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**CREDIT UNION INDUSTRY
CONSOLIDATION
IN THE 1990s**

by

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INTRODUCTION

Dramatic changes have taken place in the financial services industry in the United States over the last quarter century. This has been the era of deregulation in financial services and it has dramatically affected every institution operating within the industry. The objective of this study is to examine forces influencing the changing structure of the credit union industry as it competes with larger financial services entities.

In the years before deregulation, there were clear lines of distinction between depository institutions operating in the financial services marketplace. The largest participants, measured by assets or operating income, were the commercial banks whose primary characteristics were the offering of checkable deposits and the making of commercial loans. Mutual savings banks and savings and loan associations offered passbook savings accounts and made residential mortgage loans. Credit unions offered share savings accounts on which they paid dividends and made consumer installment loans to their members.

In the last three decades, the unique characteristics and distinctions of these institutions have blurred. Each group has expanded and diversified its product and service offerings to both lenders and borrowers. As new opportunities for providing financial services have developed, there has been increased competition from other market segments. Full service brokerage houses, money market mutual funds and mutual fund families have created new savings and investment instruments, advertising and marketing them nationwide. With the repeal of the Glass-Steagall Act in 1999, the “one-stop” financial services institution became a reality.

In terms of total assets, as well as average assets per institution, credit unions are the smallest “players” in the financial services industry. Therefore it would be easy to conclude that in this increasingly competitive marketplace, their position would be the most likely to deteriorate, vis-à-vis larger more diversified firms. Yet the operating performance of the industry has been extraordinary. Operating data analyzed in this study show clearly how the industry has grown and evolved to meet the financial services needs and desires of its growing membership base while experiencing significant consolidation.

COMPETITIVE PERSPECTIVE IN FINANCIAL SERVICES

The structure of the credit union industry has evolved over the last quarter century influenced by both internal and external forces. Inside the industry, data will show enhanced efficiencies due to asset size, providing members with expanded services at competitive prices. External forces have also been contributing to the structure and shape of the industry. The competitive landscape of financial services has created challenges and opportunities that must be addressed by credit union managers, boards of directors, and government regulators.

Since the commercial banking segment of the financial services industry is the largest in terms of assets, branches, products, etc., it has had an impact on shaping every institution in the marketplace. In the 1990s, two key pieces of legislation have had a direct impact on commercial bank structure and an indirect impact on other players in financial services.

In September of 1994, Congress passed the Riegle-Neal Interstate Banking and Branching Efficiency Act allowing banks and bank-holding companies to establish branches across state lines. This proved to be the final stage of a decades long process of bank branching deregulation in the United States whose restrictions date from the Banking Act of 1933. Along with the relaxation of state restrictions on statewide and interstate branching in the 1970s and 1980s, higher asset concentrations in the banking industry have been observed for decades.⁽¹⁾

In addition to first reducing and ultimately eliminating branching restrictions, important technological innovations have contributed to concentration throughout the financial services industry. The computer revolution for data gathering, analysis, and storage and the growth of ATM utilization by the public have had an impact on industry structure. The efficiency gains are greatest in large high-tech financial institutions with bank customers and members of credit unions deriving the benefits of lower product costs and enhanced speed of transaction execution.

In November of 1999, Congress passed the Gramm-Leach-Bliley Financial Services Modernization Act, allowing affiliations among banks, securities firms, and insurance companies. This act effectively created a new type of institution, the financial holding company, which could now offer banking, securities, and insurance products under one roof. By July of 2001, 558 financial holding companies had been formed, with 19 of the 20 largest banks in the U.S. belonging to a financial holding company.⁽²⁾

Other provisions of the Gramm-Leach-Bliley Act are intended to increase competition and efficiency not only within the banking industry but throughout all financial service institutions. These changes affect the flows of entry and exit by institutions, the optimum size and scale of operations, growth prospects, and the degree of horizontal and vertical integration of servicing entities providing financial services.

In response to regulatory changes in the financial services industry of the 1990s, the Credit Union Membership Access Act of 1998 was critical to this market segment. In an environment of larger more diversified competitive institutions, credit unions had to have the ability to attract more members by expanding their “field of membership.” Under the Federal Credit Union Act of 1934, membership was limited to “individuals sharing a common bond of occupation, association, or geographic area.” In 1982, the National Credit Union Administration (NCUA) interpreted this common bond

(1) Ennis, Huberto M., “On the Size Distribution of Banks,” *Economic Quarterly*, Federal Reserve Bank of Richmond, Volume 87/4, Fall, 2001. pp.1-25

(2) Ibid.

requirement to allow certain credit unions to add multiple groups to their membership as “select employee groups” or SEG’s. In early 1998, the Supreme Court ruled against the NCUA and its interpretation of the common bond requirement. Later that year the Credit Union Membership Access Act expressly allowed for the addition of multiple groups to a credit union’s field-of-membership.⁽³⁾

Limited membership of federally chartered credit unions has created portfolio concentration risks over the years. By expanding and diversifying fields-of-membership, these risks can be mitigated, thus providing enhanced products and services to members.

