The Future of Credit Unions: Public Policy Issues

William E. Jackson, III, University of North Carolina–Chapel Hill
The Filene Research Institute is a non-profit organization dedicated to scientific and thoughtful analysis about issues affecting the future of consumer finance and credit unions. It supports research efforts that will ultimately enhance the well-being of consumers and will assist credit unions in adapting to rapidly changing economic, legal, and social environments.

Deeply imbedded in the credit union tradition is an ongoing search for better ways to understand and serve credit union members and the general public. Credit unions, like other democratic institutions, make great progress when they welcome and carefully consider high-quality research, new perspectives, and innovative, sometimes controversial, proposals. Open inquiry, the free flow of ideas, and debate are essential parts of the true democratic process. In this spirit, the Filene Research Institute grants researchers considerable latitude in their studies of high-priority consumer finance issues and encourages them to candidly communicate their findings and recommendations.

The name of the institute honors Edward A. Filene, the “father of the U.S. credit union movement.” He was an innovative leader who relied on insightful research and analysis when encouraging credit union development.

Progress is the constant replacing of the best there is with something still better!

— Edward A. Filene
Acknowledgements

Several individuals helped me to clarify my thinking about how U.S. public policy toward credit unions, and depository institutions in general, should be developed and implemented. Robert Hoel and William Hampel provided insightful comments to many specific issues and acted as sounding boards for the entire project. Lissa Broome provided expert legal advice and thoughtful input for the project, especially chapters three and four. Jon Haller provided useful information on credit union member attributes. And Tamala Grissett provided a wealth of research and editorial assistance. My appreciation to each of these individuals is enormous. That appreciation is surpassed only by my conviction that they should be held blameless for any conceptual, factual, or editorial errors remaining in this report. All such errors, if they exist, are the exclusive property of the author.
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Over the past twenty years, Congress relaxed or eliminated many of the regulations imposed upon depository institutions. These actions responded to the impact of significant technological, competitive, and other market changes encountered by those institutions. Federal Reserve Board Chair Alan Greenspan recognized the positive effect deregulation offers consumers when he said deregulation provides “financial services at lower prices, increased access, and higher quality services that accompany the increased competition associated with permitting depository institutions to expand their activities.”

The dramatic changes in the structure and operations of depository institutions are the result of three fundamental factors which in combination created a “Perfect Storm” of change in the industry. The first and most powerful of these factors is advancements in technology. Increased competition and financial innovation including new product creation also played key roles.

In recognition of these forces, Congress and regulators re-examined public policy toward financial institutions. The Depository Institutions Deregulation and Monetary Control Act of 1980 eliminated many restrictions on bank pricing and product offerings. Limitations on bank market areas were later set aside. The Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994 permitted banks headquartered in one state to open branches in other states if permitted by state law.

This process of deregulation produced positive results. It intensified competition among depository institutions, inducing them to expand product offerings, increase efficiency, align prices with production costs, and improve service to consumers.

Deregulatory legislation culminated in passage of the Gramm-Leach-Bliley Act. The Act repealed parts of the long-standing Glass-Steagall Act of 1933, including those that prohibited banks from affiliating with securities firms and insurance companies. Under Gramm-Leach-Bliley, banks, insurance companies, securities firms, and other financial institutions can affiliate under common ownership and offer their customers a complete range of financial services.
A CALL FOR PARITY

Credit unions benefited far less from deregulation than commercial banks and thrifts. While the same factors that supported the deregulation of commercial banks and thrifts also support deregulation of credit unions, credit union powers were largely unchanged during the past twenty years.

The most significant legislation affecting credit unions was the Credit Union Membership Access Act of 1998 (CUMMA). This Act responded to a Supreme Court decision by restoring a credit union's ability to serve more than one group. However, it also codified new rules limiting who is eligible to join a credit union and credit union mergers. Furthermore, CUMMA imposed significant limitations in other areas. In particular, it created a very restrictive system of capital requirements for credit unions and placed severe limitations on business loans to credit union members.

Professor Jackson shows why credit unions deserve to share in the deregulation already afforded commercial banks and thrifts. Good public policy, he notes, demands a change in regulatory framework whenever the costs of regulatory restrictions exceed their benefits. Jackson finds the current costs of regulatory restrictions on credit unions greatly exceed any reasonable measure of their benefits. The regulation of credit unions ought to provide as much consumer choice as possible by promoting a competitive and innovative financial marketplace, while insuring a safe and sound financial system. He concludes that deregulatory legislation has not gone far enough in eliminating the restrictions limiting credit unions’ ability to provide products and services that their members and potential members deserve.

Jackson proposes that credit unions receive deregulatory relief along the following three dimensions:

• Eliminate or significantly relax legislative limits on credit union membership.
• Eliminate legislation and regulations that unnecessarily limit consumer lending and member business lending activities of credit unions.
• Revise legislation to give credit unions parity with commercial banks and thrifts in areas such as (1) investment alternatives; (2) capital requirements and capital aggregation including abilities to offer subordinated debt and other secondary capital instruments; and (3) the provision of incidental financial products and services.

If credit unions are deregulated in these ways, the result will be an overall increase in the economic efficiency of the U.S. financial system.

THE CREDIT UNION DIFFERENCE

Professor Jackson shows how credit unions differ from other depository institutions. They are member-owned and member-directed; they do not issue capital stock; and they rely on unpaid boards of directors elected by, and drawn from their membership. And credit unions do not operate for profit. Because credit unions seek more than maximized shareholder value they may require less regulation on issues including risk-taking and investing.

Economic theory predicts that credit unions take less risk than banks, based on the incentives generated by their governance structure – a primary difference between credit unions and banks. The governance structure of credit unions depends upon a board elected by the members on a one-person, one-vote basis, and board members are not usually compensated for their service. Credit unions have no separate group of stockholders, and no ability to use stock options to motivate management to take potentially profitable risks. Their primary incentive is to satisfy members, which creates multiple objectives instead of a single goal to generate profits.

A key implication of differences in structure and risk-taking behavior is that credit unions and banks should be regulated differently in the area of capital requirements. Credit unions, Jackson concludes, ought not to be required to hold as much capital as banks because they are likely to behave in a less risky manner. But in current practice, credit unions are subject to higher capital requirements than banks.
Credit unions also tend to make special efforts to help low and moderate-income households build financial savings and reduce unnecessary debts. Credit unions serve a very broad spectrum of members, but often go out of their way to serve those of modest means.

Public policy should take into account the work of credit unions to make special efforts to meet the financial services needs of low- and moderate-income households. These socially positive activities must be included in the evaluation of optimal regulatory policies for credit unions. Accordingly, Jackson calls for the elimination of laws and regulations limiting credit unions' ability to provide check cashing services, money transfers, and payday loans to a larger number of households.

A key goal of credit union regulation should be to deliver a wide range of consumer choice through a competitive and innovative financial marketplace, while insuring a safe and sound financial system. Congress has a historical opportunity to remove the restrictions that limit credit unions' ability to provide the products and services that their members need and demand.

The author of this report, William E. Jackson III, is a leading scholar in the field of empirical economics, management, and banking. An Associate Professor of Finance and Economics at the University of North Carolina at Chapel Hill, Dr. Jackson's research has been published in leading journals including the *Journal of Money, Credit, and Banking; Management Science; the Review of Industrial Organization; the Journal of Banking and Finance; and the Review of Economics and Statistics*. Much of his academic research has received support from the prestigious National Science Foundation. During 2002, Dr. Jackson was a Visiting Research Scholar at the Federal Reserve Bank of Cleveland. He is a member of the Advisory Board for the Credit Research Center at Georgetown University; and a member of the Advisory Board for the University of North Carolina School of Law-Center for Banking and Finance.

With this report, Dr. Jackson makes a landmark contribution to the literature on financial institution law and regulation, and the need for regulatory parity among depository institutions.
Introduction

By any reasonable measure, the U.S. financial system is the biggest and the best in the world. With over 80 million members and more than $500 billion in assets, U.S. credit unions are an integral part of the system. Commercial banks, thrifts (i.e., savings banks and savings and loans), investment banks, insurance companies, pension funds, investment companies (e.g., mutual funds), finance companies, and certain government-sponsored enterprises are also key components of the financial system in the United States.

 Depository institutions – commercial banks, thrifts, and credit unions – play an especially important role in the smooth functioning of the U.S. financial system. Imagine a world without checks that clear the system within days, without credit card transactions that clear the system in a matter of seconds, without wire transfers that clear the system almost instantly, and it becomes apparent just how vital depository institutions are to U.S. business and individual consumers. Depository institutions are important players in the monetary policy process of the Federal Reserve System.

Because depository institutions are so influential in the overall health of the U.S. financial system, they are subject to numerous regulations. However, Congress has changed many of these regulations over the last twenty years. Regulatory changes were enacted in recognition of the significant technological, competitive, and other market changes faced by depository institutions. Taken as a whole, these regulatory changes (mainly deregulation) produced benefits to the system and to consumers alike. Nonetheless, the issue of whether there has been enough deregulation or whether different types of institutions have been or should be treated differently by deregulation is open to question. This report addresses the issue of whether Congress should provide substantially more (or less) regulatory relief for credit unions relative to other depository institutions.

To get to a reasonable and rational answer to the question, we follow a six-step approach. In the first step, we present background information on the operations and current trends for three types of depository institutions (i.e., commercial banks, thrifts, and credit unions). In the second step, we address the general question of why Congress deregulated the depository institution industry. This allows us to develop a framework for
evaluating the dynamics of recent U.S. regulatory policy toward depository institutions. After establishing a rationale for their deregulation, we summarize in step three the major acts of Congress that codified the deregulation of depository institutions. Step four focuses in more detail on recent credit union deregulation by Congress. Step four also compares bank and thrift deregulation to credit union deregulation, to evaluate whether credit unions have received more or less deregulation than banks or thrifts. Step five is the most important part of the report. It investigates areas where deregulation has varied for credit unions relative to banks or thrifts. This investigation includes an evaluation of whether a differential deregulatory treatment of credit unions is reasonable. The criteria for judging equity is based on similarities and differences among banks, thrifts, and credit unions as depository institutions and financial services providers in the overall U.S. financial system. The key question is this: When are good reasons for deregulating banks and thrifts also good reasons for deregulating credit unions?

Step six summarizes and synthesizes the issues presented in the first five steps, to provide guidelines for considering optimal regulation of credit unions. Here we address two questions: First, what are the objectives of optimal credit union regulation? Second, are there unique characteristics of credit unions that suggest they need more or less regulation than banks or thrifts? Each of these six steps is covered in succeeding chapters of the report.

CONCLUSIONS

Our conclusions are fairly straightforward. First, the reason Congress deregulated the depository institution industry is that legislators rightly concluded that the depository institution industry had fundamentally changed. And because the industry had changed, the regulations governing the industry had to change to reflect the new competitive realities facing banks, thrifts, and credit unions. Second, a significant amount of financial deregulation occurred over the last twenty years. Third, credit unions have been deregulated less than commercial banks or thrifts. Fourth, the same factors supporting deregulation of other depository institutions also support deregulation of credit unions. And, fifth, the degree of recent deregulation in the banking
industry is likely to be appropriate for credit unions. Public policy should not be a legislative mandate for creating artificial differences in operational choices available to various types of financial institutions. Rather, public policy should establish a broad framework within which operational differences are determined by the strategic choices of the institutions themselves, given their different structures and forms of organization, within a competitive marketplace governed by prudent regulatory oversight. However, the differences in risks associated with different financial operations must be carefully considered in developing regulations for depository institutions. The legislation codifying these principles must be broad enough to allow regulatory and supervisory agencies to oversee their industries as those industries adapt to a changing competitive marketplace.

Good public policy also dictates that regulation be adjusted when the costs of regulatory restrictions exceed their benefits. The current cost of regulatory restrictions on credit unions greatly exceeds any reasonable measure of their benefits. The regulation of credit unions (as with other depository institutions) should provide as much consumer choice as possible by promoting a competitive and innovative financial marketplace that recognizes the unique cooperative nature of credit unions, while insuring a safe and sound financial system. Current regulations limit credit unions’ ability to provide the products and services that their members (consumers) demand.

A more comprehensive evaluation of how regulatory policy toward credit unions should be changed is included later in this report. Chapter 1 presents background information on credit unions, commercial banks, and thrifts.
CHAPTER 1: 
Background on Depository Institutions

This chapter provides background on the similarities and differences between three types of depository institutions. For each type of institution, we present an analysis of (a) the major sources of its funding – the liability side of its balance sheet; (b) how it lends and invests its funds – the asset side of its balance sheet; and (c) the structure of its ownership – the equity or capital portion of its balance sheet. This analysis demonstrates that the operational differences between depository institutions (banks, credit unions and thrifts) are very distinctive. The analysis also illuminates the historical power of regulations in shaping the landscape of the U.S. financial services industry. Those regulations place different limitations on the powers, or abilities, of financial institutions to enter markets or provide products and services.

A distinguishing feature between depository institutions and non-financial firms is that depository institutions’ major assets are loans (financial assets) and their major liabilities are deposits. Just the opposite is true for non-financial firms. For non-financial firms, deposits appear as assets on the balance sheet and loans appear as liabilities. In contrast to depository institutions, non-financial firms’ major assets are tangible assets such as buildings and machinery. Depository institutions provide loans to, and accept deposits from, non-financial firms and individuals, while non-financial firms provide deposits to, and obtain loans from, depository institutions.

