Recent Developments in the Credit Union Industry

By Douglas K. Pearce

Less than a decade ago, U.S. depository institutions could be clearly distinguished from each other. Banks made commercial loans and offered checkable deposits. Savings and loan associations and mutual savings banks made residential mortgage loans and offered fixed-rate passbook savings accounts. Credit unions made consumer instalment loans and offered dividend-paying share accounts. In recent years, however, financial deregulation and high and volatile interest rates have led to a substantial blurring of these differences as each type of intermediary has broadened its range of activities in an effort to become a "financial supermarket."

Changes in the structure and behavior of the credit union industry have been particularly striking. Since 1977, regulatory changes have relaxed many of the traditional restrictions on credit unions. While these changes have improved the prospects for growth of the credit union industry, similar deregulation of other depository institutions has exposed credit unions to more intense competition. Moreover, because ceilings on deposit and loan rates were still in effect when short-term interest rates rose sharply in the late 1970s, growth of credit unions slowed substantially from 1979 to 1981. The credit union industry responded by making significant balance sheet adjustments and expanding the roles of their trade associations.

This article argues that credit unions adapted well to the new financial environment and that they are likely to continue to compete effectively in unregulated markets. The first section reviews the distinctive features of credit unions, the regulatory framework in 1976 before deregulation, and the performance of credit unions from 1961 to 1976. The second section describes the restructuring of the credit union industry with respect to the regulatory framework and functions of the trade associations. The third section examines the performance of credit unions from 1977 to

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1983. The fourth section looks at the prospects for credit unions in the near term.

Structure and performance of credit unions before 1976

Distinctive features of credit unions

Credit unions are nonprofit, cooperative organizations composed of individuals with a "common bond" who borrow from and lend to each other.[1] As credit unions are mutual organizations, owned by their members, deposits are considered shares and interest payments on deposits are considered dividends.[2] Officers of credit unions are usually unpaid volunteers elected from the membership.[3] The unique feature of credit unions is their common bond requirement for membership. The bond is usually the place of employment or the occupation of members but it can also be based on association ties, such as church or union membership, or, more rarely, on area of residence. Credit unions often receive subsidies, such as free office space, from their sponsoring organization. Unlike other mutual depository institutions, federally chartered and most state-chartered credit unions are not subject to federal or state income taxes.

These characteristics have given credit unions both advantages and disadvantages relative to other depository institutions in competing for household savings and consumer loans. On the plus side, volunteer help and sponsors' subsidies lower operating costs. The common bond feature of credit unions probably keeps down consumer loan rates by lowering administrative costs. In particular, occupation-based credit unions are well positioned to obtain low-cost information on the income and job security of prospective borrowers. Moreover, loan repayments can be processed inexpensively through payroll deductions. The common bond may also make borrowers more reluctant to default on loans, and the lower default rates allow credit unions to charge lower loan rates. Payroll deduction plans for saving at credit unions are convenient for depositors, and the common bond may make them loyal to their credit union, reducing the interest sensitivity of depositors. The cooperative, nonprofit nature of credit unions combines with the common bond requirements to keep credit unions from viewing themselves as competitors. This has led to extensive pooling of resources through trade associations that allows individual credit unions to obtain some economies of scale that their small size would not otherwise permit.

The mutual organization and nontaxable status of credit unions also give them potential advantages. The capital of a credit union consists basically of reserves against loan losses, reserves built up by retaining part of the income generated in the past. This capital need not be paid a return, as is the case of such stock intermediaries as commercial

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[1] For more background on credit unions before 1977, see Peggy Brockschmidt, "Credit Union Growth in Perspective," *Monthly Review*, Federal Reserve Bank of Kansas City, February 1977, pp. 3-13; Mark J. Flannery, "An Economic Evaluation of Credit Unions," *Federal Reserve Bank of Boston Research Report No. 54*, 1974; and Donald J. Melvin, Raymond N. Davis, and Gerald C. Fischer, *Credit Unions and the Credit Union Industry*, New York Institute of Finance, 1977.

[2] Some state-chartered credit unions accept deposits, but these are often treated as equity capital. Since credit union shares are equity, they represent a residual claim on credit union assets unlike the claim of bank depositors. Because credit unions are considered depository institutions, this article will use the terms shares and deposits interchangeably.

[3] No officer except the treasurer can receive compensation. Most credit unions have paid clerical help, and larger credit unions employ professional managers. Officers of credit unions affiliated with large business firms may receive implicit payments from the firm for their services to the credit union.

banks. Therefore, if a credit union has enough capital, it can use all its income in excess of operating costs to pay depositors more or give borrowers refunds. A growing credit union generally needs to increase its capital. If credit union income were taxed in the same way as, say, mutual savings and loans, a credit union would have to generate more pre-tax income to make the desired addition to its capital. The tax-free status allows credit unions to charge less for loans or pay more on deposits given any desired addition to their capital. The taxation of credit unions is a controversial issue discussed in more detail later.

Some credit union characteristics also have negative aspects. Volunteer help may lack the incentive or the expertise to operate the credit union efficiently. A narrowly defined common bond–and this is the traditional bond–inherently limits the growth potential of a credit union. A common bond based on employment further restricts the asset growth of a credit union to the growth of its sponsoring firm. The common bond requirement also keeps credit unions from achieving much diversification across both depositors and borrowers. Thus, sudden plant closings or substantial layoffs can create severe liquidity problems for credit unions and sometimes force them into liquidation. A disadvantage to the mutual organization of credit unions is that the only source of funds is deposits. Credit unions cannot raise capital for expansion by selling equity.

