-to-Asset Ratio	12.0%	$486,656,888	3.8%
Banks Not Eligible to Increase MBLs	0.0%	$146,752,450	3.4%
Total	**100.0%**	**$141,628,444**	**100.0%**

Source: Data from NCUA call reports, CUNA assumptions for first-year increased loan dollar volume following increase in MBL cap

Increased MBL Activity Increases Risk. If proponents of a higher MBL cap are correct that credit unions bumping up against the MBL ceiling will increase their MBL activity if the ceiling is lifted, then it begs the question of whether the current regulatory regime, which would be left relatively untouched by the proposed MBL legislation, is adequate to monitor the increased risks. Table 5 below suggests that increased MBL activity is inherently risky and that NCUA may not have the tools, expertise, or willingness to crack down on irresponsible lending activity.

Even though credit unions with MBL-to-assets greater than 27.5 percent make up only 1.5 percent of all credit unions, they comprised 11 percent of all credit union failures since 2008. The opposite dynamic is visible when it comes to credit unions with no member business loans at all. Despite comprising more than 70 percent of all credit unions, institutions with no business lending activity comprised less than 65 percent of failures. The likelihood of a group of credit unions being overrepresented amongst failed firms increased as its ratio of business loans to total assets increased.

TABLE 5. DISTRIBUTION OF FAILED NON-CORPORATE U.S. CREDIT UNIONS SINCE 2008

MBL-to-Asset % Interval	Failures	Avg. MBL-to-Asset %	% of Failures	% of Credit Unions
No Member Business Loans	53	0.0%	64.6%	70.4%
Between 0% and 10%	17	4.0%	20.7%	26.9%
Between 10% and 12.25%	3	10.8%	3.7%	1.2%
Above 27.5%	9	30.7%	11.0%	1.5%
Total	**82**	**13.5%**	**100.0%**	**100.0%**

Source: NCUA call reports, press releases announcing failures from 2008 through August of 2012

EXPECTED EFFECTS OF EXPANDED LICU ELIGIBILITY

On August 7, NCUA announced that it would allow over 1,000 credit unions to be designated as low-income credit unions (LICU) if they so chose. One of the primary benefits of being designated as a LICU is the elimination of the MBL cap. In a press release announcing the regulatory move, NCUA asserted that its actions could increase member business lending at the institutions by up to $500 million if all eligible credit unions chose to participate.

A closer examination of the data, however, calls into question the claims made by NCUA. As shown in Table 6 below, the vast majority of newly eligible LICUs – over 77 percent – do not currently issue member business loans at all. In fact, 98.4 percent of the newly eligible LICUs have MBL-to-asset ratios of less than 7.5 percent – nowhere near the 12.25 percent statutory cap that is waived for LICUs. According to NCUA call report data as of March of 2012, only 16 of the 1,000 newly eligible credit unions currently bump up against the statutory MBL cap.

TABLE 6. DISTRIBUTION OF LICU-ELIGIBLE U.S. CREDIT UNIONS BY MBLs AS A % OF ASSETS

MBL-to-Asset % Interval	No. of Credit Unions	Avg. MBL-to-Asset %	% of Credit Unions
No Member Business Loans	774	0.0%	77.4%
Between 0% and 5%	190	1.4%	19.0%
Between 5% and 7.5%	20	6.0%	2.0%
Between 7.5% and 10%	7	8.6%	0.7%
Between 10% and 12.25%	6	11.1%	0.6%
Above 12.25%	3	24.7%	0.3%
Total	**1,000**	**2.1%**	**100.0%**

Sources: NCUA-provided list of LICU-eligible credit unions, NCUA call report data as of the quarter ending in March of 2012

An analysis of the asset base of the newly eligible LICUs also sheds doubt on the claim of an additional $500 million in member business lending activity due to NCUA's regulatory gambit. Table 7 below shows that of the roughly $1.9 billion in outstanding MBLs issued by the newly eligible LICUs, over $1.3 billion sits with credit unions with MBL-to-asset ratios of less than 7.5%. The credit unions currently approaching the MBL cap – those with MBL-to-asset ratios greater than 7.5% – hold approximately $600 million in outstanding MBLs. These credit unions would need to nearly double their MBL activity in order to meet NCUA's expanded MBL targets. Absent any change in the current regulatory and oversight regimes, such an extensive ramp-up in business lending activity would likely carry with it a much higher likelihood of loan defaults and credit union failures.