A snapshot of the relative size of financial institutions is shown in Table 1.

<table>
<thead>
<tr>
<th></th>
<th>Credit Unions</th>
<th>Thrifts</th>
<th>Commercial Banks</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Assets ($ billions)</td>
<td>$515</td>
<td>$1,300</td>
<td>$6,600</td>
<td>$8,415</td>
</tr>
<tr>
<td>Percent of Assets</td>
<td>6.1%</td>
<td>15.4%</td>
<td>78.5%</td>
<td>100.0%</td>
</tr>
<tr>
<td>Number of Institutions</td>
<td>10,355</td>
<td>1,533</td>
<td>8,080</td>
<td>19,968</td>
</tr>
<tr>
<td>Percent of Institutions</td>
<td>51.9%</td>
<td>7.7%</td>
<td>40.4%</td>
<td>100.0%</td>
</tr>
<tr>
<td>Average size of Institution ($ millions)</td>
<td>$49.7</td>
<td>$848.0</td>
<td>$816.8</td>
<td>$421.4</td>
</tr>
</tbody>
</table>

Source: CUNA and FDIC Web sites
Table 2 provides additional information about the assets, liabilities and equities of banks, thrifts and credit unions.

### Table 2 – Financial Institution Balance Sheets: Yearend 2001*

<table>
<thead>
<tr>
<th></th>
<th>Banks</th>
<th>Thrifts</th>
<th>CUs</th>
<th>%</th>
<th>%</th>
<th>%</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Assets:</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Loans secured by real estate</td>
<td>$1,803,587</td>
<td>$758,394</td>
<td>$135,315</td>
<td>27</td>
<td>58</td>
<td>26</td>
</tr>
<tr>
<td>Commercial &amp; industrial loans**</td>
<td>$982,480</td>
<td>$36,754</td>
<td>$5,624</td>
<td>15</td>
<td>3</td>
<td>1</td>
</tr>
<tr>
<td>Loans to individuals</td>
<td>$631,160</td>
<td>$69,421</td>
<td>$188,250</td>
<td>10</td>
<td>5</td>
<td>37</td>
</tr>
<tr>
<td>Other loans &amp; leases</td>
<td>$478,128</td>
<td>$6,807</td>
<td>$1,654</td>
<td>7</td>
<td>1</td>
<td>0</td>
</tr>
<tr>
<td>Total loans &amp; leases</td>
<td>$3,895,355</td>
<td>$871,376</td>
<td>$330,843</td>
<td>59</td>
<td>67</td>
<td>64</td>
</tr>
<tr>
<td>Cash &amp; investments</td>
<td>$1,888,205</td>
<td>$347,658</td>
<td>$166,914</td>
<td>29</td>
<td>27</td>
<td>32</td>
</tr>
<tr>
<td>Other assets</td>
<td>$785,680</td>
<td>$79,975</td>
<td>$16,933</td>
<td>12</td>
<td>6</td>
<td>3</td>
</tr>
<tr>
<td>Total assets</td>
<td>$6,569,240</td>
<td>$1,299,010</td>
<td>$514,690</td>
<td>100</td>
<td>100</td>
<td>100</td>
</tr>
<tr>
<td><strong>Liabilities and Equity:</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Demand/checkable deposits</td>
<td>$575,894</td>
<td>$50,404</td>
<td>$55,633</td>
<td>9</td>
<td>4</td>
<td>11</td>
</tr>
<tr>
<td>Savings deposits</td>
<td>$1,889,319</td>
<td>$346,275</td>
<td>$225,225</td>
<td>29</td>
<td>27</td>
<td>44</td>
</tr>
<tr>
<td>Total time deposits</td>
<td>$1,296,730</td>
<td>$226,964</td>
<td>$161,516</td>
<td>20</td>
<td>17</td>
<td>31</td>
</tr>
<tr>
<td>Small time deposits</td>
<td>$635,200</td>
<td>$173,284</td>
<td>$161,516</td>
<td>10</td>
<td>13</td>
<td>31</td>
</tr>
<tr>
<td>Large time deposits***</td>
<td>$661,530</td>
<td>$53,680</td>
<td>$0</td>
<td>10</td>
<td>4</td>
<td>0</td>
</tr>
<tr>
<td>Other deposits</td>
<td>$629,680</td>
<td>$174,179</td>
<td>$6,281</td>
<td>10</td>
<td>13</td>
<td>1</td>
</tr>
<tr>
<td>Total deposits</td>
<td>$4,391,623</td>
<td>$797,822</td>
<td>$448,655</td>
<td>67</td>
<td>61</td>
<td>87</td>
</tr>
<tr>
<td>Other liabilities</td>
<td>$1,580,160</td>
<td>$391,570</td>
<td>$9,779</td>
<td>24</td>
<td>30</td>
<td>2</td>
</tr>
<tr>
<td>Equity capital</td>
<td>$597,457</td>
<td>$109,618</td>
<td>$56,256</td>
<td>9</td>
<td>8</td>
<td>11</td>
</tr>
<tr>
<td>Total liabilities and equity</td>
<td>$6,569,240</td>
<td>$1,299,010</td>
<td>$514,690</td>
<td>100</td>
<td>100</td>
<td>100</td>
</tr>
</tbody>
</table>

* Dollars in millions

** CU Member Business Loans are categorized as C&I loans.

*** At year-end 2001 92% of total deposits at federally-insured credit unions were insured. Amounts in CU deposits exceeding $100,000 are assumed to be retail deposits.

Source: FDIC, NCUA and CUNA E&S.
COMMERCIAL BANKS

We will first examine how commercial banks raise money (liabilities), how they invest money (assets), and how their ownership structure (capital) is organized. At the end of 2001, there were 8,080 commercial banks in the United States. These banks held about $6.6 trillion in total assets. This made commercial banks the largest of the depository institutions measured by asset size. Commercial banks perform functions similar to those of thrifts and credit unions. They accept deposits (liabilities) and make loans (assets). Commercial banks are distinguishable from thrifts and credit unions, however, by the size and composition of their loans and deposits. While deposits are their major source of funding, commercial bank liabilities usually include several types of non-deposit sources of funds, such as subordinated notes and debentures, as part of their liabilities. Moreover, their loans are broader in range, including consumer, commercial, international, and real estate loans. Commercial banks are regulated separately from savings institutions and credit unions. And within the banking industry itself, the structure and composition of assets and liabilities varies significantly for banks of different asset sizes.

How commercial banks raise their money – liabilities

Commercial banks raise money from two major sources: 1) deposits; and 2) borrowed funds. The equity provided by owners and stockholders is also a source of funds. Banks use a high proportion of liabilities relative to equity capital to fund their assets. For example, U.S. commercial banks had an average ratio of equity to assets of about 9% at the end of 2001. This implies that about 91% of the assets held by commercial banks were funded by debt, either deposits or borrowed funds.

The aggregate balance sheet of U.S. banks, at December 31, 2001, showed deposits amounted to $4,392 billion, or 67% of total assets. Of the total stock of deposits, transaction accounts represented 13%, or $576 billion. Transaction accounts are checkable deposits that either pay no interest (demand deposits) or are interest bearing (most commonly called negotiable order of withdrawal accounts or NOW accounts). Since their introduction in 1980, interest-bearing checking accounts, especially NOW accounts, have dominated the transaction accounts of banks.
Nevertheless, since limitations are imposed on the ability of corporations to hold such accounts, and NOW accounts often have minimum balance requirements, non-interest-bearing demand deposits are still held.

The second major segment of deposits is retail or household savings and time deposits, and money market deposit accounts (MMDAs) (see Table 3). These are normally individual accounts with balances of less than $100,000. These accounts represent about $2.525 billion (or about 57%) of total deposits. However, this disguises an important trend in the supply of deposits to banks. The amount held in retail savings and time deposits has been falling in recent years, largely as a result of competition from money market mutual funds. These funds pay a competitive rate of interest based on wholesale money market rates by pooling and investing funds while requiring relatively small-denomination investments.

<table>
<thead>
<tr>
<th>Table 3 – Share of Savings by Institution</th>
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</thead>
<tbody>
<tr>
<td>Distribution of Consumer Savings ($ billions)</td>
</tr>
<tr>
<td><strong>Outstanding</strong></td>
</tr>
<tr>
<td>Commercial Banks</td>
</tr>
<tr>
<td>Savings Institutions</td>
</tr>
<tr>
<td>MMMFs</td>
</tr>
<tr>
<td>Credit Unions</td>
</tr>
<tr>
<td>U.S. Savings Bonds</td>
</tr>
<tr>
<td>Total</td>
</tr>
</tbody>
</table>

Source: CUNA Web site (www.cuna.org)

The third major segment of bank deposit funds is large time deposits of $100,000 or more; these deposits amounted to $662 billion, or approximately 15% of total deposits, at December 31, 2001. Large time deposits are primarily negotiable certificates of deposit (deposit claims with promised interest rates and fixed maturities of at least 14 days) that can be resold to outside investors in an organized secondary market. As such, they are usually distinguished from retail time deposits by their negotiability and secondary market liquidity.
Non-deposit liabilities, or other liabilities, totaled about 26% of all bank liabilities ($1,580 billion) at the end of 2001. These categories include a broad array of instruments, such as purchases of federal funds (bank reserves) on the interbank market and repurchase agreements (temporary swaps of securities for federal funds) at the short end of the maturity spectrum; and issuance of notes and bonds at the longer end of the spectrum.

Overall, the liability structure of commercial banks’ balance sheets reflects a shorter maturity structure than that of their asset portfolio. Relatively more liquid instruments such as deposits and interbank borrowings are used to fund relatively less liquid assets such as loans. Thus, interest rate risk and liquidity risk are key exposure concerns for bank managers (Saunders and Cornett, 2001).

How commercial banks invest their money – assets

The aggregate balance sheet and percentage distributions for all U.S. commercial banks as of December 31, 2001 reveal that the majority of their assets are loans. Total loans amounted to $3,895 billion, or 59% of total assets. These loans fell into four broad classes: business or commercial and industrial loans, accounting for 25% of total loans; commercial and residential real estate loans, accounting for a little over 46% of total loans; individual loans (auto purchases and credit card loans), at about 16% of total loans; and all other loans, such as loans to emerging market countries, which account for about 12% of total loans (see Table 4).

<table>
<thead>
<tr>
<th>Table 4 – Share of Installment Credit by Institution</th>
</tr>
</thead>
<tbody>
<tr>
<td>Share of Installment Credit Outstanding by Selected Lenders ($ billions)</td>
</tr>
<tr>
<td>-------------------------------</td>
</tr>
<tr>
<td>Commercial Banks</td>
</tr>
<tr>
<td>Pool of Securitized Assets</td>
</tr>
<tr>
<td>Finance Companies</td>
</tr>
<tr>
<td>Credit Unions</td>
</tr>
<tr>
<td>Savings Institutions</td>
</tr>
<tr>
<td>Nonfinancial business</td>
</tr>
<tr>
<td>Total</td>
</tr>
</tbody>
</table>

Source: CUNA Web site (www.cuna.org)
The next major asset on the balance sheet of banks is investment securities. Investment securities consist of items such as interest-bearing deposits purchased from other financial institutions, federal funds sold to other banks, repurchase agreements, U.S. Treasury and agency securities, municipal securities issued by states and political subdivisions, mortgage-backed securities, and other debt and equity securities. At the end of 2001, the investment portfolio of commercial banks totaled $1,180 billion, or 18% of total assets. Investment securities generate interest income for the bank and are also used for trading and liquidity management purposes. Many investment securities held by banks are highly liquid, have low default risk, and can usually be traded in secondary markets.

A major inference we can draw from banks’ asset structure (and the importance of loans in this asset structure) is that the major risk faced by modern commercial bank managers is credit or default risk and, ultimately, insolvency risk (Saunders and Cornett, 2001).

**The structure of commercial banks ownership – equity capital**

Commercial bank equity capital (9% of total assets) consists primarily of common and preferred stock (listed as par value), surplus (i.e., additional paid-in capital), and retained earnings. Regulators require banks to hold a minimum level of equity capital to act as a buffer against losses from on- and off-balance sheet activities. Because of the relatively high cost of equity funding compared to deposit funding, banks tend to hold equity levels close to the minimum levels set by regulators. This impacts banks’ exposure to risk and their ability to grow over time.
THRIFT INSTITUTIONS

Thrift institutions are comprised of two groups of depository institutions: savings associations and savings banks. Thrift institutions were first created in the early 1800s in response to commercial banks’ failure to adequately serve the needs of individuals requiring borrowed funds to purchase homes. Thus, while today’s thrifts generally perform services similar to those of commercial banks, they are grouped separately from commercial banks because they are often thought of as providing important specialty lending services to households. For example, savings associations and savings banks have both concentrated heavily on residential mortgages. However, savings banks have been slightly more diversified institutions, holding significant amounts of commercial loans, corporate bonds, and a small amount of corporate stock. Both categories of thrift institution include federally chartered and state chartered institutions. For the purposes of our discussion, both are included in a consolidated analysis of the thrift industry.