The cooperative or mutual nature of credit unions presents problems in analyzing the industry. First, the objective of individual credit unions is not clear. While stock institutions, such as banks, may seek to maximize profits, the goals of credit unions are less well defined. Since members can be primarily savers or primarily borrowers, a conflict of interest arises when credit unions decide the rates to pay savers and charge borrowers.[4] A decision to pay higher rates on deposits, all else equal, means a decision to charge higher loan rates. Refunds to borrowers or lower loan rates, on the other hand, imply lower dividends to saving members. This internal conflict exists as long as external competition does not force both loan rates and deposit rates to their market values. In other words, any "profit" a credit union makes is divided among borrowers and savers but the division can vary across credit unions.

A second problem is measuring industry performance. This article follows the custom of the credit union movement and takes asset growth as the measure of success. Since the traditional goal of credit unions has been to promote thrift among members and provide them with low-cost consumer credit, asset growth seems a reasonable proxy for this goal, particularly if most assets are consumer loans. As noted above, however, the officers of individual credit unions have no pecuniary interest in growth and may even prefer the ease of operating a small institution. On the other hand, the cadre of professionals in the credit union trade associations and managers of large credit unions have a clear interest in industry growth.

Regulatory framework in 1976

Credit unions can obtain either federal or state charters. Since regulations governing state-chartered credit unions vary across

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[4] Flannery, "An Economic Evaluation of Credit Unions," analyzed a 1972 sample of federal credit unions and found that most credit unions appear to balance the goals of savers and borrowers or to be dominated by savers. He reported that credit unions with a residential bond are more likely to be saver dominated. This issue is also discussed in Donald J. Smith, Thomas F. Cargill, and Robert A. Meyer, "An Economic Theory of a Credit Union," *Journal of Finance*, May 1981, pp. 519-28.

states, this article concentrates on the regulations imposed on federal credit unions.[5] The regulatory agency for federal credit unions is the National Credit Union Administration (NCUA), which is responsible for chartering and supervision. Since 1971, the NCUA has also administered share insurance for federal and many state credit unions through the National Credit Union Share Insurance Fund (NCUSIF).

In 1976, federal credit unions faced several restrictions on their lending activities and on the types of accounts they could offer. They could not charge more than 12 percent a year on loans, inclusive of all charges. The size of loans was limited, maximum maturities were five years on unsecured loans and ten years on secured loans, and loans had to be approved by a loan committee.[6] These constraints effectively excluded credit unions from making loans through credit card programs and severely limited their ability to initiate residential mortgage loans. Consumer instalment loans for relatively small amounts made up most of the loan portfolio of credit unions. Funds not loaned to members could be invested in U.S. government and agency securities, deposits at insured savings and loans or mutual savings banks, or in loans to or shares at other credit unions.[7]

Federal credit unions also faced restrictions on the accounts they could offer. Each share had a legislated par value of $5 so that a member with as little as a $5 deposit qualified for voting on credit union policy. The NCUA placed a 7 percent ceiling on share account dividend rates. Since this exceeded the Regulation Q ceiling deposit rates at banks and savings and loan associations, credit unions enjoyed a competitive advantage over other depositories when market rates were high enough to make their competitors' ceilings effective. Federal credit unions were not formally authorized to offer shares that resembled checkable deposits. The NCUA, however, had given temporary permission to some credit unions to offer share drafts. Because these accounts were essentially interest-earning demand deposits, their introduction subsequently led to legal challenges from banks.

Unlike banks, credit unions did not have to keep a specific ratio of cash assets to shares, although the needs of members necessitated that a small proportion of assets be held in cash. However, credit unions were required to maintain a reserve against possible loan losses. Gross income had to be allocated to maintain this ratio, analogous to a capital-asset ratio requirement, at 10 percent of their risky assets.[8]

Credit union performance, 1961-76

Credit unions grew rapidly throughout the 1961-76 period. Assets at credit unions rose at an annual rate of 12.8 percent, compared with 11.2 percent at savings and loans and 8.6 percent at commercial banks. Credit union deposits also grew an average of 13.7 percent a year, compared with 11.1 percent at savings and loans and 11.6 percent for passbook and small time deposits at banks. As a result of this more rapid growth, credit unions' share of total household savings deposits rose from 3 percent in 1961 to 4.4 percent in 1976. Over

[5] Differences between state regulations are given in issues of *Comparative Digest of Credit Union Acts*, Credit Union National Association, Inc.

[6] The maximum unsecured loan was $2,500 while the maximum secured loan was 10 percent of the credit union's capital.

[7] Many states allowed state-chartered credit unions more investment choices.

[8] Risky assets are essentially loans that are not guaranteed by the government or secured by the borrower's shares.

this same period, credit unions increased their share of total consumer instalment credit from 9.3 percent to 16.1 percent.[9] While the number of credit unions did not increase substantially over this period, membership almost tripled, reaching close to 34 million members by 1976.

Despite substantial growth, the credit union industry remained small compared with other depository institutions. Although total credit union assets exceeded $45 billion by 1976, this was only about 5 percent of commercial bank assets and 11 percent of savings and loan assets. Most of the 22,533 credit unions operating in 1976 were small. Four out of five credit unions had assets of less than $2 million. Together these institutions held only 18.5 percent of total credit union assets. The 60 largest credit unions held 14.5 percent of all credit union assets.[10] Thus, the credit union industry was characterized by a large proportion of small institutions and few large ones.[11]

Table 1 summarizes the balance sheets of credit unions at the end of 1976. Loans to members made up 76 percent of the assets. These loans were mainly for durable goods purchases (about 48 percent) and personal loans (32 percent). The restriction on maximum loan maturity kept residential mortgage loans to less than 5 percent of all loans.