TABLE 7. DISTRIBUTION OF MBLs BY THEIR LOAN-TO-ASSET LEVEL

MBL-to-Asset % Interval	MBLs Outstanding ($)	% of MBLs Outstanding	Avg. Assets ($)
No Member Business Loans	$0	0.0%	$36,680,311
Between 0% and 5%	$721,769,974	37.3%	$252,817,630
Between 5% and 7.5%	$600,782,449	31.1%	$511,306,773
Between 7.5% and 10%	$219,760,838	11.4%	$374,513,721
Between 10% and 12.25%	$129,450,175	6.7%	$200,534,068
Above 12.25%	$262,068,906	13.6%	$556,741,983
Total	**$1,933,832,342**	**100.0%**	**$92,147,072**

Sources: NCUA-provided list of LICU-eligbile credit unions, NCUA call report data as of the quarter ending in March of 2012

If the credit unions that are closest to the current MBL cap are the most likely to benefit from NCUA's expanded access to the LICU designation, it appears that large credit unions will benefit disproportionately from NCUA's move. For example, while the newly eligible credit unions with zero MBL activity have average assets of $36.7 million, the 16 credit unions with MBL-to-asset ratios in excess of 7.5 percent have average assets in the hundreds of millions of dollars. Three of the credit unions that currently operate above the MBL cap – a cap that would be waived entirely should they choose to be designated as LICUs – have average assets in excess of half a billion dollars.

Just as the Small Business Lending Enhancement Act of 2012 appears to favor a handful of a large credit unions, so too does the NCUA's latest move to allow some credit unions to become LICUs and avoid the MBL cap altogether.

CONCLUSION

Increasing the cap placed on credit unions on the amount of member business loans they can make promises few benefits—concentrated in a small number of credit unions—but adds the risk of significant costs to taxpayers and the economy should more credit unions fail as a result of the policy change.

The current MBL cap constrains very few credit unions. Most are nowhere near the number of business loans they can make and for good reason: making such loans is not typically the core competency of a credit union, and it certainly falls outside the purview of the original intent of a credit union in the first place. Most of the credit unions that wish to be more aggressive in providing business loans can avail themselves of any of a number of loopholes and easily exceed the cap. Over thirteen percent of all credit unions currently are over the MBL cap.

There is no reason to think that increasing the cap will provide any sort of economic stimulus as claimed by the credit union associations. The ostensible "loan drought," to the extent that such a thing exists, is the result of heightened scrutiny by regulators and a natural caution on the part of banks to not extend themselves too far in an uncertain, mediocre economic climate. It is unclear why credit unions would face an environment any different than that which banks face, or why they would behave any differently than banks.

CASE STUDY – MEMBER BUSINESS LOANS AND THE FAILURE OF TELESIS COMMUNITY CREDIT UNION

The failure and final liquidation of Telesis Community Credit Union came as no surprise to anybody who followed the financial reports regularly submitted by the California-based institution. For years it was allowed by federal regulators to maintain a ratio of business loans-to-total assets that approached 50 percent – roughly four times higher than permitted by law. Unfortunately for Telesis, a significant number of those loans were delinquent. When the credit union was liquidated in June of 2012, nearly half of those bad business loans had been delinquent for over a year.

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Business Lending Losses Bring Down Telesis

MBL Program in Downward Sprial Since at Least 2010

BY MICHELLE A. SAMAAD
April 1, 2012 • Reprints

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Since at least 2010, Telesis Community Credit Union's member business loan program has been in a downward spiral.

Telesis was deemed "Undercapitalized" by federal regulators in September of 2011 and again in December of the same year. But that didn't force its management to change course. During the first quarter of 2012, when it was declared "Critically Undercapitalized," it nonetheless increased its balance of member business loans by another \$2 million. By the time Telesis was shut down in June of 2012, the amount of delinquent business loans – nearly \$16 million – exceeded the bank's entire net worth by a factor of four, notwithstanding the federal law capping a credit union's entire business loan portfolio at 1.75 times net worth. The business loan portfolio of Telesis was more than 36 times larger than its net worth when its doors were finally shut.

The causes of the credit union's failure were neither complicated nor novel. In the end, poor management and poor oversight were the culprits. At the end of 2010, a year in which Telesis CEO Grace Mayo took home \$2.1 million, the call reports submitted by the credit union to its federal regulator showed Telesis to be "Undercapitalized."Over \$30 million worth of business loans, which comprised more than half of the credit union's assets, were delinquent. And \$7.5 million in bad loans that year – two-thirds of which were member business loans – were written off as uncollectible.

Ironically, the demise of Mayo's credit union was due in large part to a business loan problem that she swore would be no problem at all. In 2006, Mayo testified before Congress on behalf of CUNA and told lawmakers about the unfairness of the cap on member business loans. Her written statement said the limit was "arbitrary and unnecessarily restrictive" and that it "discourages credit unions from entering into business lending."

But the real coup de grace was Mayo's claim before Congress that "there is no safety and soundness reason" to cap business loans at 12.25 percent of total credit union assets. When Mayo's credit union was finally shut down and declared insolvent, business loans comprised 47 percent of her credit union's remaining assets.

Perhaps Grace Mayo and the Telesis Community Credit Union should have been discouraged from entering into business lending.