How thrifts raise their money – liabilities

At the end of 2001, there were 1,533 thrift institutions in the United States. These thrifts held about $1.3 trillion in total assets. Small time and savings deposits were the predominant source of funding for these assets, accounting for about 43% of total liabilities. The second most important source of funds was borrowing from the 12 Federal Home Loan Banks (FHLBs), which the institutions themselves own. Because of their size and government-sponsored status, FHLBs have access to wholesale money markets for notes and bonds, and can re-lend the funds borrowed in these markets to thrifts at a small markup over wholesale cost. FHLB borrowings represented about 21% of total liabilities for the thrift industry on December 31, 2001. Other borrowed funds in the thrift industry included such items as repurchase agreements and direct federal fund borrowings.
How thrifts invest their money – assets

The investment activity of the thrift industry is concentrated in residential real estate products. The balance sheet of the thrift industry at the end of 2001 shows that mortgages represented about 58% of total assets. In an attempt to diversify their asset holdings using recently deregulated lending powers, thrifts invested in commercial loans and consumer loans to the extent of 3% and 5% of total assets, respectively. Finally, thrifts are required to hold cash and investment securities for liquidity purposes, and to meet regulator-imposed reserve requirements. Thus, cash and investment holdings amounted to about 27% of total assets at the end of 2001.

The structure of thrift ownership – equity capital

The book value of the equity holders’ capital contribution in the thrift industry amounted to approximately 8% of total assets in 2001. Most thrifts were established as mutual organizations in which the depositors are the legal owners of the institution and no stock is issued. As mutual organizations, member deposits and retained earnings represent the equity of thrifts. Since there are no stockholders, and thus no demand for equity investment returns, mutual organizations are generally less risky than stock-chartered organizations. This is because mutual thrift managers can concentrate on low-risk investments and the prevention of failure rather than higher risk investments needed to produce higher required returns on stockholders’ investments (Saunders and Cornett, 2001). However, over time many thrifts have switched from mutual to stock charters, in which the holders of the stock or equity are the legal owners of the institution rather than depositors. Conversion usually occurs because stock ownership allows thrift institutions to attract capital investment from outside stockholders beyond levels achievable at a mutual institution.
CREDIT UNIONS

Credit unions (CUs) are not-for-profit depository institutions mutually organized and owned by their members (depositors). Credit unions were first established in the United States in the early 1900s as self-help organizations intended to meet the financial needs of working class families. The first credit unions were organized in the Northeast, initially in Manchester, New Hampshire. Members paid an entrance fee and deposited funds to purchase at least one share. Members were expected to deposit their savings in the CU, and these funds were lent only to other members.

This limit in the customer base of CUs continues today as, unlike commercial banks and thrifts, CUs are prohibited from serving the general public. In organizing a credit union, members are required to have a common bond of occupation (e.g., police CUs), association (e.g., church-affiliated CUs), or cover a well-defined neighborhood, community, or rural district. Under certain conditions CUs may, however, serve multiple groups with more than one type of membership.

The primary objective of credit unions is to satisfy the depository and borrowing needs of their members. CU member deposits (called shares, representing ownership in the CU) are used to provide loans to other members in need of funds. Earnings from these loans are used to pay interest on member deposits. Because credit unions are not-for-profit organizations, their earnings are not taxed. CUs tend to use this tax-exempt status to offer higher rates on deposits and charge lower rates on some types of loans compared to banks and thrifts. CUs also benefit from their unpaid volunteer boards of directors, and from not being obligated to pay returns to stockholders.

Background on the composition of the credit union industry

Credit unions are the most numerous of the three types of depository institutions. As of the end of 2001 there were 10,355 CUs in the U.S. During the 1980s, CUs were less affected by the crisis that adversely impacted commercial banks and thrifts. This is because more than 40% of CUs assets were typically in small consumer loans, often for amounts less than $10,000. These loans to members were funded mainly by deposits from members. This combination of relatively matched credit risk and maturity in CU
asset and liability portfolios left credit unions less exposed to credit and interest rate risk than commercial banks and thrifts (Saunders and Cornett, 2001).

In recent years, to attract and keep members, CUs have expanded their services to compete with commercial banks and thrifts. For example, many CUs now offer mortgages, credit lines, and automated teller machines. Some credit unions also offer business and commercial loans to members.

As CUs have expanded in membership, size, and services, bankers claim that CUs unfairly compete with small banks in small towns and local communities. The American Bankers Association claimed that the tax exemption for CUs gives them the equivalent of a $1 billion a year subsidy. The Credit Union National Association (CUNA) responds that any cost to taxpayers from CUs’ tax-exempt status is more than passed on to their members and society at large through favorable fees and interest rates on deposits and loans. For example, CUNA estimates that the benefits of CU membership can range from $200 to $500 a year per member for those members that use their CU as their primary financial institution (Saunders and Cornett, 2001).

**How credit unions raise their money – liabilities**

Credit union funding comes mainly from member deposits. Member deposits totaled $449 billion in 2001. This represented about 87% of total assets. Share draft accounts (similar to NOW accounts at other depository institutions), regular shares and other shares, accounted for 63% of all CU deposits. Certificates of deposits accounted for 36% of CU deposits.

**How credit unions invest their money – assets**

As of 2001, 10,355 credit unions had assets of $515 billion. This compares to $270 billion in assets in 1992, or a growth rate of 91% over the period 1992-2001. Individually, credit unions tend to be very small, with an average asset size of $49.7 million in 2001. This is less than 7% of the average size of a commercial bank in 2001 ($813 million). The total assets of all credit unions are smaller than the individual assets of several of the larger U.S. banking organizations. For example, Citigroup, BankAmerica, and Chase each had more assets than the total of all credit union assets in 2001.
Because credit unions focus mainly on consumer lending, it is not surprising to find that 37% of CU assets are in consumer loans and another 26% are in home mortgages. Together these member loans comprise 63% of total assets, and over 98% of total loans. Few business or commercial loans are issued by CUs.

Credit unions also invest heavily in investment securities. Such investments represented approximately 27% of total assets of credit unions in 2001. About 38% of the investment portfolio of CUs was in U.S. government Treasury securities or federal agency securities. This large investment portfolio allowed credit unions ample liquidity to meet their daily cash needs.

**The structure of credit union ownership – equity capital**

Credit unions tend to hold higher levels of equity than other depository institutions. Since CUs are not stockholder owned, this equity is basically the accumulation of past earnings from CU activities. These past earnings are collectively “owned” by member depositors. This equity protects a CU against losses on its loan portfolio as well as other financial and operating risks. At the end of 2001, CUs capital-to-assets ratio was 10.9% compared to 8.5% for thrifts, and 9.1% for commercial banks. However, these comparisons must be interpreted carefully, as credit unions have a much more restrictive definition of capital than either thrifts or banks (Saunders and Cornett, 2001).
CREDIT UNIONS COMPARED TO OTHER DEPOSITORY INSTITUTIONS

Credit unions are depository institutions. Like banks and thrifts, they accept deposits and make loans. At this basic financial level, credit unions resemble banks and thrift institutions: by intermediating funds from savers to borrowers, credit unions take on credit risk (the risk that borrowers will not repay loans) and interest rate risk (the risk that changes in interest rates will alter the value of assets relative to liabilities). Managing these risks represents a key aspect of credit unions’ financial operations. Supervising such risk-taking represents a key aspect of credit unions’ federal oversight and makes the responsibilities of the National Credit Union Administration (NCUA) much like those of the federal banking agencies.¹

However, credit unions have several characteristics that, taken together, distinguish them from commercial banks and thrifts. A recent report by the U.S. Department of the Treasury (2001b), discusses five basic credit union characteristics. The report suggests that although other financial institutions may also have one or more of these characteristics, it is the combination of all five that defines credit unions as a distinct class of depository institutions.

First, credit unions are member-owned, member-directed depository institutions.² Each member has one vote in selecting board members and making certain other decisions. This voting structure (one member, one vote) differs from that of mutual thrifts because a mutual thrift, although also member-owned, allocates voting rights according to the size of a member’s deposit (roughly equivalent to one vote per $100).

Like mutual thrifts, credit unions do not issue capital stock. Credit union member deposits are generally considered part of capital. But federal insurance protects virtually all of these deposits, and the deposits themselves do not represent the kind of capital available for absorbing losses and thereby protecting the Share Insurance Fund. Credit unions derive that kind of capital (i.e., net

¹ The federal banking agencies are the Office of the Comptroller of the Currency, the Office of Thrift Supervision, the Federal Reserve Board, and the Federal Deposit Insurance Corporation.

² Credit unions are structured as cooperatives. As a business form, the modern cooperative dates from the mid-1800s. Democratic participation in management by the cooperative’s members is a fundamental characteristic of cooperatives.
worth) from their accumulated retained earnings. Most credit
unions start their existence with no net worth, and build it up over
time. The absence of capital stock – and the concomitant reliance
on retained earnings – reinforces the member-owned character of
credit unions. It also means that credit unions, unlike most other
depositories, do not have the option of increasing their net worth
in time of stress by issuing stock.  

Second, credit unions rely on unpaid, volunteer boards of
directors elected by, and drawn from, each institution’s mem-
bership. The board sets policy for the credit union and hires the senior
management team. In small credit unions, member volunteers
may staff the institution. The board appoints member-volunteers
to a supervisory committee, which has responsibility for auditing
the credit union, reviewing its performance, and making recom-
endations to the board on these and other policy matters.

Third, credit unions do not operate for profit. They return any
earnings to their members, typically as reduced fees or reduced
interest rates on loans or as “dividends on shares” (which in
substance resemble interest paid on deposits), or reinvest those
earnings in the credit union as retained earnings.

Fourth, credit unions have a public purpose. According to the
Federal Credit Union Act, Congress intended credit unions “to
make more available to people of small means credit for provident
purposes.”  

The Act declares that credit unions are established for
“promoting thrift among [their] members and creating a source of
credit for provident or productive purposes.”  

Other depository
institutions are also required to incorporate the public purpose
into their operations, so the distinction here is one of degree. For
example, both national and state banks are required by the FDIC
to consider the “convenience and needs of the community to be
served” in their applications for deposit insurance (Spong, 1994).

Fifth, credit unions have certain limitations on their membership,
generally based on some affinity among members. According to
the International Credit Union Operating Principles of the World

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3 Although mutual savings banks and mutual savings associations also do not issue
stock, such institutions have the option of converting to stock form without
fundamentally altering their basic character. Credit unions cannot become stock
institutions and still remain credit unions.


Council of Credit Unions, “[m]embership in a credit union is voluntary and open to all within the accepted common bond of association that can make use of its services and are willing to accept the corresponding responsibilities.” The Federal Credit Union Act embodies this principle by limiting federal credit union membership to “groups having a common bond of occupation or association, or to groups within a well-defined neighborhood, community, or rural district.” Most state credit union statutes also impose some sort of common bond requirement. Thus, unlike other depository institutions, credit unions cannot serve just anyone from the general public.

Taken together, these characteristics lead to the conclusion that credit unions are indeed unique financial institutions for which some variation in regulatory treatment may be appropriate. However, they also suggest that, in general, credit unions have more limited powers than banks or thrifts. It is these limitations on credit union powers that this report seeks to evaluate. In particular, we question whether these limitations enhance or hinder the economic efficiency and fairness of the U.S. financial system. Stated differently, do the costs of regulatory limitations currently in place for credit unions outweigh the benefits? We consider the benefits of regulatory limitations as enhancing the safety and soundness of the credit union industry, and the costs of regulatory limitations as the detrimental impact on consumer choice caused by stifled financial innovation associated with such limitations. Obviously, good public policy dictates that these regulatory limitations on credit unions (or any group of financial institutions) be adjusted whenever their costs exceed their benefits. It seems likely that the current costs of the limitations imposed by credit union regulations greatly exceed any reasonable measure of their current benefits. In the final analysis, the regulation of credit unions should seek to provide as much consumer choice as possible by promoting a competitive and innovative financial marketplace, while insuring a safe and sound financial system. It appears that deregulation has not gone far enough in removing the limits on the ability of credit unions to provide the products and services that their members demand.

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7 Ibid.
8 Ibid.
A more comprehensive evaluation of how regulatory policy toward credit unions should be changed is presented later in this report.
CHAPTER 2: Rationale for Deregulating Depository Institutions

In this chapter we demonstrate that the recent deregulation of commercial banks, thrifts and credit unions has been a positive public policy decision by Congress and the regulators. Even though certain components of the deregulating legislation were not fully developed and parts of the regulatory policy instruments were not well implemented, the U.S. financial system is better off today because of deregulation over the last twenty years. In the next chapter, we will present an overview and summary of some of the more important recent legislation that deregulated depository institutions. Our major question of concern in this chapter is: Why was deregulation necessary?

The depository institution industry is dynamic, and changed dramatically over the period 1980-2001. Depository institution regulation also needed to change. However, the complex relationship between the industry and the set of regulations that govern the industry requires an appreciation of the goals of depository institution regulation. And to understand the goals of depository institutions regulation, one must begin with an appreciation of the role of depository institutions in a modern economy (Greenspan, 1993). One must also consider how the role of depository institutions and the economy has changed over the past two decades. In the next three sections of this chapter we present discussions of: (1) the role of depository institutions in a modern economy, (2) the major factors that spurred changes in the economy and the depository institution industry, and (3) the goals of optimal depository institution regulation.