TABLE 1
Balance sheet for all credit unions, 1976

Total Assets, $45,225 million	
Distribution of Assets	**Percent**
Loans to members	76.0
Cash	2.6
Investments	19.1
Other	2.3
Distribution of Liabilities and Capital	
Members' savings	86.6
Reserves and undistributed earnings	8.4
Notes payable and other	5.0

Source: NCUA, 1976 Annual Report on State-Chartered Credit Unions

Investments were divided among U.S. government or agency securities (45 percent), common trust investments (21 percent), deposits at savings and loans (19 percent), and loans to or shares in other credit unions (15 percent).[12] On the liability and capital side, members' savings accounted for 86.6 percent. These were almost all in the form of regular share accounts since share drafts and other types of shares were uncommon.

Credit union restructuring, 1977-83

Three major developments affected the credit union industry over the 1977-83 period. First, the general movement toward financial deregulation eliminated many of the previous constraints on credit unions but also exposed credit unions to more competition. Second, changes in the regulatory structure provided the credit union industry with new sources of

[9] All data are from *Flow of Funds Accounts, Assets and Liabilities Outstanding, 1959-82*, Board of Governors of the Federal Reserve System, August 1983.

[10] The largest credit union was the Navy Federal Credit Union in Washington, D.C., with $568 million in assets. The sixtieth largest credit union had about $56 million in assets in 1976.

[11] The size distribution of other depository institutions are also skewed. For example, in 1976, commercial banks with assets under $50 million comprised 83 percent of all insured banks but held only 19.8 percent of all insured bank assets while the 18 largest banks held 26.3 percent of all assets (*Annual Report of the Federal Deposit Insurance Corporation 1976*, Table 104, p. 227).

[12] Common trust investments are NCUA-approved mutual funds that invest in securities approved for credit unions. They are often run by credit union trade associations.

liquidity. Third, expansion of the services offered by credit union trade associations helped credit unions broaden their range of financial services and gave credit unions more convenient access to money markets.

Deregulation of credit unions

Of all the regulatory changes in the U.S. financial sector from 1977 to 1983, the most dramatic changes may have been in the credit union industry. Many of the restrictions on credit unions were removed either by legislation or administrative ruling, enabling credit unions to compete across a broad range of financial services. Some of these changes, however, have also eliminated or reduced competitive advantages of credit unions. Table 2 chronicles the major regulatory changes affecting federal credit unions since 1976.[13]

The lending powers of credit unions have been significantly enlarged. First, credit unions can now make residential mortgage loans of any size or maturity. They can also sell the mortgages they originate in the secondary mortgage market.[14] Second, the NCUA can temporarily increase the interest ceiling on loans if warranted by economic conditions.[15] Third, credit unions can now establish self-replenishing lines of credit for members. These latter two changes removed the barriers to credit union participation in credit card programs.

Regulatory changes have also increased the ability of credit unions to attract deposits. Credit unions can offer members a wide variety of share accounts, including accounts similar to money market deposit accounts, with no restrictions on the interest they can pay. Since the interest rates banks and savings and loan associations can offer on some accounts are still restricted, credit unions continue to have a competitive advantage. The Depository Institutions Deregulation and Monetary Control Act (DIDMCA) of 1980 gave credit unions permanent authority to offer share drafts (checkable accounts). This provision was coupled at first with the stipulation that credit unions must meet the same reserve requirements as other depository institutions. The Garn-St Germain Depository Institutions Act of 1982, however, excluded from the reserve requirement credit unions and other depository institutions with less than $2 million in checkable deposits (about 95 percent of all credit unions).

Two other changes that may benefit credit unions are the less restrictive interpretation of the common bond requirement and the wider access of depository institutions to Federal Reserve services. The NCUA and state regulators have relaxed substantially the common bond aspect of credit union membership.[16] This increases the potential membership for credit unions and allows more mergers between credit unions. The DIDMCA provided for the pricing of Federal Reserve services, such as wire transfers, and permitted the credit union industry to access such services directly rather than indirectly through correspondent relationships with member banks. This may reduce the costs of such services to some credit unions.

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[13] See issues of *Comparative Digest of Credit Union Acts* for how these changes affected state-chartered credit unions.

[14] Initially, credit unions were restricted to 30-year loans on homes that were less than 150 percent of the median house price in their area.

[15] The NCUA can raise the ceiling (15 percent) for up to 18 months if it can demonstrate that growth, liquidity, capital, and earnings have been adversely affected and that interest rates have been rising in the last six months. The NCUA must inform Congress before raising the ceiling.

[16] For a discussion of this change, see *1983 Annual Report*, NCUA, pp. 9-11.

TABLE 2
Credit union regulatory changes, 1977-83

1977 Amendments to Federal Credit Union Act
- Increased loan maturities on nonresidential loans to 12 years.
- Allowed 30-year residential mortgage loans and 15-year mobile home and home-improvement loans.
- Permitted self-replenishing lines of credit.
- Permitted participation loans with other financial institutions.
- Permitted government-insured or guaranteed loans.
- Lowered reserve formula for larger credit unions.
- Allowed different types of share accounts, including share certificates.

1978 Financial Institutions Regulatory and Interest Rate Control Act
- Restructured NCUA into three-member board.
- Established Central Liquidity Facility under NCUA.

NCUA regulations
- Permitted sale of mortgages to FNMA, FHLMC, or GNMA.
- Set maximum rate on small share certificates at 8 percent.
- Permitted market rates on large share certificates ($100,000 or more).
- Permitted six-month, $10,000 certificates paying 1/4 percent above the six-month Treasury bill rate.

1979 Congress
- Gave 90-day authorization (starting December 28) for credit unions to offer share drafts.

NCUA regulations required credit unions with over $2 million in assets or offering share drafts to hold 5 percent of member accounts plus notes payable in liquid assets.

