# Banks v. Credit Unions: Old Rivalry, New Developments

NIXON PEABODY

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# INTRODUCTION:

- Who We Are
- The Credit-Union Universe: In The Swirl of Change

# MARKET DRIVERS:

1. The technology explosion: the speed of data transfer, the ubiquitous nature of the internet, and algorithmic analysis.

2. Online lending/online credit shopping.

3. Competition from other sources of lending . . . and not just banks.

# THE LITIGATION:

Significant efforts by both state and federal regulators to enhance the profitability of credit unions. But this doesn't come without pushback or risk—which brings us to our two cases.

- *Independent Community Bankers of America v. National Credit Union Administration* (E.D. Va.)
- *American Bankers Association v. National Credit Union Administration* (D.D.C.)

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# THE GOAL:

The Lens Through Which to View These Cases:

- What are the implications for credit-union lending?
- What are the implications for regulators?
- What will be the long-term impact on the industry?

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# *ICBA v. NCUA*

*Independent Community Bankers of America v. National Credit Union Administration*, Case No. 16-cv-1141 (United States District Court for the Eastern District of Virginia)

# OVERVIEW:

- ICBA sued NCUA to enjoin enforcement of NCUA's 2016 proposed rule on participation interests in nonmember business loans ("2016 MBL Rule").

- **Policy Rationale**: Excluding nonmember participation interests from statutory lending limits places community banks at competitive disadvantage with tax-exempt credit unions.

- **Legal Argument:** The 2016 MBL Rule is "arbitrary and capricious" and exceeds the scope of NCUA's regulatory authority.

# RELEVANT LAW #1:

- Section 1757a of the Federal Credit Union Act caps the amount of "member business loan[s]" that a federally insured credit union may hold on its balance sheet. *See* 12 U.S.C. § 1757a.

- "Member business loan" is "any loan . . . the proceeds of which will be used for a commercial, corporate or other business investment property or venture . . . ."

- No member business loans in excess of 1.75 times net worth or 12.25% of total assets.

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# RELEVANT LAW #2:

- 2003 MBL Rule – Federally insured credit unions' purchase of participation interests in loans to nonmember borrowers no longer counts toward Section 1757a lending limits.

- Purchasing participation is not equivalent to making loan to member.

- **But**, agency approval is required for any purchase exceeding lending limits.

# RELEVANT LAW #3:

- 2016 MBL Rule – Agency approval is **no longer** required for purchasing participation interests in nonmember business loans in excess of statutory lending cap.

- Prudential considerations apply:

  - Is there sufficient collateral to cover the risk of loss?

  - Are there adequate risk-mitigating factors to justify the investment?

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# THE COURT'S DECISION:

(1) ICBA did not have standing to sue on behalf of its members.

- Allegations of competitive injury were too speculative to sustain the case.

(2) Action was barred by the statute of limitations.

- Since complaint essentially challenged 2003 MBL Rule, and since any challenge to that rule was subject to a six-year statute of limitations, ICBA filed its suit too late.

(3) NCUA's promulgation of the rule was not arbitrary and capricious.

- It was based on a deliberative process entitled to substantial deference.

# PRACTICAL IMPLICATIONS:

- Federally insured state-chartered credit unions are affected.
- Expanded involvement in commercial lending.
- Greater need for understanding complex commercial loans.
- Participating credit unions aren’t primary underwriters but can be held responsible for loan outcome.

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# REGULATORY RESPONSE #1:

Directors and officers need to:

- Understand their fiduciary duties of loyalty and care.
- Understand the market and monitor trends.
- Regularly audit the portfolio and its embedded risk.
- Ignorance is no excuse nor is it a defense to poor lending decisions.

# REGULATORY RESPONSE #2:

Regulators need to:

- Test the credibility of loan-presentation materials.
- Test whether directors and officers understand borrowers' financials.
- Carefully record the materials received and relied upon.

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# *ABA v. NCUA*

*American Bankers Association v. National Credit Union Administration*, Case No. 16-cv-2394 (United States District Court for the District of Columbia)

# OVERVIEW:

- ABA sued NCUA to enjoin enforcement of NCUA's 2016 final rule expanding field of membership for federally chartered credit unions ("2016 Membership Rule").

- **Policy Rationale**: Membership expansion places community banks at competitive disadvantage with tax-exempt credit unions as both industries seek new depositors.