THE ROLE OF DEPOSITORY INSTITUTIONS IN A MODERN ECONOMY

At their most basic level, depository institutions create value by providing insurance (risk management) services, information services, and intermediation services. The intermediation service results in depositors receiving rates that are lower than the yields on loans and securities in the depository institutions’ asset portfolio. However, in return for this lower yield, the depository institution provides liquidity, payment services (i.e., demand deposits), and perhaps most importantly, increased safety or decreased risk. The intermediation process, in turn, is predicated on the ability of depository institutions to develop specialized information on the credit worthiness of their borrowers, and to use
In short, depository institutions are in the business of managing risk and information. If they manage correctly, they create value. If done incorrectly, the depository institution misallocates real resources and may even fail. Of course, even depository institutions that manage correctly may fail because they are unlucky. Historically, the value of a commercial depository institution’s franchise depended on the credit insights and evaluative ability of the institution’s manager. The manager's ability to gauge the capacity and willingness of a borrower to repay a loan, or to sense and calculate which risks appear to hedge others is important. These old-fashioned concepts remain relevant in evaluating depository institution managers, even as we move toward using more sophisticated risk management models involving betas, deltas, covariances, and other evolving techniques of risk reduction (Greenspan, 1993).

To better understand the important economic function that depository institutions' play, imagine a simple world in which they do not exist. In such a world, households generating excess savings by consuming less than they earn would have two options: They could 1) hold cash as an asset or 2) invest it in the securities issued by corporations. In general, corporations issue securities to finance their investments in real assets and to cover the gap between their investment plans and their internally generated savings such as retained earnings. In such a world, savings would flow from households to corporations; in return, financial claims (equity and debt securities) would flow from corporations to household savers. The same argument can be made to explain why depository institutions are essential in accommodating households and small businesses in need of funds.

Actually, depository institutions greatly enhance the level of fund flows between household savers and corporate or individual borrowers by reducing the cost of such flows. This is because depository institutions have the ability to reduce the costs facing the saver who desires to invest in the financial claims of corporations or individuals. In general, the saver faces at least

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9 This part of this section is based on Cornett and Saunders (1999).
three types of investing costs. These include information costs, liquidity costs, and price risk costs.

**Information costs**

One problem that an average saver faces when seeking to directly invest in the financial claims of a commercial firm or individual is the high cost of information collection. First, the saver must expend significant resources to collect enough information to decide which securities to purchase. Second, after purchasing these securities household savers must expend additional resources to monitor the actions of the securities issuers in a timely fashion. Failure to monitor exposes investors to agency costs, that is, the risk that the borrower will take actions with the saver’s money that are contrary to the promises contained in the covenants of its securities contracts. One solution to this problem is for a large number of small savers to place their funds with a single depository institution. This depository institution groups the funds and invests them in the direct or primary financial claims issued by firms or individuals. This aggregation of funds resolves a number of problems. The relatively large depository institution now has a much greater incentive to collect information and monitor the borrower’s actions, because the depository institution has far more at stake than any small individual household.

**Liquidity costs and price risk costs**

How can depository institutions offer highly liquid and low price-risk contracts to savers on the liability side of their balance sheets while investing in relatively illiquid and higher price-risk securities issued by corporations, or individuals, on the asset side? And why should savers and investors believe depository institutions’ promises regarding the liquidity of their investments?

The answers to these questions lie in the depository institutions’ ability to diversify some of their portfolio risks. So long as the returns on different investments are not perfectly positively correlated, by exploiting the benefits of size, depository institutions diversify away significant amounts of portfolio risk – for example, the risk specific to individual loans. This risk diversification allows a depository institution to predict more accurately its expected return on its asset portfolio. As a result, it can credibly fulfill its promise to households to supply highly liquid claims with little price or capital value risk. A good example
of this is a depository institution’s ability to offer highly liquid demand deposits – with a fixed principal value – as liabilities while investing in risky loans as assets. As long as a depository institution is sufficiently large to gain from diversification and monitoring, its financial claims are likely to be viewed as liquid and attractive to small savers, compared to direct investments in the capital market. The smaller and the less diversified a depository institution becomes, the less able it is to credibly promise household savers that its financial claims are highly liquid and have low capital risk. Specifically, the less diversified the depository institution, the higher the probability that it will default on its liability obligations and the riskier and more illiquid its claims will be. However, to the extent that government provides deposit insurance, small savers’ concerns about default risk are reduced, as is the necessity for depository institutions to be large and diversified to credibly provide highly liquid claims.

**Maturity intermediation**

Another dimension of depository institutions’ risk reduction by diversification is their ability to bear the risk of mismatching the maturities of assets and liabilities. Thus, depository institutions offer what is often called *maturity intermediation* services to the rest of the economy. Through maturity mismatching, depository institutions produce new types of contracts such as long-term mortgage loans, while raising funds with short-term liability contracts. Although such mismatches can subject a depository institution to interest rate risk, a large depository institution is better able to manage the risk because it has greater access to markets and instruments for hedging, including loan sales, asset securitizations, futures, swaps, and options.

**Special nature of depository institutions and regulation**

Without these risk management services, both savers and borrowers would be at considerable risk. Regulation is necessary to protect savers in times of economic stress. Depository institution failures can destroy household savings and at the same time restrict a borrower’s access to credit (Cornett and Saunders, 1999).
THE CHANGING DEPOSITORY INSTITUTION INDUSTRY

Over the last two decades there have been drastic changes in the structure and operations of depository institutions markets and the industry itself. To a large degree, these changes can be traced to three factors. These factors are significant individually, but combined they created a “Perfect Storm” of change for the industry. The first and most powerful factor was advancements in technology. The second was increased competition. And the third was financial innovation and new product creation. These three factors were the driving forces behind the need for the deregulation of the industry.

Advancements in technology

Depository institutions are fundamentally in the information business: information collecting, processing, and evaluation. Whether evaluating the credit risk of a new borrower, providing account information for a long-time depositor, or creating a new risk management derivative instrument for a large corporate client, depository institutions must have the ability to process information. And when a business depends on information and the associated cost of processing information, a radical change in the basic cost of processing information produces a radical change in its basic business model.

There has been a radical change in the cost of processing information (or computing costs) over the last twenty years. The magnitude of this change is difficult to comprehend. For example, the cost of computing power today is less than one-thousandth of what it was fifteen years ago. This is a remarkable development. Personal computers (PCs), for example, are so much more powerful and less costly today relative to fifteen years ago, that a small depository institution today can run its entire operation on a few PCs, a feat that was totally unrealistic fifteen years ago. To put in perspective just how revolutionary the change in the cost structure of computing power has been, consider what a similar change would have done in the automobile industry. If the U.S. automobile industry had experienced a similar change in cost structure over the last fifteen years, the average domestically produced automobile would cost about $20.00 to produce. Or, if mileage efficiency were the metric of improved performance, the
average automobile would be able to get about 15,000 miles on a
gallon of gas. Obviously, cost changes of this magnitude are
difficult to appreciate by extrapolating existing industry models.
These cost changes dictated a shift in the fundamental paradigm
for the depository institution industry. These radical changes in
the cost of computing were accompanied by the development of
the Internet.

As industry analysts have proclaimed, the Internet changes
everything. For depository institutions, the Internet changes the
competitive landscape in two fundamental ways. First, the
Internet reduces the importance of geography in the production of
financial services and the maintenance of financial relationships.
And, second, it greatly reduces the cost of delivering most
financial services (DeYoung and Hunter, 2002). Exhibit 1 is a list
of estimated costs associated with providing a simple depositor
transaction. It shows that an Internet transaction costs about 1%
of a teller based transaction (in 1997 dollars).

<table>
<thead>
<tr>
<th>Exhibit 1: Cost by Channel</th>
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<tbody>
<tr>
<td>Channel</td>
</tr>
<tr>
<td>Teller Transaction</td>
</tr>
<tr>
<td>Live Call Center</td>
</tr>
<tr>
<td>Electronic Call Transaction</td>
</tr>
<tr>
<td>ATM</td>
</tr>
<tr>
<td>Internet</td>
</tr>
</tbody>
</table>


As the Internet became more popular during the 1990s, many
depository institutions switched from a PC based delivery channel
to an Internet based delivery channel. These depository
institutions recognized that at its most basic level, the Internet was
simply an alternative distribution channel. Exhibit 2 provides
summary data on the frequency of use of different financial
services delivery channels.
The Internet also spurred other firms to compete with traditional depository institutions. For example, portals such as Yahoo! began to incorporate finance-related content. At the Yahoo! Finance Web site, a traditional depository institution customer finds the same products offered by their local depository institution. These products (loans, insurance, investment accounts, etc.) are embedded into the finance-related material that the consumer can readily access while considering other financial products. For example, a customer can apply for a mortgage as well as read a short description of how mortgages function. These financial portals developed strategies to take advantage of the potential of Web sites to utilize economies of scope, and cross-sell products. For example, suppose a potential customer visits a financial portal to apply for a home equity loan. While at the web site the customer can also easily comparison shop for a better life insurance rate, investment brokerage services, or a better credit card rate. The competitive pressure from these types of Internet-related financial services providers helped foster a new, unprecedented era of competition and financial innovation in the depository institution industry. In the next two subsections, we discuss market competition and financial innovations as change agents that helped insure the need for depository institutions deregulation.


<table>
<thead>
<tr>
<th>Channel</th>
<th>1994</th>
<th>1999</th>
</tr>
</thead>
<tbody>
<tr>
<td>Branch</td>
<td>54%</td>
<td>40%</td>
</tr>
<tr>
<td>In-store branch</td>
<td>2%</td>
<td>3%</td>
</tr>
<tr>
<td>ATMs</td>
<td>22%</td>
<td>24%</td>
</tr>
<tr>
<td>PC/Online</td>
<td>–</td>
<td>2%</td>
</tr>
<tr>
<td>Mall</td>
<td>5%</td>
<td>3%</td>
</tr>
<tr>
<td>Telephone</td>
<td>12%</td>
<td>22%</td>
</tr>
<tr>
<td>Other</td>
<td>5%</td>
<td>3%</td>
</tr>
</tbody>
</table>

*Increases in market competition*

The delivery of retail, or consumer based, financial services has undergone substantial realignment in the past twenty years. With the relaxation of regulatory constraints on traditional financial intermediaries such as commercial banks, thrifts, credit unions, mutual funds, insurance companies, and brokerages houses, products and services became increasingly similar. For example, while banks and insurance companies were selling mutual funds, mutual fund companies like Fidelity and Schwab offered a full line of banking products and services. Even investment advice, once the hallmark of full-service brokers, was offered by almost everyone in the mutual fund business.

On the financial services demand side, the emergence of 401(k)-based retirement plans and growing personal responsibility for retirement finances heightened consumer interest in capital markets (albeit at an unsophisticated level). Consumer choices expanded thanks to a dizzying array of new products and services, and an abundance of financial information in the popular press and on the Internet. However, with 20% of investors generating about 80% of profits in consumer financial services markets, financial intermediaries began focusing on two key market segments: high net worth investors (often defined as individuals with over $250,000 in financial assets to invest), and technologically savvy investors who make their own decisions and execute them online.

Twenty years ago, there were expectations that a “supermarket” for consumer financial services would emerge. Firms such as Sears, American Express, Prudential-Bache, and others, were expected to be the leaders of this financial services restructuring. However, by 1998, Sears was no longer in the business, American Express retrenched, and Prudential-Bache encountered expansion difficulties. Nonetheless, this blurring of traditional boundaries between depository institutions, mutual funds, insurance, and brokerage, greatly intensified the scope of competition in the consumer financial services industry and produced great uncertainty concerning future developments.

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10 This subsection is based on Bradley and Mahmood (1998).
In response to this new competitive landscape, all types of financial institutions tried to alter their core customer base. For example, First Union Bank, a large regional concern, developed a strategy based on expanding its geographic reach and utilizing highly automated branches. Fidelity Investments, the mutual funds giant, developed a strategy based on offering combinations of banking and investment accounts, as well as insurance and annuities. Travelers Group joined its brokerage and insurance operations with Citicorp’s banking business, forming the world’s largest financial services firm. Merrill Lynch sold a vast array of products and services within the context of personalized financial advice. And Charles Schwab, the aggressive discount broker, broadened its products and added advisory services for the do-it-yourself investor.

All of these factors served to greatly increase competition in the markets faced by depository institutions and forced them to adapt to the new competitive landscape in order to survive. Competition led to more consumer choice among traditional financial products and an enormous increase in new types of financial products and services. This financial innovation will be discussed in the next subsection.

Financial innovation and new product creation

The explosive growth of new financial instruments and institutions over the past two decades places increased competitive pressures on commercial banks, thrifts, and credit unions. Bank depositors now have access to a vast array of mutual funds as an alternative vehicle for savings and liquidity. In the commercial credit arena, some borrowers now have access to a much greater set of financing vehicles – commercial paper for the most creditworthy firms to junk bond financing for riskier firms. To be sure, the depository institutions sector grew more slowly as a result of these new financial instruments and institutions. But the loss of market share has been limited, in part because depository institutions have responded with new financial technologies that create entirely new business strategies. In many cases, these changes fundamentally change the way depository institutions do business.