1980 Depository Institutions Deregulation and Monetary Control Act
- Classified credit unions as depository institutions.
- Gave permanent authority for share drafts.
- Set required reserves on share drafts.
- Established timetable for phasing out interest ceilings.
- Raised loan rate ceiling to 15 percent and authorized NCUA to increase this ceiling.
- Required Federal Reserve System to price its services.

NCUA regulations raised loan ceiling to 21 percent for nine-month period (starting December 3).

1981 NCUA regulations
- Extended 21 percent ceiling on loan interest rate to June 1982.
- Allowed credit unions to make variable interest rate consumer and mortgage loans

1982 Garn-St Germain Depository Institutions Act
- Freed credit unions to set par value of shares and to determine internal organization.
- Eliminated limits on size and maturity of mortgage loans, allowed refinancing of first mortgages, and extended maturity limit on second mortgages.
- Excluded credit unions with less than $2 million in reservable accounts from reserve requirements.
- Permitted Central Liquidity Facility (CLF) to lend to the National Credit Union Share Insurance Fund (NCUSIF) and also made CLF an agent of the Federal Reserve System.

NCUA regulations
- Allowed credit unions to determine the kinds of shares offered and the dividend rates paid.
- Repealed fixed liquidity requirement on federally insured credit unions.
- Permitted credit unions greater flexibility in the kinds of services they can offer and the joint sharing of activities with other credit unions.

1983 NCUA regulations expanded definition of "family member" in common bond requirement.

Financial deregulation also increased the range of activities of competing depository institutions. Savings and loan associations and mutual savings banks can now compete actively in the consumer loan market. While commercial banks, savings banks, and savings and loans are still legally constrained on the interest rates they can offer on some accounts, they can offer any rate on many of their deposit options and the remaining limits are being phased out. Thus, the traditional advantage of credit unions–the ability to offer higher deposit rates–is dissipating. Another earlier advantage for large credit unions has been eliminated by the requirement that they maintain noninterest earning reserves with the Federal Reserve based on the amount of their share drafts.[17]

Changes in the regulatory structure

Several important changes in the credit union regulatory structure were made between 1977 and 1983. The NCUA was reorganized more along the lines of the Federal Home Loan Bank Board and the Board of Governors of the Federal Reserve. Up to 1978, the NCUA was run by an administrator counseled by an advisory board. The Financial Institutions Regulatory and Interest Rate Control Act of 1978 replaced this structure with a three-member board headed by a chairman. Members of the board are appointed by the President, confirmed by the Senate, and serve staggered six-year terms.[18]

Perhaps a more significant change, also due to the 1978 legislation, was the establishment of the Central Liquidity Facility (CLF), under the administration of the NCUA. Until the creation of the CLF, credit unions had no access to a "lender of last resort," such as the Federal Reserve.[19] The CLF fills this gap. Both federal and state-chartered credit unions can join the CLF by subscribing 0.5 percent of their unimpaired capital. The CLF generally makes short-term loans to member credit unions having unexpected liquidity problems. The CLF raises most of its funds by borrowing through the Federal Financing Bank and can, if the need arises, borrow directly from the U.S. Treasury. In addition to lending to individual credit unions, the CLF can lend to the NCUSIF.

The relationship between the credit union industry and the Federal Reserve System also changed considerably over this period. Not only can credit unions now buy Federal Reserve services directly, as large credit unions must hold reserves with the Federal Reserve, these credit unions also have legal access to the discount window. They do not really have the choice between borrowing from the CLF or the Federal Reserve, however, since the Federal Reserve requires that credit unions first approach the CLF. One difference between the CLF and the discount window is that the CLF always sets a penalty interest rate on its loans, that is, a rate slightly above market rates.[20]

[17] The NCUA had required larger credit unions to keep a 5 percent ratio of liquid assets to deposits beginning in 1979, but this requirement was removed in 1982. The reserve requirements for credit unions are being phased in over time. By September 1987, credit unions will face the same reserve requirements as do member banks.

[18] The NCUA divides the United States into six administrative regions, each with its own regional office.

[19] For a discussion of previous recommendations for such a facility, see Flannery, "An Economic Evaluation of Credit Unions," pp. 162-64.

[20] As discussed later, credit unions can also borrow from other credit unions through the Corporate Credit Union Network. The CLF sets its rate just above the average rate charged by corporate central credit unions.

Expanded role of trade associations

While regulatory changes have greatly increased the services that credit unions can offer, credit unions have had to turn to their trade associations for help in competing in these new areas. Credit unions have always relied heavily on services provided through trade associations.[21] They rely even more now because of the competitive disadvantages they face in a deregulated environment where competition is vigorous and financial innovation rapid. The small size of most credit unions keeps them from realizing any economies of scale in such areas as data processing and investment. Moreover, the unpaid volunteers who make the investment decisions for most credit unions usually do not have the expertise in portfolio management that their counterparts in the banking or savings and loan industries have. These disadvantages have been largely offset, however, by the credit union trade associations having essentially integrated most credit unions into one financial network. The cooperative nature of credit unions and the common bond requirement encourage such integration since credit unions do not generally consider one another as competitors and their nonprofit status avoids antitrust problems.

By far the largest and most influential of the credit union trade associations is the Credit Union National Association (CUNA). CUNA, as the major spokesman and lobbyist for the credit union industry, is the umbrella organization for several companies providing services to credit unions. There are also trade associations at the state level. Known as credit union leagues, most of them are also affiliated with CUNA so that about 90 percent of all credit unions are connected with CUNA.