CREDIT UNION INDUSTRY OVERVIEW

Credit union industry membership grew by almost 18 million in the 1990s from 61.1 million in 1991 to 78.9 million in 2000 and 80.7 million in 2001. This represented an average annual growth rate of 2.8 percent, almost three times the growth rate of the U.S. population (1.01 percent per year).

Table 1 presents credit union members grouped by the asset size of the credit unions to which they belonged. There has been a steady exodus of members in all asset categories below \$50 million. All the growth in membership has taken place in the four asset categories from \$50 million up to the \$500 million plus group. Upon further examination, there was a 23.7 million member increase in just those credit unions with assets of \$200 million and higher. This consolidation trend, especially in the larger asset size credit unions, is the significant story of the last decade.⁽⁴⁾

The number of operating credit unions has declined steadily over the last eleven years, from 13,524 in 1991 to 10,206 in 2001. In Table 2, data show that there has been a decline in the number of credit unions with assets below \$10 million. Every other category has grown in numbers from a 2.9 percent increase in the \$10-20 million category to a 323.1 percent increase in the \$500 million plus group. The sharpest decline was experienced by the smallest asset size group, those with assets under \$500,000. Almost two-thirds of all these credit unions have disappeared in the last decade. No doubt most of them either grew in size or merged with larger credit unions.

Table 3 presents member assets held by various asset size credit unions. Once again, it is clear that there has been a significant shift in funds toward the larger institutions. Smaller credit unions with assets below \$10 million have seen declines in asset holdings, while those above \$10 million have attracted funds. Also the larger the asset category the greater the asset growth, while the smaller the asset category the larger the decline in asset holdings.

(3) Frame, W. Scott, Gordon V. Karels, and Christine McClatchey, “The Effect of the Common Bond and Membership Expansion on Credit Union Risk,” *Working Paper 2001-10* Federal Reserve Bank of Atlanta, April 2001.

(4) All data in this study cover an eleven-year period from 1990 through 2001.

FACTORS UNDERLYING CREDIT UNION CONSOLIDATION

Credit union members desire the best terms for the products and services available from the financial services marketplace. As members, they have already decided to save with their credit union. Therefore, they must have “comparison shopped” and determined that their credit unions savings rates equaled or surpassed those of other financial institutions.

From data in Table 4, it may be observed that within the credit union industry there is a positive relationship between the level of savings rates and the size of the credit union. For every year of the period under analysis, larger credit unions paid out higher average savings rates to their members. Larger credit union (assets over \$50 million) payouts were 30 to 40 percent higher each year than those paid out by the smallest asset categories (under \$5 million)! The \$500+ million asset group has paid interest rates above the “all credit union” category every year of this study. Credit unions under \$100 million have paid lower rates each year, while the \$100 million to \$500 million asset groups generally paid approximately the overall industry average rates. For individuals who are members of more than one credit union, it is not difficult to expect them to keep most of their funds in the larger asset institutions. This study will examine the method by which larger credit unions can afford to be more competitive.

Credit union members utilize their institutions as a source of funds for a variety of loan needs. From unsecured borrowings to car loans, to home equity loans and mortgages, most credit unions offer a broad variety of lending products. The costs as well as the terms of these deals are critical to the members’ financial situation and satisfaction.

Again, credit unions have been very successful at supplying members with funds when required. Data in Table 5 present average loan rates charged by credit unions of different asset sizes. These loans generate the greatest source of income needed to sustain a credit union’s operations, but members are still interested in paying the lowest rate for their borrowings. It can be observed quite clearly that the largest credit unions (assets over \$200 million) charged their members rates lower than those of the industry average. In fact, the \$500 million plus asset group has charged rates at least 20 percent lower on average than those charged by the smallest credit unions (under \$5 million) every year. This has been another reason for the much more rapid expansion in membership and asset growth of large over small credit unions.

It is neither the volume of loans nor the interest charged on those loans that generates income for the credit union. All loans involve the risk of delinquency and/or default by the member, resulting in expenses that must be covered as part of the operations of the institution. Credit unions have a long history of working with members to keep these delinquencies as low as possible, using prudent managerial techniques. However, not all problem loans can be resurrected and paid in full.

Table 6 presents data comparing delinquent loan levels to total loans by credit union asset size. Variations between large and small credit unions are quite significant

for our data period. The smallest credit unions consistently exhibit delinquency ratios that are 4 to 5 times as high as those for the largest credit unions! Even when credit union size reaches \$10 million, delinquency rates are approximately double those of the \$500 million plus asset group.