For example, by securitizing their loans (rather than holding them in portfolios) banks have economized on increasingly scarce sources of funds. Similarly, by reorienting their business mix
toward off-balance sheet activities like back-up lines of credit, banks continue to earn revenues from business customers who switch from loan financing to, say, commercial paper financing. And banks have made themselves relatively more attractive to depositors by offering increased convenience (e.g., ATM machines) and a broader array of investment options (e.g., proprietary or third-party mutual funds).

These changes greatly affect the composition of bank revenues, particularly at large banks. A bank with a securitized lending strategy collects little interest income because the loans it underwrites are not held for long on the books, but it collects lots of non-interest income (e.g., loan origination fees) because the volume of loans it underwrites increases. Similarly, a bank that writes back-up lines of credit (rather than writing loans) receives a fee for this service, but receives interest income only in the rare case that the client draws on the credit line. And a bank with a large ATM network receives income from third-party access fees as well as disproportionate fee income from its own customers. These customers may actually have chosen the bank because of its large ATM network, so they are probably willing to pay a little extra for the convenience (DeYoung and Hunter, 2002).

While many of these financial innovations allow some depository institutions to successfully compete, credit unions have not been allowed to enjoy the same measure of competitive flexibility. The lack of deregulatory flexibility for credit unions will be discussed in later chapters. Next we discuss banking industry consolidation, an important result flowing from the deregulation of the depository institution industry.

The impact of deregulation: Consolidation and structural change

Even if the stock of technology had remained constant over the past 20 years, the liberalization of U.S. banking laws alone would have resulted in drastic changes in the structure of the U.S. depository institution industry. The relaxation and eventual repeal of federal and state depository institutions regulations during the 1980s and 1990s eliminated barriers to geographic mobility. These barriers artificially limited the size of U.S. banks. Many banks took advantage of the new laws and grew substantially larger in a relatively short period of time, typically via in-market and out-of-
market mergers and acquisitions. The cumulative effect of these mergers greatly increased the size of the participating banks, and also substantially changed the overall structure of the depository institution industry. For example, in 1990 the largest U.S. commercial bank held about $150 billion in assets and the average bank held about $275 million. One decade and over 9,000 bank mergers later, the largest U.S. bank now holds about $600 billion in assets and the average bank now holds about $750 million. In addition, a growing number of large U.S. banks are becoming global players by making acquisitions across international borders (DeYoung and Hunter, 2002).

DeYoung and Hunter (2002) see a variety of motivations for these acquisitions. Benefits from increased scale are the most obvious. These benefits include but are not limited to: reduced unit costs; higher per unit revenues; improved access to capital markets; the ability to make larger loans or offer broader product lines; the ability to attract and retain high quality managers; reduced portfolio risk from diversifying into new geographic markets; and network benefits from integrating systems of branches and ATMs that cover different geographic areas. For banks that use traditional bank distribution channels, acquiring existing banks is simply faster and easier than growing internally by building new physical capacity. Acquiring physical branches may become a less important motivation for bank mergers as depository institutions products and services are increasingly delivered over electronic channels.

Other motivations are not related to enhanced efficiency. Banks operating in the same local or regional banking markets might merge in order to acquire market power. Bank managers might also pursue mergers because managing a large bank tends to produce high salaries.

Now, let us consider the impact of geographic deregulation on market concentration and competition in U.S. banking markets.

Since the mid-1980s, the geographic reach of the typical U.S. bank holding company has more than doubled. For example, in 1985 the average holding company affiliate with more than $100 million in assets was located about 160 miles from its holding company headquarters; by 1998 this distance increased to about 300 miles. The increase in the geographic reach of banking companies
substantially changed the overall structure of the U.S. banking industry, but it has had little effect on the structure of local markets. The share of the national market held by the ten largest U.S. banks doubled from about 20% to about 40% over the past two decades. Over the same period the Herfindahl index (a standard measure of market concentration, and a proxy for market competition) in the average urban banking market fluctuated between 1,950 and 2,050 with no clear upward trend. These data reflect the fact that most large bank mergers have been market extension mergers, in which a target bank is purchased by a bank from outside the local market (DeYoung and Hunter, 2002).

Even though local Herfindahl indices remained stable during the bank merger wave, competition in local depository institutions markets has probably grown more intense. A number of recent studies find that local banks tend to operate at higher levels of efficiency after the acquisition of a local competitor by an out-of-market bank. There are a number of explanations for this phenomenon, all of which begin with a post-merger change in the behavior of the local acquired bank. The new owners of the bank often replace under-performing managers, reallocate assets to higher yielding investments, slash expenses, introduce new products and services, cut fees, raise deposit rates, and make numerous other changes that intensify competitive rivalry in the local market. Local banks either respond in kind or they lose market share (DeYoung and Hunter, 2002).

**Summary: Industry, environment, and regulatory changes**

The powerful forces and environmental changes described earlier in this chapter caused Congress and regulators to re-examine public policy regarding financial institutions over the past 20 years. The Depository Institutions Deregulation and Monetary Control Act of 1980 eliminated many restrictions on banks’ pricing and product offerings. Limitations on banks’ market area were later set aside. For example, the Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994 permits banks headquartered in one state to open branches in other states if permitted by state law.

This process of deregulation brought positive results. It intensified competition among depository institutions, inducing them to
expand product offerings, increase efficiency, align prices with production costs, and improve service to consumers.

Recently, the string of deregulatory legislation culminated in the passage of the Gramm-Leach-Bliley Act; also known as the Financial Modernization Act of 1999. This Act repealed parts of the long-standing Glass-Steagall Act of 1933, including the parts that had prohibited banks from affiliating with securities firms and insurance companies. Under Gramm-Leach-Bliley, banks, insurance companies, securities firms, and other financial institutions can affiliate under common ownership and offer their customers a complete range of financial services.

The ultimate impact of Gramm-Leach-Bliley is yet to be realized. Will people want one-stop shopping for financial services at a financial “supermarket?” Or do they prefer purchasing services from a variety of different specialized providers? With the presence of both big institutions and niche players, people have choices. Maybe both types of institutions will do well because consumers’ tastes and preferences are not uniform (Santomero 2002).

This brings us to our main conclusion concerning the positive aspects of deregulation: deregulation expands consumer choice. Consumer choice will determine the mix of suppliers in the financial services industry. Therefore, the market will be driven by consumer preferences, and overall economic productivity will increase.

**THE GOALS OF OPTIMAL DEPOSITORY INSTITUTION REGULATION**

To understand why the regulations for depository institutions changed, we need to ask why depository institutions are regulated. What are the goals of depository institution regulation?

Depository institutions have come to be treated as a matter of public interest in the U.S. Law and regulations extend into almost every aspect of the depository institutions business. For example, banking laws specify who can start a bank, how the bank grows, and what products and services it can offer. Because depository institution regulation is so extensive, we need to understand the goals of regulation as well as its development.
The U.S. depository institutions regulatory system developed largely in response to financial crises and other historical and political events. No central agency was assigned to develop the fundamental principles or lay out the overall system of regulation. Instead, many individuals and agencies with many different viewpoints, objectives, and experiences wove the current regulatory framework. As a consequence, depository institution regulation evolved to serve numerous goals. Many of these goals changed over time and on occasion even conflicted with one another (Spong, 1994).

Conflicts aside, it is important to remember that the fundamental goal of regulation is to allow financial markets and institutions to work efficiently for the consumer, while maintaining the fundamental integrity, or safety and soundness, of the system. Optimal depository institution regulation lets the market work within a framework that keeps the market on the right track.

Spong (1994) lists four goals that optimal depository institution regulation should consider. In order of importance, these four goals are: (1) maintaining an efficient financial system; (2) protecting depositors; (3) protecting consumers; and (4) maintaining monetary stability.

*Maintaining an efficient financial system*

An effective financial system provides consumers with quality services at competitive prices. One of the purposes of depository institution regulation, therefore, is to create a regulatory framework that encourages efficiency and competition and ensures an adequate level of financial services throughout the economy.

Efficiency and competition are closely linked. In a competitive financial system, depository institutions must operate efficiently and use their resources wisely if they are to keep customers and remain in business. Without such competition, individual depository institutions might attempt to gain higher prices for their services by restricting output or colluding with other depository institutions. Competition is also a driving force in keeping depository institutions innovative in their operations and in designing new customer services. A further consideration is that in order for economic resources to flow to activities and places where they are of greatest value, competitive standards should not
differ significantly across depository institutions markets or between depository institutions and other industries.

The promotion of an efficient and competitive financial system carries a number of implications for regulation. Competition and efficiency depend on the number of depository institutions operating in a market, the freedom of other depository institutions to enter and compete, and the ability of depository institutions to achieve an appropriate size to serve their customers. Too few depository institutions in a market could encourage monopolization or collusion, while depository institutions of a suboptimal size might be unable to serve major customers and might be operating inefficiently. Consequently, regulators must be concerned not only with the concentration of resources in the depository institution industry, but also with the opportunities for entry and expansion across individual depository institutions markets (Spong, 1994).

Regulation must take an approach that does not needlessly restrict the operations of depository institutions. Such restrictions could place them at a competitive disadvantage with less regulated firms, or hinder the ability of depository institutions to serve their customers’ credit and other financial needs. Regulation should also foster a financial system that can adapt quickly to changing economic conditions and technological advances.

**Protecting depositors**

One of the earliest documented reasons for the regulation of depository institutions was depositor protection. Pressure for such regulation arose as the public began making financial transactions through depository institutions, and as businesses and individuals began holding a significant portion of their funds in depository institutions.

Depository institutions pose a number of unique problems for customers and creditors. Many customers use a depository institution primarily when writing and cashing checks and carrying out other financial transactions. To do so, they must maintain a deposit account. As a consequence, depository institution customers assume the role of creditors and become linked with the fortunes of the institution. This contrasts with most other businesses, where customers simply pay for goods or services and never become creditors of the firm.
A second problem for depositors is that under the U.S. fractional reserve system, deposits are only partially backed by the reserves depository institutions hold in the form of cash and balances maintained with the Federal Reserve. Consequently, depositor safety is linked to many other factors as well, including capital in depository institutions and the condition and value of the institution’s loans, securities, and other assets. A thorough investigation of these factors is likely to be too complex and costly for the vast majority of depositors, many of whom may have checking and savings accounts too small to justify the scrutiny given to major investments. Even if a depositor could make an initial assessment of the current value of a depository institution’s assets relative to its liabilities, the condition of the depository institution could change quickly as the economy changes or as the depository institution alters its asset portfolio and takes on new depositors and creditors. In addition, an important part of the information needed to evaluate the condition of a depository institution may be confidential and unavailable to the public.

In summary, depositors may have more difficulty protecting their interests relative to customers of other types of businesses. While depositors could conceivably make general judgments about the condition of depository institutions, the task would still be difficult, costly, and occasionally prone to error. These facts, especially when combined with the history of depositor losses before federal deposit insurance, explain much of the public pressure for depository institutions regulation to protect depositors (Spong, 1994).

**Protecting consumers**

Another goal of regulation is to protect consumer interests in their interactions with depository institutions. Broadly interpreted, this objective could encompass most depository institution regulations, as well as the legal protection given to all customers. Thus, it could include regulations designed to protect depositors, antitrust statutes, and state and federal laws regarding both creditor protection and the enforcement of financial contracts. Consumer protection concerns have commonly focused on the stream of legislation implemented under this goal over the past few decades.
Consumer protection Acts serve two basic purposes. The first is to require financial institutions to provide their customers with a meaningful disclosure of deposit and credit terms. The main intent of these disclosures is to give customers a basis for comparing and making informed choices among different institutions and financial instruments. The disclosure Acts also serve to protect borrowers from abusive practices and make them more aware of the costs and commitments in financial contracts. The second purpose of consumer protection legislation is to ensure equal treatment and equal access to credit among all financial customers. The equal treatment Acts can be viewed as the financial industry’s counterpart to civil rights legislation aimed at ensuring equal treatment in such areas as housing, employment, and education (Spong, 1994).

**Maintaining monetary stability**

Depository institution regulation must also seek to provide a stable monetary framework for making payments. This is important because checkable deposits held by depository institutions make up about one-half (51% at yearend 2001) of the M1 money supply, which includes currency, travelers’ checks, and checkable deposits.

With the vast volume of transactions conducted every day by individuals and businesses, a safe and acceptable means of payment is critical to the health of our economy. In fact, it is hard to envision how a complex economic system could function and avoid serious disruptions if the multitude of daily transactions could not be completed with a high degree of certainty and safety. Ideally, depository institution regulation should keep fluctuations in business activity and problems at individual depository institutions from interrupting the flow of transactions across the economy and threatening public confidence in the financial system.

The Federal Reserve is responsible for controlling the overall volume of money circulating throughout the economy, thus providing a stable base for our payment system. Banks, credit unions, and thrifts play an important role in our monetary system because their deposits make them the major issuers of money in the economy. This role is further acknowledged through specific laws and regulations determining which institutions can offer
deposit accounts, the level of reserves that must be held against these accounts, and the various deposit reports that must be filed (Spong, 1994).

Another policy aspect of monetary stability is supervision and regulation of the financial system. To provide stability, depository institution regulation should foster the development of adequate liquidity and discourage practices that might harm depositors and disrupt the payments system.

In the regulation of depository institutions, the objective of monetary stability has been closely linked with the goal of depositor protection. Financial crises and unintended fluctuations in the money supply have been prevented primarily by promoting confidence in depository institutions and guaranteeing the safety of deposits (Spong, 1994).