CUNA provides services to credit unions through the CUNA Service Group, Inc., and the Corporate Credit Union Network. The Service Group has several subsidiaries. ICU Services, Inc., sells to credit unions financial services such as investment trusts in U.S. government securities, automatic teller machine (ATM) and electronic funds transfer (EFT) systems, credit card programs, and IRA/Keough plans. CUNA Mortgage Corporation buys mortgages originated by credit unions and sells pools of these mortgages on the secondary mortgage market. CUNA Supply, Inc., wholesales operational and promotional supplies to credit unions. Credit Union Internet provides credit unions with computer services and allows credit unions to be linked to an online telecommunications network. These service companies, catering only to credit unions, make it possible for the industry to compete more effectively by gaining the benefits of economies of scale.

Since it was started in the mid-1970s, the Corporate Credit Union Network has grown rapidly, probably in response to the volatility of interest rates. The network provides liquidity and investment expertise for the credit union industry. It has a pyramid structure with about 17,500 individual credit unions at the bottom, 42 corporate central credit unions in the middle, and the U.S. Central Credit Union at the top. A corporate central credit union, owned by its member credit unions through capital subscriptions, acts as a credit union for credit unions. Corporate centrals provide an outlet for credit union investments by offering a variety of shares and deposits. They also make loans to member credit unions needing liquidity. U.S. Central, in turn, acts as a credit union for the corporate centrals. It offers investment instruments ranging in maturity from overnight to three years and makes

[21] For background on the trade associations, see Melvin, Davis, and Fischer, *Credit Unions and the Credit Union Industry*, chap. 3.

loans to corporate centrals with liquidity needs.[22] Essentially, the Corporate Credit Union Network allows credit unions to channel investment funds through the corporate centrals to one portfolio run by U.S. Central. In this way, individual credit unions do not need financial expertise to obtain competitive rates on their investments. Moreover, the Internet system permits the Corporate Network to be linked electronically so that instructions and information can be transmitted quickly and inexpensively.

In addition to providing liquidity and investment expertise, the Corporate Network also provides credit unions with services traditionally acquired through correspondent relationships with commercial banks. This is accomplished by U.S. Central, which, through the corporate centrals, serves as the credit unions' main link to the Federal Reserve System. U.S. Central can provide such correspondent services as wire transfers, share draft settlements, federal funds trading, coin and currency delivery, and corporate share drafts. Corporate share drafts are essentially NOW accounts for corporate centrals, a replacement for the correspondent balance accounts at banks. The corporate centrals can also hold the required reserves of credit unions on a pass-through basis. The ultimate goal of the Corporate Network is to supply all the services that credit unions have traditionally acquired through correspondent relationships with banks and savings and loans.

The dominant role of CUNA and its subsidiaries makes the credit union industry resemble in some respects one large financial entity. The individual credit unions collect deposits and originate loans. They buy their office supplies, computer services, and investment advice within the industry. Funds in excess of loans can be funneled into one pool to be managed by professionals or loaned to other credit unions. Thus, in analyzing the competitiveness of credit unions relative to other depository institutions, it may be more realistic to view the credit union industry as one financial network with thousands of branches rather than thousands of small intermediaries.[23]

Credit union performance, 1977-83

The performance of the credit union industry between 1977 and 1983 reflected both economic conditions and regulatory changes. This section examines the growth of credit unions, the changes in their assets and liabilities, and the rise of the Corporate Credit Union Network over this period.

Growth

Total assets at credit unions more than doubled during the 1977-83 period, rising at an annual rate of 12 percent. While this growth rate was slightly less than in the 1961-76 period, it still exceeded asset growth rates at banks (9.9 percent) and savings and loan associations (11.4 percent).[24] Deposits at credit unions grew slightly faster than assets at an annual rate of 12.7 percent. In contrast, deposits at banks grew an average of 9.2 percent a year and deposits at savings and loans grew an average of 9.5 percent. As a result of better deposit performance, the share of total

[22] U.S. Central belongs to the CLF and thus its member credit unions also have access to the CLF.

[23] Large credit unions are much less dependent on trade associations.

[24] All assets are at book value. Since savings and loans had assets with much longer maturities than banks or credit unions, the market value of their assets fell considerably when interest rates rose unexpectedly in 1979. The source of all data is *Flow of Funds*.

household deposits (including money market shares) held at credit unions rose to 4.9 percent in 1978. With the dramatic rise in money market funds beginning in 1979, however, this share fell to about 4.4 percent in 1983.

While credit union membership rose to over 48 million by the end of 1983, the number of credit unions declined by over 3,300, falling to 19,205 by December 1983. The size distribution of credit unions, however, did not change radically. Credit unions with less than $2 million in assets still made up more than 70 percent of all credit unions and held about 10 percent of all assets. The 60 largest credit unions still held about 14 percent of all assets.[25]

Growth in assets and deposits varied considerably from 1977 to 1983. Charts 1 and 2 show the annual growth rates in assets and deposits at credit unions, banks, and savings and loans. As these charts indicate, credit union growth was relatively rapid in 1977 and 1978, considerably slower from 1979 through 1981, and then rapid again in 1982 and 1983. The growth pattern was similar for savings and loans while bank growth fluctuated moderately.

The pattern of credit union growth reflects a combination of regulatory and economic conditions. Up until the end of 1980, there was a ceiling on the rates most credit unions could pay on small certificates of deposit and other accounts. When short-term interest rates began rising sharply in 1978, credit unions found it difficult to pay competitive rates. At first, the difference between the rates paid by credit unions and the ceiling rates paid by banks and savings and loans gave credit unions a competitive advantage. This advantage was largely offset, however, by the surge in money market funds, which had no interest rate ceilings. The competitive advantage of money market funds caused slower growth in deposits and assets at credit unions as well as other depository institutions throughout the 1979-81 period.