Not all delinquent loans result in net charge-offs to operating income. Credit union managers across all asset sizes are proud of their record in this area. Table 7 presents data showing net charge-offs to average loans by asset size and, while larger credit unions sustain smaller write-offs, the differentials in size categories are not nearly as great as they were for delinquencies. The largest credit unions (\$500 million plus assets) generally have net charge-off/average loan ratios that are approximately one-half of the smallest credit unions (under \$2 million assets).

For asset groups above \$200 million, charge-off rates are equal or less than the overall average. In contrast, all credit unions with assets under \$20 million have charge-offs higher than industry averages. These differentials translate into significant average cost savings for larger institutions.

When operating expenses are examined by asset size, it is observed that per dollar of asset, the largest credit unions have the lowest expense ratios. Table 8 presents these data for the last eleven years, noting that the variance, while declining over the period, still is significantly lower for the largest credit unions. The operating expense/asset ratios for large credit unions (\$500 million plus assets) are approximately 60 to 65 percent of those for the smallest credit union (assets under \$5 million).

The \$500 million plus asset category has achieved operating expense ratios below the industry average in every year of the study. All groups with assets under \$100 million have higher operating ratios, while the \$100 to \$500 million categories have mixed levels in relation to the industry average. By holding down expenses, larger credit unions take advantage of economies of scale and scope, passing along these savings to their members.

Another set of data also contribute to the findings of this study. Table 9 presents net capital/asset ratios of credit unions by asset size. There are significant inverse relationships between the size of this ratio and the asset size of the credit union. The trends over time have been towards the increasing size of the net capital/asset ratio for all asset size credit unions. This shows that credit unions have been able to generate more income each year than expense, with the result being an increasing trend in the net capital/asset ratio. For each year, it may be observed that the smallest credit unions have the highest capital ratios.

The net capital account of a credit union represents reserves against the adverse effects of various risks that credit unions are exposed to in their operations. These data seem to conclude that smaller credit unions are more risky and, therefore, their managements feel it is prudent to keep higher levels of reserves in the form of capital. In contrast, larger credit unions, with more diversified loan and investment portfolios and lower relative expense levels, are able to operate with lower levels of the net capital.

Over the years, the net capital/asset ratios of even these larger credit unions have grown. Interestingly, percentage growth increased from the smallest credit unions to those in the \$1-2 million category. From that size on, the general trend was downward from a 57 percent increase to the 46 to 48 percent range.

In the annual CUNA yearbook survey of credit union services, it may be observed that selected services offered by credit unions expand significantly as the asset size of the credit union increases (Table 10). Credit unions with assets under \$10 million generally do not offer many services needed by their members. For organizations between \$10 million and \$50 million, the offerings grow significantly and above \$50 million, members can be quite confident of being offered the broadest spectrum of financial services.

SUMMARY

Analysis of the data presented in this study explains clearly the underlying reasons for growth and consolidation experienced by the credit union industry in the eleven-year period ending in 2001. Larger asset size credit unions simply provide their members with a more varied portfolio of financial services in a more efficient and cost effective manner. Loan rates are lower, savings rates are higher, delinquencies and charge-offs are lower, operating expenses are lower and lower reserve levels allow for more benefits to flow through to the membership (the owners of the credit union). Members have been better off at larger credit unions or at least at those with asset levels over \$50 million. It seems quite likely that continued consolidation in the industry will take place well into the 21st century.

Do these findings imply that the “small” credit union (assets under \$10 million) will soon disappear? No. There will always be small credit unions to provide services to new membership groups. Smaller credit unions (assets under \$20 million) have enhanced their competitive positions over the last decade. Strategies such as “shared branching” and sharing ATM networks have contributed to expanded member services. These initiatives may have slowed the rate of decline in those series, but were ultimately unsuccessful in stopping the declines. Yet data in Tables 1, 2, and 3 show a significant trend of declines in members, credit unions, and assets over the 1991 through 2001 period.

While smaller credit unions will continue to be formed, they will quickly realize that their membership will expect expanded-loan and savings products as well as other financial services. If they are able to grow their assets and expand their offerings, members will be served. However, if they lag behind member demands, select employee groups (SEGS) may find consolidation with a larger credit union will be the best strategy for their membership. A more diversified portfolio of services is needed to keep members in their credit union and not pursuing services from other financial institutions.

The industry has performed very well for its numbers and there is every reason to be optimistic about the future of credit unions as long as they continue to meet member needs and desires effectively and efficiently in the years ahead. However, the number of operating credit unions is likely to continue to decline with membership and assets continuing to grow faster at the largest institutions.

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TABLES

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