**Summary: Goals of depository institution regulations**

The fundamental question in considering the proper goals of regulation or deregulation is how regulations impact the consumer. Optimal regulatory policy grants financial institutions flexibility in responding to the financial needs and preferences of businesses and consumers, while maintaining safety and soundness of the overall financial system. Optimal regulatory policy also permits individual financial institutions to identify special needs of individual customers and market segments, tailor product and service offerings to meet those needs, and differentiate their offerings from those of other financial institutions.

Optimal regulatory policy recognizes that consumers vary greatly, and they want choices along several financial service dimensions, including such things as:

1. Product types, features, and assortment or variety
2. Reasonable prices
3. Convenient delivery systems
4. Relationships – some consumers want long-term relationships others only want to fill their immediate needs (i.e., a commodity-type service or product)
5. Service personnel (this may go beyond a simple delivery system)

6. Information and advice

7. Trust

8. Convenience

9. Product and service customization

10. Ownership form and structure

The end goal of optimal regulatory policy is a marketplace with many choices for consumers, businesses, and other users of financial services. A financial system composed of homogeneous financial institutions is not ideal. The ideal is not a 1920's marketplace of Henry Ford where “the customer can have any color car he wants, as long as it is black.” Consumer choice, not restriction, should be the primary driver of change in the marketplace.
CHAPTER 3: Overview of Major Legislative and Regulatory Changes Affecting the Depository Institution Industry Over the Last Twenty Years

Since 1980, Congress enacted several laws that dramatically changed the landscape under which banks and thrifts operate. Credit union powers were largely unchanged during this same time period. Indeed, the most significant legislation affecting credit unions was the Credit Union Membership Access Act of 1998 (CUMAA). While CUMAA slightly expanded the ability of credit unions to be composed of multiple employer groups, it imposed significant limitations in other areas. In particular, CUMAA created a very restrictive system of capital requirements for credit unions. CUMAA also placed severe limitations on business loans to credit union members. A detailed discussion of CUMAA is provided in chapter four.

In this chapter, we present a general summary of recent legislation that: (1) deregulated the liabilities of all depository institutions and made the assets of thrifts and credit unions more like, but not equivalent to, the assets of banks; (2) responded to the savings and loan crisis by strengthening supervision and enforcement; (3) removed restrictions on interstate expansion of banks and bank holding companies; and (4) increased the activities that may be conducted by a company that owns a bank. We also present a brief summary of recent legislation and regulatory action that affected credit unions.

LEGALIZATION THAT DERRGULATED THE LIABILITIES OF ALL DEPOSITORY INSTITUTIONS AND MADE THE ASSETS OF THRIFTS AND CREDIT UNIONS MORE LIKE, BUT NOT EQUIVALENT TO, THE ASSETS OF BANKS\(^1\)

**Background**

In the late 1970s, inflation increased market interest rates and seriously impaired the earnings of banks and thrifts. Interest rates became increasingly volatile in 1979 when the Fed announced that it would attempt to control inflation by restricting the growth in the money supply, rather than by maintaining interest rates. One effect of inflation was that depositors withdrew their funds from

\(^1\) Much of the material from this section is based on Lissa L. Broome & Jerry W. Markham, *Regulation of Bank Financial Service Activities*, Chapter 1 & 2 (West Group 2001).
depository institutions where interest rates on savings accounts were capped by Regulation Q at 5.25% for banks and 5.5% for thrifts, and invested instead in Treasury bills and money market mutual funds. In March of 1980, these types of investments were paying annualized rates of return between 14 and 15%. To meet withdrawal demands, some depository institutions were forced to borrow money at the high market rates of interest or sell, at large discounts, longer-term assets earning below-market interest rates, such as low interest rate home mortgage loans. As a result, by 1981 most thrifts were losing money. Losses soon depleted capital accounts resulting in the insolvency of eighty-one thrifts in 1981 and over 250 in 1982.

**Depository Institutions Deregulation and Monetary Control Act of 1980 (DIDMCA)**

To address the funding issue for depository institutions, Congress phased out the Regulation Q limits on the maximum interest rates payable on savings accounts, and permitted banks to pay interest on non-business checking accounts.\(^{12}\) Thrifts and credit unions significantly expanded their funding sources beyond traditional savings accounts to include negotiable order of withdrawal (NOW) accounts for thrifts and share draft accounts for credit unions, which were the functional equivalents of checking accounts. Federal savings banks were authorized to offer demand deposits to commercial customers.

To address the use of funds by depository institutions so that they might earn market rates of interest, thrifts were granted the ability to devote a limited percentage of their assets to loans other than traditional fixed-rate, 30-year home mortgage loans.\(^{13}\) Among the new, but still limited, loans were secured and unsecured consumer loans, loans secured by improved nonresidential real estate, and (for federal savings banks) commercial loans. Credit unions already had the power to make business loans to their members.

Thrift regulators realized these measures were not adequate to address thrift institution losses. Consequently, the Federal Home Loan Bank Board (FHLBB) reduced required capital reserves

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\(^{12}\) Regulation Q did not apply to credit unions.

\(^{13}\) The Credit Union Modernization Act of 1974 permitted credit unions to offer thirty year home mortgage loans and fifteen year mobile home and home improvement loans.
for thrifts from 5% of assets to 4%, and then to 3%. At the same time, the FHLBB developed “regulatory accounting principles” (RAP) to replace the more stringent generally accepted accounting principles previously used to account for thrifts’ financial performance.

**Garn – St Germain Act of 1982**

The Garn – St Germain Act continued the asset and liability expansion for thrifts to help ensure that these institutions could attract funds by offering market rates of interest and permitting the funds to be used for loans which would earn interest at current rates of interest. Federally chartered savings and loans were authorized to offer non-interest-bearing checking accounts to their commercial loan customers. On the asset side, the Act expanded the authority for thrifts to make consumer loans (other than home mortgage loans) for up to 30% of the thrift’s assets, nonresidential real estate loans for up to 40% of assets, and secured or unsecured business loans to up to 10% of assets. Finally, the Act permitted the first inter-depository acquisitions when it authorized a failed thrift or bank to be purchased by either a bank holding company or a savings and loan holding company, and authorized such interindustry purchase on an interstate basis, overriding other federal statutory provisions restricting interstate and interindustry acquisitions.

**Major public policy changes**

DIDMCA and Garn – St Germain significantly diminished the historical distinctions between banks and thrifts. Previously, banks were the only type of depository institution that could offer checking accounts or make commercial loans. Thrifts and credit unions offered only savings accounts to their customers and only consumer loans to their borrowers, with thrifts concentrating on fixed-rate home mortgage loans. DIDMCA and Garn – St Germain eliminated these basic distinctions, and enabled many consumers to opt out of maintaining two banking relationships – one with a bank for a checking account and another with a thrift or credit union for savings accounts and consumer loans.

The 1980 and 1982 Acts, however, continued to limit the ability of thrifts to serve business customers. Federal thrifts could offer checking accounts to business customers only if they were also commercial loan customers. Federal thrifts could make business
loans, but subject to a percentage of assets limitation. With most funding coming from small consumer checking and savings accounts, many thrifts were so small that the percentage of assets limitation posed a significant limitation on the amount of business lending they could undertake, making this expansion of lending authority less significant than it might appear. Banks remained free to determine the mix of loans they would make pursuant to market demand and safety and soundness considerations, since they were not subject to any percentage of assets limitation by type of loan.

## LEGISLATION THAT RESPONDED TO THE SAVINGS AND LOAN CRISIS

### Background

The DIDMCA and Garn – St Germain Acts did little to stem the tide of failing savings and loans and banks. Many industry observers questioned whether the Garn – St Germain Act may have actually contributed to the rapid increase in saving and loan and bank failures. For example, the Garn – St Germain Act increased deposit insurance levels per account from $40,000 to $100,000. This feature of the Garn – St Germain Act gave weak depository institutions the ability to rapidly raise much larger amounts of funds in the capital markets than they would have been able to without the new deposit insurance levels. Weak institutions had relatively high incentives to invest in riskier projects because they had less to lose given their low equity levels relative to industry standards. In essence, weak institutions gambled that they might hit a big payoff. Unfortunately for the U.S. taxpayer, they gambled using the deposit insurance program’s money. To make matters worse, some states expanded the investment authority for state chartered thrifts beyond that permitted in the 1980 and 1982 legislation for federal thrifts.

Thrifts chartered in California were permitted to invest up to 25% of their gross capital in the stock and debt instruments of corporations. However, they did have a 10% of capital limit for the obligations of any one corporation. Congress later concluded that some thrifts misused their newly granted privileges. Thus, a second round of legislative responses followed, strengthening
bank and thrift regulatory supervision and enforcement and placing a premium on strong capital.

**Competitive Equality Banking Act of 1987 (CEBA)**

CEBA recapitalized the Federal Savings and Loan Insurance Corporation (FSLIC), which insured the deposits of failed thrift institutions. The amount pledged for this effort by Congress was generally agreed to be too little, too late. CEBA also amended the definition of “bank” under the Bank Holding Company Act (BHCA) so that a company could less easily escape regulation under the BHCA which limited the activities of bank holding companies to those “closely related to banking.” CEBA also placed a moratorium on the expansion of these “closely related” activities while Congress studied proposed financial modernization legislation.

**Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA)**

FIRREA totally revamped the regulatory structure for thrift institutions. FSLIC was abolished and its deposit insurance function was replaced by the new Savings Association Insurance Fund (SAIF) of the FDIC. The Office of Thrift Supervision (OTS) was created in the Department of Treasury to be the federal regulator of thrifts and assume a parallel position within Treasury to the national bank regulator, the Office of the Comptroller of the Currency (OCC). The OTS replaced the Federal Home Loan Bank Board (FHLBB) as the federal regulator of thrift institutions. The final structural change was the creation of the Resolution Trust Corporation (RTC) to manage and dispose of the assets of failed thrifts. Congress preempted state statutes authorizing expansive thrift powers for state chartered thrifts by capping the powers of state thrifts to those powers authorized for their federally chartered counterparts. The attempt to facilitate interindustry acquisition continued with FIRREA’s authorization of the purchase of a healthy (not just a failed) thrift by a bank holding company.

FIRREA also mandated that the OTS prescribe tough new capital standards for savings associations, reforming the accounting gimmicks, but mandating core capital of at least 3% of assets.
**Crime Control Act of 1990**

One title of this comprehensive crime control act expanded the ability of federal regulators to control and punish financial fraud.

**Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA)**

FDICIA recapitalized the FDIC, instituted a scheme of prompt corrective action for institutions with declining capital positions (rather than waiting until an institution was insolvent to take action), established risk-based assessments for federal deposit insurance to replace the previous flat-rate deposit insurance premiums, and limited the principal activities of state chartered banks to those permitted for national banks.

**Major public policy changes**

This set of statutes increased depository institution supervision and toughened enforcement measures. They diminished some of the benefits provided by the dual chartering system that permits banks and thrifts to elect a national/federal charter or a state charter, as the powers of state chartered institutions were limited to the powers afforded the federally chartered counterpart. There is no similar federal limitation on the powers of state chartered credit unions, although the NCUSIF, administered by the federal regulator NCUA, is a major force that has moved the credit union industry toward a more uniform standard of operations. Strong capital was emphasized, as was the importance of managing risk, since increased risk could increase capital requirements as well as deposit insurance premiums. The effort to achieve consolidation among the different charter types was largely unsuccessful, as banks wishing to expand did so by acquiring or merging with other banks rather than with thrifts. Banks generally are larger in size than thrifts, so expansion by acquisition of a single bank was usually more cost effective than the acquisition of several thrift institutions.
LEGISLATION THAT REMOVED RESTRICTIONS ON INTERSTATE EXPANSION

Background

From the mid-1980s through FDICIA of 1991, legislation responding to the savings and loan debacle brought more restrictions on depository institutions. However, since that time most legislation concerning depository institutions has been deregulatory in nature. One of the most important areas of deregulation dealt with geographic restrictions on depository institutions.

Historically, banks and thrifts were limited in the geographic area in which they could operate branches. Thrifts received relief from these restrictions before banks did, although the small size and local nature of most thrifts meant that few took advantage of the situation. Federal thrifts have long been afforded the right to branch throughout the state in which they are located, regardless of the branching privileges afforded by state law to state chartered thrifts. This was in contrast to the scheme for bank branching in which a national bank was limited to the same in-state branching restrictions as state banks within the state.

Prior to the Riegle-Neal Act discussed below, federal thrifts received the right to establish branches across state lines. When thrifts gained more bank-like powers in the 1980 and 1982 legislation, national banks successfully argued that they should enjoy the same branching privileges as state thrifts, since thrifts were exercising the same powers as state banks. This usually meant statewide branching, as most state legislatures authorized statewide branching for state chartered thrifts. They did this because they did not want state chartered thrifts to be at a disadvantage to federally chartered thrifts, which had long been permitted to branch throughout the state in which they were located.

This argument was successful in many states and permitted national banks located in those states to branch statewide even though state chartered banks within that state may have been subject to limited branching within the state. Interstate banking had effectively been achieved prior to Riegle-Neal by bank holding companies that owned multiple banks in multiple states pursuant to state statutes which authorized such acquisitions.
pursuant to the Douglas Amendment to the Bank Holding Company Act.