Chart 3, which plots deposit growth at credit unions and the interest rate on three-month Treasury bills, supports the argument that high money market rates had a significantly, negative effect on credit union growth. The relatively high rate of unemployment over much of this period also was probably detrimental to growth. Since many credit union members make deposits through payroll deductions, high unemployment could have more adverse effects on credit unions than other depository institutions.

Deposit growth at credit unions began to increase after April 1982, when the NCUA lifted all restrictions on the rates and maturities of federal credit union deposits. Since this preceded by about eight months the authorization for banks and savings and loans to offer money market deposit accounts, credit unions had a head start in offering accounts with money market rates. The general decline in interest rates may have reduced the attractiveness of money market funds to the point where the convenience and insurance of credit union deposits outweighed the interest differential. The exceptionally rapid growth in 1983 probably reflected the lower short-term interest rates and the rapid recovery from the 1982 recession.

Balance sheet composition

The composition of both assets and liabilities of credit unions changed substantially over the 1977-83 period. Table 3 presents the bal-

[25] The asset distribution of commercial banks became somewhat more skewed over the same period. Banks with less than $50 million in assets comprised 66 percent of all insured banks and held about 9 percent of all bank assets. The largest 18 banks held 37.6 percent of all bank assets at the end of 1983.

CHART 1
Asset growth rates

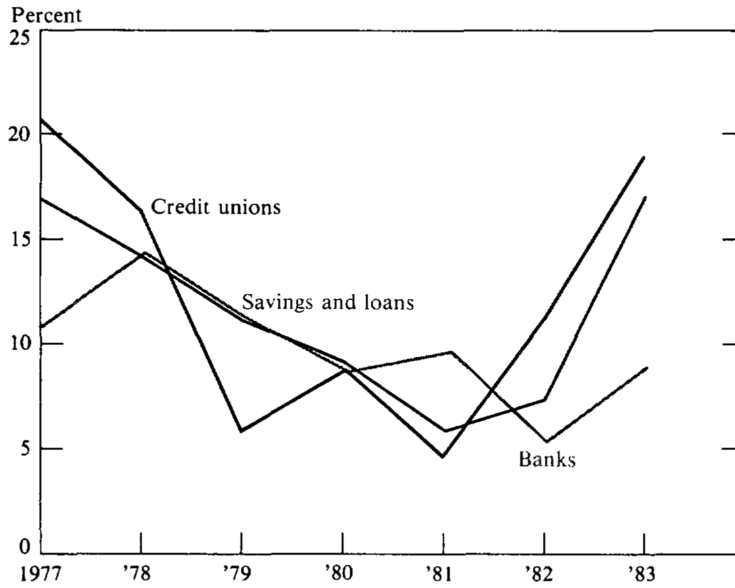


CHART 2
Deposit growth rates

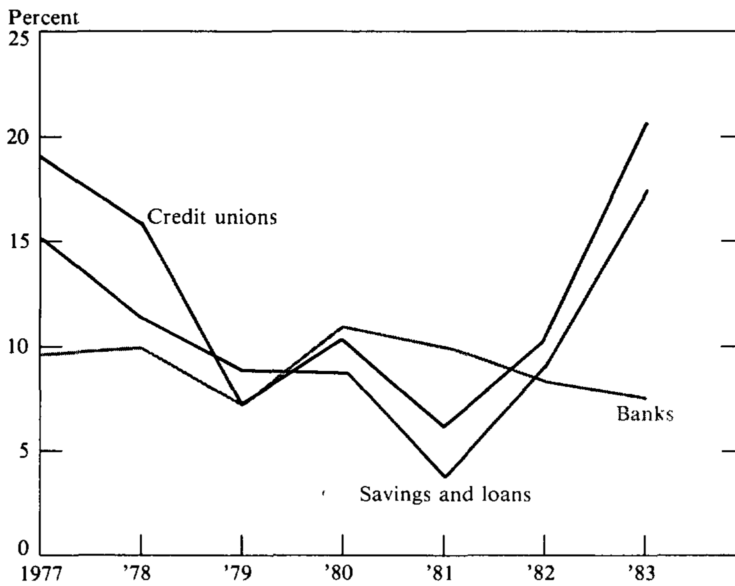
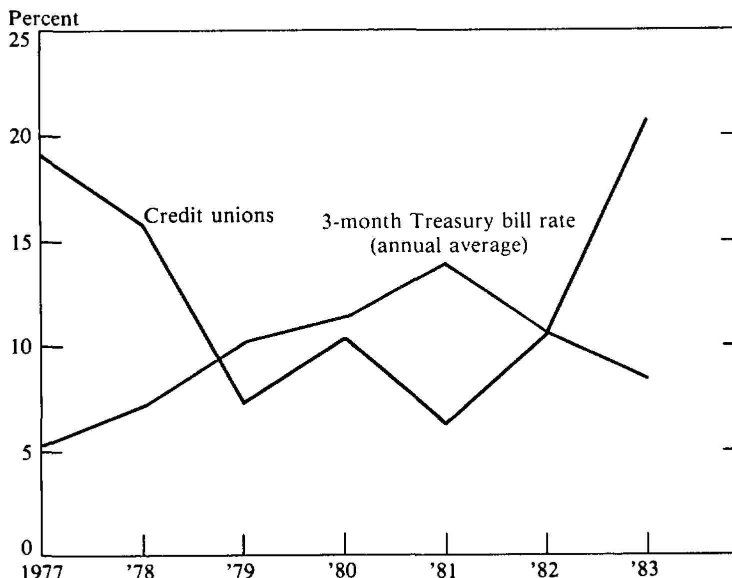