- **Legal Argument:** The 2016 Membership Rule is "arbitrary and capricious" and exceeds the scope of NCUA's regulatory authority.

# RELEVANT LAW #1:

- Section 1759 of the Federal Credit Union Act limits a community credit union's field of membership to "[p]ersons or organizations within a well-defined local community, neighborhood, or rural district." *See* 12 U.S.C. § 1759(b)(3).

- No legislative definition of "local community" or "rural district."

- Congress empowered NCUA to "prescribe, by regulation, a definition for the term 'well-defined community, neighborhood, or rural district.'"

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# RELEVANT LAW #2:

- 1998–2013 NCUA rules – Gradual shift toward bright-line rules for evaluating charter applications.

- Initially required charter applicant to provide "narrative summary" supporting its contention that the area it intended to serve was a "well-defined" local community or qualifying "rural district."

- Agency moved toward discrete statistical categories with population limits to make rules more easily administrable.

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# RELEVANT LAW #3, PART 1:

- 2016 Membership Rule – Expands geographic areas that satisfy Section 1759(b)(3)'s field-of-membership requirements.

- **Combined Statistical Area**: Creates new statistical category that defines community to include a combined-statistical area, or portion thereof, of up to 2.5 million people.

- **Core-Based Statistical Area**: Eliminates requirement that communities defined by "core-based statistical" area must include the core area; still includes up to 2.5 million people.

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# RELEVANT LAW #3, PART 2:

- **Adjacent Area**: Permits the addition of an "adjacent area" to a single political jurisdiction, qualifying combined statistical area, or qualifying core-based statistical area, subject to a population limit of 2.5 million people; charter applicant must convince NCUA that adjacent area qualifies as part of local community.

- **Rural District**: Increases population limit for a "rural district" from a quarter million to one million people; "rural" still means that 50% of population resides in units Census Bureau designates as "rural" or that population density is less than 100,000/sq. mi.

# ISSUES BEFORE THE COURT, PART 1:

- Is a statistical area or core-based statistical a "well-defined local community" within the meaning of Section 1758(b)(3) of the FCUA?
  - Banks: Credit unions must serve one truly local community that's not spread out across a geographic area encompassing multiple unrelated communities.
  - NCUA: Agency has regulatory discretion; a "local" community need not be a particularly small one.
- Is an "adjacent area" a "well-defined local community" within the meaning of Section 1758(b)(3) of the FCUA?
  - Banks: By definition, no. Mere interaction across a border isn't enough to satisfy this requirement.
  - NCUA: Not ripe for review; wait to resolve challenge to particular charter application.

# ISSUES BEFORE THE COURT, PART 2:

- Does the new definition of a "rural district" exceed the scope of that term as intended by Congress in Section 1758(b)(3) of the FCUA?
  - Banks: A "rural district" must be both rural and relatively small; the 2017 Membership Rule quadruples the numeric limit of such a district's population to one million, encompassing entire states, including sparsely populated ones with primarily urban populations.
  - NCUA: Agency has regulatory discretion; a "local" community need not be a particularly small one; no substantial change from prior rule, under which NCUA approved eight charters for credit unions serving rural districts with average population of 536,646.

# PRACTICAL IMPLICATIONS:

- Expanded membership means increased lending volume.
- Dovetails with increased business lending.
- Will state governments further expand field of membership at the state level?

# REGULATORY RESPONSE:

- Follow the litigation.
- Compare state field-of-membership rules to expanded federal field-of-membership rules—will any of your credit unions be incentivized to alter their charters?
- Monitor affected credit unions within your jurisdiction.

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# TAKEAWAY POINTS:

1. NCUA has broad discretion to alter regulatory landscape.
2. Volume and complexity of credit-union lending is expanding.
3. Encourage continued training.
4. Encourage organizational audits.
5. Encourage financial literacy.
6. Encourage directors and officers to retain outside professionals/vendors to assist.
7. The pressure to professionalize.

# OTHER RESOURCES:

- *ICBA v. NCUA*: the legality of relaxed restrictions on non-member business lending, Commercial Litigation Alert, Nixon Peabody LLP, December 2016

- *ICBA v. NCUA*: case dismissed, for now, Commercial Litigation Alert, Nixon Peabody LLP, February 2017

- *ABA v. NCUA*: the legality of expanded fields of membership for credit unions, Commercial Litigation Alert, Nixon Peabody LLP, August 2017

# THANK YOU!

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