Federally chartered credit unions have long been authorized to establish branches if they determine that the “members currently within the FCU’s field of membership to be served by the branch constitute a significant portion of all of the individuals to be served by the branch.”\(^{14}\)

**Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994 (Riegle-Neal)**

Riegle-Neal repealed the Douglas Amendment to the Bank Holding Company Act. As a result, bank holding companies were allowed to acquire banks located in a state other than the bank holding company’s home state without regard to whether such an interstate acquisition was specifically authorized by state law of the host state. Interstate branching was also authorized. As of July 1, 1997, a bank holding company with adequately capitalized and adequately managed bank subsidiaries could merge its banks even though located in different states and operate the interstate offices as branches. Banks were also authorized to apply to establish a new branch or to buy an existing branch located across state lines if the second state opted in to interstate branching.

**Major public policy changes**

The advent of interstate banking facilitated interstate mergers and consolidation of the number of bank charters throughout the U.S. The permission to branch interstate also allowed multiple bank holding companies to merge their bank subsidiaries into one bank and operate an interstate branch network instead of an interstate collection of commonly owned banks. Many holding companies achieved significant administrative cost savings from these consolidations.


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LEGISLATION THAT INCREASED THE ALLOWABLE ACTIVITIES OF A COMPANY THAT OWNS A BANK

Background

A 1995 memorandum prepared by the Department of the Treasury cataloged many of the reasons banks had lobbied for relief from the limitation of the activities of bank holding companies to those activities that were “closely related to banking.” The memorandum noted that:

1. The share of total private financial assets held by insured depository institutions had declined from about 60% in 1970 to less than 35%;

2. Of the 20 largest financial firms in the United States, only five were commercial banks;

3. The differences between the products of banks and non-bank financial firms had diminished;

4. A number of commercial banks engaged in little traditional banking (funding commercial loans with deposits), but rather specialized in trading activities, consumer finance and fee-based services;

5. Technological innovations had redefined the nature and delivery of financial services and the roles played by bank and non-bank firms.15

Banks and their holding companies had managed to overcome some of the Bank Holding Company Act’s activity limits in various ways. National banks acted as insurance agents. Bank holding companies owned companies engaged in significant securities brokerage and underwriting activities. However, these forays into non-bank financial services were subject to various significant statutory and regulatory limits.

15 Department of the Treasury, Memorandum for Members of the Secretary's Advisory Commission on Financial Services from Joan Affleck-Smith, Director, Office of Financial Institutions Policy (October. 23, 1995).
The Gramm-Leach-Bliley Act of 1999 (GLBA)

Through regulatory interpretation, the regulators were already allowing many of the permissible activities introduced by GLBA. However, GLBA codified those allowable activities and changed the basic doctrine of permissible activities. Specifically, GLBA expanded the principles for determining the permissible activities of a bank holding company from “closely related to banking” to “financial in nature.” To be entitled to undertake the expanded array of powers, the bank holding company must be well-capitalized, well-managed, and have Community Reinvestment Act (CRA) ratings for all of its depository subsidiaries of satisfactory or above. A bank holding company that meets these requirements may apply for certification by the Fed as a financial holding company authorized to engage in “financial in nature” activities. Specifically denominated as “financial in nature” are securities brokerage and underwriting, insurance agency and underwriting, and the ability to make merchant capital investments. GLBA provides that Treasury and the Fed may designate additional activities as “financial in nature.” In addition, a special kind of subsidiary of a bank – a financial subsidiary – may engage in some, but not all, of the financial in nature activities.

While expanding the permissible activities for financial holding companies, GLBA limited the activities available to certain savings and loan holding companies. A savings and loan holding company that owned only one savings and loan was termed a “unitary” holding company. Prior to GLBA, a unitary savings and loan holding company could engage in any other commercial activities (even non-financial activities) so long as the savings and loan maintained a certain percentage of its assets devoted to home mortgages and other consumer lending. This significant loophole in the separation of banking and commerce was closed by GLBA, although unitary holding companies in existence as of a particular date were permitted to retain their commercial activities.

GLBA also subjected all financial institutions, including credit unions, to new customer privacy protection provisions that required financial institutions to develop a policy regarding the use of customer information, disseminate that policy to the customer at the beginning of the relationship and annually thereafter, and afford a mechanism for the customer to opt out of having information about the customer shared with third parties.
**Major public policy changes**

While GLBA significantly expanded the array of activities that may be undertaken by a financial holding company, it still limited those activities to “financial” activities and maintained the historical division between banking activities and commercial (non-financial) activities. It reinforced this separation by closing the unitary thrift holding company loophole. Finally, it imposed significant new burdens on financial institutions related to compliance with the privacy provisions.

**LEGISLATION AND REGULATORY ACTIONS AFFECTING CREDIT UNIONS**

**DIDMCA of 1980 and Share Draft Authority**

By 1978, almost one-half of all states permitted state chartered credit unions to offer share draft accounts, the functional equivalent of checking accounts. Share draft accounts permitted members to draw a draft (check) against their credit union shares (deposits). A pilot program permitting this authority for federal credit unions was conducted in 1976. At the end of 1979, President Carter signed legislation authorizing federal credit unions to offer share draft accounts until May 31, 1980. On that date, Congress enacted DIDMCA, which made permanent share draft authority for credit unions and NOW accounts for thrift institutions.

**NCUA regulatory limits on member business loans (MBLs) in 1987**

Prior to 1987, business loans to credit union members, known as member business loans (MBLs), were offered virtually without statutory or regulatory limitation. In 1987, the NCUA introduced regulations for such business lending following NCUSIF losses that were the direct or indirect result of member business lending.

**GLBA of 1999**

GLBA provided no expanded authority for credit unions, although it did subject credit unions to requirements that they develop a privacy policy, communicate that policy annually to their customers, and permit customers to opt out of information sharing by the credit union with third parties.
CONCLUSION

Although thrifts benefited from expanded lending authority in the early 1980s, they remain subject to aggregate percentage of asset limits on their commercial loans, while banking companies face no similar limitations and now have the authority to engage in a wide range of “financial in nature” activities, extending beyond the traditional banking business of making loans. Business lending by credit unions is subject to limitation in various respects, some of which are detailed in a later section. The activities of bank holding companies were expanded by GLBA in 1999 to include a broad array of “financial in nature” activities. The activities of a unitary thrift holding company in existence on the grandfather date were permitted to continue, but otherwise unitary thrift holding company activities became subject to the restrictions of the Savings and Loan Holding Company Act. Not only did credit unions not benefit from any expansion of activities in GLBA, they remained subject to the constraints described above on the most basic banking activity – making a commercial loan.

A January 2001 Department of Treasury study (mandated by CUMAA) concluded, “In general, federal credit unions have more limited powers than national banks and federal savings associations. Most notably, federal credit unions face stricter limitations on their commercial lending and securities activities. In addition, a usury ceiling prevents them from charging more than 18% on any loan, and the term of many types of loans may not extend beyond twelve years.”

16 Thrifts, however, are subject to a qualified thrift lender (QTL) test that provides compensating benefits for thrifts that maintain their historical emphasis on home mortgage and other consumer lending.

CHAPTER 4: Overview of the Credit Union Regulatory Environment Since the Membership Access Act of 1998

The Credit Union Membership Access Act of 1998 (CUMAA) did not remove significant regulatory limitations from credit unions as the Gramm-Leach-Bliley Act did for banks and thrifts. To some extent, credit unions were faced with more limitations after the enactment of CUMAA. In this chapter, we discuss three areas where CUMAA may have increased (not decreased) restrictions on the operations of credit unions. Those three areas are: (1) field of membership limitations; (2) member business lending limitations; and (3) capital level limitations.

FIELD OF MEMBERSHIP LIMITATIONS

A dramatic difference between banks and credit unions is the limitation imposed on credit unions requiring credit union depositors and borrowers to be members and satisfy the credit union’s common bond requirement.18 The required common bond must fall into one of three categories: occupation, association or community.19 The occupation common bond is met if all members are employed by the same employer(s). The association common bond requires that all members belong to an organization(s), participation in whose activities develops common loyalties, mutual benefits, or mutual interests. The community common bond is satisfied for those persons or organizations that live or work within a well-defined local community, neighborhood, or rural district. Also eligible for membership in a credit union are members of the immediate family or household of an eligible credit union member (12 U.S.C. § 1759(e)(2)). Unless expelled, once a person becomes a member of a credit union that person may remain a member of the credit union until he or she elects to withdraw from membership (12 U.S.C. § 1759(E)(2)).

In 1982, the NCUA first permitted a federal credit union to include multiple, but unrelated, employer groups. This interpretation of the Federal Credit Union Act by the NCUA was challenged by competing banks, resulting in the Supreme Court decision in National Credit Union Administration v. First National Bank & Trust Co., 522 U.S. 479 (1998). The Supreme

18 12 U.S.C. §1757(7) (a credit union may invest its funds in loans, but the loans may only be made to credit union members).
Court held that the NCUA's interpretation of the Federal Credit Union Act was impermissible since “Congress has made it clear that the same common bond of occupation must unite each member of an occupationally defined federal credit union.” The swell of popular protest to this decision led Congress to respond by enacting the Credit Union Membership Access Act of 1998 (CUMAA), which reversed the Supreme Court’s decision and permitted multiple groups, each with their own common bond, to join together in a single credit union.

The new statute, however, generally restricted the size of each single group in the multiple group credit union20 to no more than 3,000 (12 U.S.C. § 1759(d)(1)).21 There are several exceptions to this size limitation. The 3,000 person limit does not apply if (a) the NCUA Board finds that a group “could not feasibly or reasonably establish a new single common-bond credit union” because of certain criteria;22 (b) a group transferred from another credit union pursuant to a Board-recommended (or State supervisor-recommended) merger or consolidation; or (c) a group that transferred pursuant to a voluntary merger that had been approved by the NCUA prior to October 25, 1996, if the merger was consummated within 180 days of August 7, 1998 (12 U.S.C. § 1759(d)(2)).23 In addition, a grandfather provision permits federal credit union members as of August 7, 1998 (the effective date of CUMAA) to remain members of the credit union even though it is composed of multiple employer groups with sizes in excess of 3,000. Further, a nonmember of such a credit union as of August 7, 1998, may become a member of the grandfathered credit union if the nonmember is within a group that constituted a portion of

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20 There is, however, no limit on the size of the original or ‘core’ group of the credit union.

21 A recent case held that the Federal Credit Union Act does not require NCUA to count family and household members of credit union members toward the 3,000 person member limit in a multiple employer credit union. American Bankers Association v. National Credit Union Administration, 271 F.3d 262, 269 (D.C. Cir. 2001).

22 Id. (upholding NCUA rule that made the intent of the group one of several factors to be considered by the NCUA in determining whether a group with 3,000 or more members could not “feasibly or reasonably” establish a new credit union).

23 Generally, the NCUA will encourage the formation of separately chartered credit unions, rather than adding an additional group to an existing credit union. 12 U.S.C. § 1759(f).
the federal credit union (12 U.S.C. § 1759(c)(1)(A)). Finally, a multi-group employment based credit union may also extend membership to any person or organization within its local community if the community is an “investment area” as defined in the Community Development Banking and Financial Institutions Act of 1994 (12 U.S.C. § 4703(16)), is “underserved” as defined in 12 U.S.C. § 1813, and if the credit union maintains an office or facility in the community (12 U.S.C. § 1759(c)(2)). During the decade before CUMAA, the NCUA did not apply these types of numerical restrictive policies on membership. Thus, CUMAA may have added more restrictions on field of membership than it eliminated. However, the enactment of CUMAA did address the problem created by the Supreme Court decision mentioned earlier. But its net effect was ex post a more restrictive operating environment for credit unions.

MEMBER BUSINESS LENDING LIMITATIONS

Credit unions face numerous constraints on their business lending activity. Most of these constraints are in the form of NCUA regulations and are not mandated directly by legislation. Nonetheless, as a consequence, only a small percentage of credit unions engage in business lending. Larger credit unions are more likely to offer member business loans (MBLs) than are smaller credit unions. For instance, a recent U.S. Department of Treasury study25 states that as of June 30, 2000, 53% of the 338 federally insured credit unions with more than $250 million in assets offered MBLs. But, less than 5% of the smallest credit unions (those with less than $10 million in total assets) offered MBLs. Even among the larger credit unions, MBLs are on average less than 3% of total loans.

A specific statutory category encompasses many credit union commercial loans. MBLs are subject to significant statutory and regulatory limitations as detailed below. Loans that are for business purposes but for $50,000 in the aggregate or less are


excluded from the MBL category and its related regulatory limitations. These excluded loans are sometimes referred to as “business purpose loans” (BPLs). Member business loans (MBLs) are loans, lines of credit, or letters of credit (including any unfunded commitments) whose proceeds are used for commercial, corporate, agricultural, or other business investment property or venture (12 U.S.C. § 1757a(c)(1)(A); 12 C.F.R. § 723.1). MBLs primarily serve as financing for service businesses, agricultural businesses, and rental properties (Treasury Study at page 22). Excluded from the definition of MBLs are (a) loans fully secured by liens on a one to four family dwelling that is the member's primary residence; (b) loans fully secured by shares in the lending credit union or by deposits in other financial institutions; (c) loans to a member or an associated member that are less than or equal to $50,000 in the aggregate;26 (d) loans whose payments are fully guaranteed or insured by a federal or state agency or for which there is an advance commitment to purchase in full by a federal or state agency; and (e) loans granted by a corporate credit union to another credit union (12 U.S.C. § 1757a(c)(1)(B)); (12 C.F.R. § 723.1(b)).