CHART 3
Deposit growth and interest rates



ance sheet for credit unions in 1983. A comparison of Table 3 with Table 1 shows that the proportion of loans to total assets dropped abruptly from 76 percent at the end of 1976 to 57 percent at the end of 1983. Several factors account for this decline. First, interest rate differentials often favored investments over loans. Until late 1980, the maximum interest rate many credit unions could charge on loans was 12 percent. When interest rates on short-term investments, such as Treasury bills, rose above this ceiling, as they often did between late 1979 and late 1980, loans became unattractive assets. Second, the expansion of the Corporate Credit Union Network made money market investing easier for small credit unions. Third, the riskiness of consumer loans was increased by swings in interest rates and unemployment rates in the 1977-83 period. Fourth, as discussed below, credit union deposits became more sensitive to market interest rates. As a result, the share of consumer instalment loans held by credit unions peaked in 1978 at 16.7 percent. By the end of 1983 they had fallen to 13.8 percent.[26]

Not only did the distribution between loans and investments change between 1976 and 1983, the composition of investments held by credit unions also changed considerably. These changes represented a move toward

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[26] Commercial banks' share of the consumer instalment market also fell from 48.3 percent in 1976 to 45.7 percent in 1983. The share of savings and loans and mutual savings banks combined rose from 3.9 percent to 5.7 percent over this period and the share of nondepository institutions also increased.

TABLE 3
Balance sheet for all credit unions, 1983

Total Assets, $100,156 million	
Distribution of Assets	**Percent**
Loans to members	57.4
Cash	2.4
Investments	37.7
Other	2.5
Distribution of Liabilities and Capital	
Members' savings	90.5
Reserves and undistributed earnings	6.1
Notes payable and other	3.4

Source: CUNA

short-term money market assets. The percentage of investments held in U.S. government or agency securities fell from 45 percent in 1976 to 22 percent in 1983, while the percentage in common trust investments fell from 21 percent to under 2 percent. Over the same period, investments in the form of deposits at corporate central credit unions rose from essentially 0 to 34 percent. Investments in the form of deposits at banks and savings and loans, mostly large certificates of deposit, rose from 19 to 37 percent. This last trend partly reflects credit union use of money brokers who direct the deposits to banks and savings and loans offering the highest yields.[27]

The changing composition of credit union deposits also caused credit unions to hold more of their assets in money market investments so they could match the characteristics of their assets and liabilities more closely. At the beginning of 1977, almost all deposits were regular share accounts similar to passbook savings accounts at banks. By November 1983, however, share accounts comprised only 45.4 percent of all deposits. Share drafts, money market accounts, and fixed-rate certificates–all of which pay market-related rates–comprised 8.3, 9.0, and 37.3 percent of deposits, respectively.[28] Deposit growth was also faster in large accounts. The rapid shift in deposit composition at credit unions suggests that depositors at credit unions are quite sensitive to the rates on alternative assets. Volatile interest rates thus required that credit unions, to offer competitive rates on deposits, hold assets with yields that moved with market rates.

Corporate credit union growth and balance sheets

The growth of the Corporate Credit Union Network over the 1977-83 period was extraordinary. Because of the large increase in deposits from member credit unions, total assets at corporate centrals rose from under $1 billion to about $7.9 billion. The composition of corporate centrals' assets reflected the needs of their members. The percentage of deposits loaned to member credit unions requiring liquidity was high at first, peaking at 89 percent at the end of 1978. This percentage dropped quickly, however, to 5 percent by 1983. About 77 percent of corporate centrals' assets are deposits at U.S. Central with the rest in U.S. government and agency securities, shares at the CLF, and other assets. About 90

[27] Institutions offering exceptionally high interest rates are likely to be more risky. While deposit insurance eliminates the risk for deposits up to $100,000, credit unions often made uninsured deposits. For example, when the Penn Square bank failed in July 1982, 139 credit unions held a total of $111.5 million in uninsured deposits in the bank (*Annual Report 1982*, NCUA, p. 6).

[28] Other depository institutions experienced similar changes in the composition of their deposits. Passbook savings accounts at banks as a percentage of total bank deposits fell from 23.7 percent in 1976 to 8.9 percent in 1983, while such accounts at savings and loans declined from 40.4 percent of all deposits in 1976 to 19.9 percent in 1982.

percent of the corporate centrals' funds come from deposits by member credit unions.

Growth of the corporate centrals brought similar growth at U.S. Central, which had assets of $7.2 billion by the end of 1983. Most (85 percent) of U.S. Central's assets are funded by the deposits of corporate centrals, while the rest are funded largely through the issue of commercial paper (2.7 percent) and the sale of government securities under repurchase agreements (7.3 percent). The composition of U.S. Central's assets reflects the needs of the corporate centrals. Depending on market conditions and the maturities of their own liabilities, corporate centrals choose from a variety of deposit options, ranging from regular deposits available on demand to fixed-rate, fixed-maturity certificates of deposit. In 1983, corporate centrals held about 56 percent of their deposits in regular deposits and 44 percent in certificates. U.S. Central, in turn, makes investments that closely match the maturity composition of its deposits. In 1983, U.S. Central held about 46 percent of its investment portfolio in federal funds, 40 percent in repurchase agreements, and the rest in a variety of money market securities.[29]

Prospects for credit unions

While the credit union industry seems to have adapted well to changing financial markets, the future growth and structure of the industry are uncertain. One trend likely to continue is the softening of the common bond requirement for membership. Traditionally, only a credit union member's immediate family was eligible for membership in the union. Eligibility requirements have now been diluted to where a credit union can allow anyone to join who is related by blood or marriage to a current member, substantially increasing potential membership. In addition, the NCUA has promoted mergers between healthy and weak credit unions, regardless of differences in their common bonds. These rulings will allow more diversification across borrowers and depositors as ties to specific employers are weakened.

There are, however, drawbacks for credit unions to a weaker common bond requirement. To the extent that the common bond kept default rates on loans relatively low, default rates should rise as the common bond requirement fades. Weaker common bonds also imply less of an advantage on information regarding borrowers. The disintegration of the common bond further reduces the distinction between credit unions and other depository institutions, making it more difficult for the credit union industry to argue for the continuation of their nontaxable status.

A second trend that is likely to continue is the expansion of financial services offered by credit unions. At present, there are considerable differences in the services offered by large credit unions (over $5 million in assets) and small credit unions. Many large credit unions have taken advantage of financial deregulation and now offer money market accounts, first and second home mortgages, credit cards, and share drafts. Most small credit unions, however, have yet to offer these services, maybe because of lack of expertise or incentives of their volunteer officers or inadequate capital to acquire the necessary equipment.[30] The Corporate Credit Union Network is trying to provide the support necessary for more small credit unions to expand their services, particularly in the areas of share drafts and credit cards.

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[29] The composition of U.S. Central's portfolio is for February 29, 1984.

[30] For a breakdown of credit union services by asset size, see *Credit Union Magazine*, December 1983, p. 23.

Recently, CUNA started CUNA Brokerage, which gives credit union members access to discount stock brokerage through their credit union. This development is clearly a response to similar services now offered by banks and such "nonbank banks" as Sears. Some state-chartered credit unions have even begun making commercial loans.[31]

It is not clear whether the trend toward smaller consumer loan-asset ratios will continue. Credit unions will have a greater incentive to increase loan-asset ratios, if money market interest rates do not return to the high and variable levels of 1979-81 and if the interest ceiling on loans does not become binding. Consumer lending should also rise if credit unions' credit card programs become more widespread. On the other hand, the competition for consumer lending is increasing now that savings and loans are in the market and large banks are aggressively seeking to expand their share of the market by starting so-called "consumer banks." In addition, the volunteers running smaller credit unions may have become accustomed to the ease of investing funds instead of making loans, particularly given the convenience of investing through the Corporate Credit Union Network.

Complete deregulation of deposit rates could force credit unions to focus more on consumer lending if they want to continue their rapid growth. Consumer loans may generate higher returns than investments, given credit unions' expertise, lower information costs, and comparatively low default rates. These higher returns will be required to maintain rapid deposit growth in the face of unrestricted competition for deposits from other depository institutions. Moreover, since the FDIC and FSLIC are requesting legislation to eliminate insurance on the deposits of institutions, credit unions may soon be unable to make insured deposits at risky institutions that offer high rates. Thus, credit unions may be forced to return to their previous practice of loaning out most of their deposits if they want to maintain growth. This strategy will be successful, however, only if interest rates are relatively stable.

An issue with potentially important implications for the growth of credit unions is their tax-exempt status. There have been many challenges to this status, the latest being the report of the Grace Commission.[32] The traditional argument for the nontaxable status of credit unions is that they are restricted in membership and exist only to promote thrift and provide low-cost credit to their members. As credit unions expand their services and phase out the common bond requirement, competitors will argue strongly for the taxation of credit unions.

The effects of taxation on credit unions would depend on the specific legislation. If credit unions were treated like mutual savings and loans or mutual savings banks, they could deduct the interest they pay on deposits, even though it is formally a payment of dividends. They could also deduct at least some of the income set aside for possible loan losses. If credit unions could add without limit to their loan loss reserves, they would never have to pay any tax. Presumably, therefore, some limit would be placed on the ratio of loan loss reserves to assets. It would seem that the only case in which credit unions would be significantly affected by such tax provisions is if

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[31] Credit unions in 23 states were making commercial loans in 1983, although the volume was quite small. See *Credit Union Magazine*, January 1984, pp. 60-61.

[32] *President's Private Sector Survey on Cost Control*, U.S. Government Printing Office, January 1984. Also, Flannery, "An Economic Evaluation of Credit Unions," pp. 155-57, argues for the taxation of credit unions and discusses past recommendations.

they wanted to build up their capital beyond the tax-free maximum. If they are satisfied with the maximum ratio, they can adjust their loan rates and deposit rates and invest in tax-preferred investments, such as state and local securities, to keep their tax liability negligible. If, however, credit unions wanted to increase their capital more rapidly, maybe in the anticipation of higher costs arising from complete deregulation or in anticipation of additional expenditures required to expand services, taxation would retard their growth. This is because credit unions would have to raise loan rates or lower deposit rates to generate enough after-tax income to meet their capital needs. In this case, taxation would reduce the competitiveness of credit unions and slow their growth.

Conclusions

Volatile economic conditions and financial deregulation have caused considerable change in credit unions since 1977. While credit unions have maintained their position as the fastest growing depository institutions, their growth has been uneven. The high interest rates of 1979-81 combined with interest ceilings on loans and deposits and high unemployment rates to slow credit union growth substantially. With the subsequent removal of the ceiling restrictions, the fall in market interest rates, and the revival of the economy, credit unions resumed their rapid growth in 1982 and 1983.

The most dramatic change in credit union portfolios was the relative decline in consumer loans from about 80 percent of assets in 1976 to below 60 percent in 1983. This decline reflected both the more attractive returns on money market investments and the changing composition of credit union deposits from passbook accounts to more interest-sensitive accounts. Another important development was the expansion of services provided by credit union trade associations. The trade association connection allows credit unions economies of scale that are not available to most individual credit unions due to their small size. As a result, credit unions have greatly broadened the financial services they offer. In addition, credit union liquidity has been substantially increased by the creation of the Central Liquidity Facility and the growth of the Corporate Credit Union Network.

The prospects for future credit union growth are uncertain. Complete deregulation of interest rates by 1986 will eliminate the deposit rate advantage they have had. Credit unions should be able to compete successfully, however, if they retain their tax-free status and renew their emphasis on consumer lending.