Construction and development loans are a kind of MBL. These are “loans granted for the construction or development of commercial or residential property” (12 C.F.R. § 723.3). These loans are also subject to various restrictions unless waived by the NCUA regional director. The aggregate of all construction and development loans may not exceed 15% of the credit union's net worth,27 the borrower must have a minimum of 35% equity investment in the property, and the funds may only be advanced after on-site, written inspections by authorized personnel and pursuant to a pre-approved draw schedule (12 C.F.R. § 723.3).

26 The NCUA recently issued a legal opinion letter that clarified this exception by explaining that a credit union “may add the outstanding balance of a member’s aggregate MBLs to the original loan amount of any new, subsequent loan to determine if, when added together, they exceed the rule's $50,000 threshold for qualifying as an MBL. 12 C.F.R. § 723.1(b)(3).” NCUA Legal Opinion Letter 02-0384 (May 30, 2002) (emphasis added), available at www.cuna.gov/ref/opinionletters/2002/02-0384.html.

27 Certain portions of loans will be excluded from the aggregate limit. 12 C.F.R. § 723.3(a).
The Treasury Study identified four legal constraints that distinguished MBLs made by credit unions from commercial loans made by banks:

- The loans can only be made to credit union members;
- The loans generally require the personal guarantee of the borrower;
- The loans generally must be fully collateralized; and
- Total member business lending is generally subject to a portfolio limitation of 12.25% of total assets.

Of the four restrictions mentioned above, the last was introduced by the CUMAA of 1998. The first restriction was already part of the legal code. And, restrictions two and three are the result of regulations introduced by the NCUA. More details about the principal limitations applicable to MBLs are presented below.

**The borrower must be a credit union member**

According to the Federal Credit Act of 1934, the borrower of any loan from a credit union must be a member of that credit union. Therefore, the borrower must be (a) an individual borrowing money for business purposes who meets the common bond requirement; (b) a corporation or organization that satisfies the employment, association or community common bond requirement; or (c) a corporation that borrows from a community development credit union for the purpose of promoting community development in the relevant investment area or by the targeted population. Most MBLs are made to individuals who then use the loan proceeds for business purposes. Approximately 20% of MBLs, however, are made directly to businesses.

In contrast, bank borrowers need not have any affiliation with the bank or the bank’s other customers in order to be eligible to borrow from it.

**The duration of the loan may not exceed twelve years**

The Federal Credit Union Act also specifies that the term on many types of loans made by credit unions may not exceed twelve years (12 U.S.C. § 1757(5)). Exceptions to this term limit include residential real estate loans on a one-to-four family dwelling that will be the principal residence of the credit union member and
secured by a first lien on the dwelling, which may have a maturity of up to thirty years (12 U.S.C. § 1759(5)(A)(i)).

The commercial loans of banks are not subject to any length limitation, although it is quite likely that most commercial loans will be for a term of much less than twelve years.

**The borrower's personal guarantee is required for an MBL**

Loans made to not-for-profit corporations do not require personal guarantees; otherwise, MBLs may not be granted without the personal guarantees of the principals (12 C.F.R. pt. 723). The commercial loans of banks or thrifts are not subject to any personal guarantee restriction, but the NCUA requires these personal guarantees.

**MBLs must be fully collateralized**

Unless waived by the NCUA, MBLs may only be granted on a fully secured basis. For second liens, the loan-to-value (LTV) ratio may not exceed 80% (12 C.F.R. § 723.7). The LTV for first liens is limited to 80% as well unless the amount exceeding 80% (up to 95%) is fully insured by private mortgage insurance (12 C.F.R. pt. 723). The LTV for construction and development loans is 65% (12 C.F.R. § 723.3). Credit card line-of credit programs offered to businesses do not require collateral. Again, the commercial loans of banks or thrifts are not subject to this type of collateralization restriction.

**The amount of an MBL that may be loaned to one borrower is limited**

Loans by credit unions, like loans by banks, are subject to a general aggregate limit to any one borrower. MBLs, however, are subject to an additional per borrower limitation that does not apply to banks or thrifts. The NCUA restricts the aggregate amount of outstanding loans to any one member or group of associated members of a credit union to be no more than the greater of 15% of the credit union's net worth or $100,000 (12 C.F.R. § 723.8). Not included in the aggregate amount are any portions of loans that are (a) secured by shares in the credit union; (b) secured by deposits in another financial institution; (c) insured or guaranteed fully or partially by federal or state agencies or
political subdivisions;\textsuperscript{28} and (d) purchased by advance commitment by an agency of the government (12 C.F.R. § 723.9). In addition, it is possible that the appropriate NCUA regional director may award a waiver of the LTOB requirement for MBLs (and for construction and development loans) for credit unions that follow the procedure for obtaining a waiver and have achieved appropriate CAMEL composite and component ratings at their last examination (12 C.F.R. § 723.10-13).

\textit{Aggregate limits on a credit union’s outstanding MBLs}

CUMAA placed the first statutory limit on MBLs, although the NCUA had regulated MBLs to some extent since 1987. The aggregate limit of a credit union’s MBLs is the lesser of 1.75 times the credit union’s net worth (retained earnings) or 12.25\% of the credit union’s total assets (12 U.S.C. § 1757a(a); 12 C.F.R. § 723.16 (2002)). Other exceptions from aggregate MBL limit include: (a) credit unions that were chartered for the purpose of making or have a history of primarily making MBLs to their members; (b) credit unions that serve predominately low-income members; and (c) credit unions that are community development financial institutions (CDFIs) as defined in 12 U.S.C. § 4702. 12 U.S.C. § 1757a(b)(1); or 12 U.S.C. § 1747a(b); 12 C.F.R. § 723.17. In addition, the NCUA may exempt federally insured state chartered credit unions in a particular state from the MBL rule if the NCUA approves the substitution of the state’s rule. However, the state rule must also include the 12.25\% of assets limit (12 C.F.R. § 723.20). Some credit unions have had to turn away MBLs because the credit union already has too many other MBLs.\textsuperscript{29} The inability to offer MBLs in such circumstances is likely to impact negatively on a credit union’s ability to grow core deposits from the potential MBL member.\textsuperscript{30} Additionally, some credit unions that are currently not in the MBL market, but were potential market entrants, may now decide not to enter the market because of these restrictions on MBLs.

\textsuperscript{28} Credit unions are trying to increase their participation in SBA loans since the guaranteed portion does not count against the limit. See for example, Ed Roberts, “At Summit: CU’s Press for Expanded Business Lending”, \textit{Credit Union Journal} (April 22, 2002).
\textsuperscript{29} Frank J. Diekmann, Sharpening Your Pencil: More of What CU需 Need to Know Before Plunging Into the MBL Market, \textit{Credit Union Journal}, (May 13, 2002).
\textsuperscript{30} Id.
The NCUA recently issued a letter clarifying that for purposes of determining the aggregate MBL limit as well as whether the limit on loans to one borrower has been exceeded, the *outstanding* balance of existing MBLs (rather than the original principal amount) will be used.\(^{31}\) The Treasury Study reported that NCUA had granted 90 exceptions to the aggregate MBL limits as of year-end 1999. To the extent that a credit union exceeds 12.25% of total assets in MBLs, however, its risk-based net worth requirements increase from 6% to 14% of the MBLs in excess of the 12.25% limit (12 C.F.R. § 702.16).

The Treasury Study concludes that “changes to the credit union membership restrictions in the Act will increase member business lending” since expanding membership opportunities will lead to growth in credit union membership and assets and as more credit unions adopt community charters that accept businesses as members.\(^{32}\) On the other hand, the report cautions that the aggregate limit on MBLs contained in CUMAA along with risk-based net worth requirement of 14% for credit unions that receive exemptions from the limit will “temper the future growth of member business lending.”\(^{33}\) The overall effect on lending by other depository institutions, however, should be “modest – especially given credit unions’ relatively minor role in serving commercial borrowers.” As of June 30, 2000, only 14% of credit unions had any MBLs outstanding and the total dollar volume of MBLs was $4.3 billion.\(^{34}\) Credit unions are certainly not a threat to banks as a source of business loans. Even if there is significant growth in credit union business lending, credit unions will likely not become major sources of credit to business, especially if they continue to be subjected to the numerous restrictions on their business lending activities. However, credit unions may be able to help fill a perceived need for alternative sources of credit for small businesses.

The availability of adequate credit to small businesses has historically been a public policy concern in the U.S. The recent wave of mergers and acquisitions in the banking industry has

\(^{31}\) Legal Opinion Letter 02-0384 – Aggregate Limits on Member Business Loans (MBLs). This report is available at www.ncua.gov/ref/opinion_letter/2002/02-0384.html.

\(^{32}\) U.S. Department of Treasury, “Credit Union Member Business Lending” (January 2001), at page 34.

\(^{33}\) Ibid. at page 35.

\(^{34}\) Ibid. at page 1.
raised concerns about the impact industry consolidation will have on the availability of credit to small businesses. To a large degree these concerns were initiated by scholarly studies that documented that small banks tend to lend to small businesses while large banks tend to lend relatively more to large businesses. The concern is that as large banks acquire smaller banks, which is the typical banking acquisition scenario, the resulting decline in the number of small banks may result in an aggregate decline in the credit available to small businesses. These studies, however, do not consistently document a substantial decline in small business lending correlated with banking consolidation. So this is an unresolved empirical question. Samolyk (1998) provides a useful summary of the issues and studies associated with this controversial topic.

Given that a possible aggregate reduction in small business lending from the banking industry is a significant concern, it is reasonable to investigate alternative sources of credit for small businesses. Credit unions could become part of this alternative supply of credit, if allowed to do so. Small business – especially very small business – lending is a natural fit for many credit unions. This is partially because many small business owners are already members of credit unions, and many credit union members may be poised to start their own small business. Thus, some credit unions already have a relationship with at least two groups that may need small business loans.

**CAPITAL LEVEL LIMITATIONS**

CUMAA also imposed upon credit unions a scheme of capital requirements regulation and prompt corrective action that mirrored in many respects the rules imposed on bank and thrift capital in 1991. Bank capital is composed of capital paid in by shareholders, common equity, retained earnings, and subordinated debt (as well as other sources of secondary capital). As mutual institutions, the only source of capital for credit unions is retained earnings.  

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35 The net worth is the retained earnings of the credit union as defined by generally accepted accounting principles. The net worth ratio is the ratio of the credit union’s net worth to its total assets. For a credit union that is designated as a “low-income credit union,” net worth also includes secondary capital accounts that are uninsured and subordinate to all other claims against the credit union. 12 U.S.C. § 1790d(o)(2) & (3).
Net worth ratios were established for a credit union to be characterized as well capitalized (7%), adequately capitalized (6%), undercapitalized (less than 6%), significantly undercapitalized (less than 4%), and critically undercapitalized (less than 2%) (12 U.S.C. § 1790d(c)). These percentages are two percentage points higher than those required for banks and are statutory rather than regulatory.36 A recent U.S. Department of the Treasury report states that “Congress determined that a higher ratio was appropriate because credit unions cannot quickly issue capital stock to raise their net worth as soon as a financial need arises. Instead, credit unions must rely on retained earnings to build net worth, which necessarily takes time.”16 Granting credit unions the ability to quickly change their capital positions by issuing capital-like securities would have negated this stated need for credit unions to hold higher levels of capital.

The statute also mandated that any credit union that is undercapitalized must submit a net worth restoration plan to the NCUA. In addition, an insured credit union that is undercapitalized is subject to restrictions on its asset growth and may not make any increase in the total amount of its MBLs outstanding until the credit union becomes adequately capitalized.

It is apparent that the Credit Union Membership Access Act of 1998 (CUMAA) did not remove significant regulatory limitations from credit unions as the Gramm-Leach-Bliley Act did for banks and thrifts. Indeed, to some extent, credit unions were faced with more limitations on their operations after CUMAA than before its introduction.

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CHAPTER 5: Should Credit Unions be Allowed to Evolve?

Summarizing key points from the previous four chapters, in Chapter 1 we provided some background on the similarities of, and differences between, commercial banks, thrifts, and credit unions, focusing on (a) the major sources of its funding, (b) how it invests its funds, and (c) the structure of its ownership. We found that the operational differences between the three types of depository institutions are distinctive. This analysis illuminated how powerful historical regulations have been in shaping the landscape of the industry by placing limitations on the powers of financial institutions to enter markets and provide products and services.

Chapter 2 presented an analysis supporting the conclusion that the U.S. economy has derived significant benefits from deregulating the depository institution industry. We argued that changes in the structure and operations of markets and the depository institution industry required the industry to be deregulated. These changes are linked to three underlying factors: (a) advancements in technology; (b) increases in market competition; and (c) financial innovations and new product creation. These three factors were the driving forces behind the need for the deregulation.

In Chapter 3, we saw that over the last two decades, Congress rightly enacted several laws that significantly deregulated the environment in which banks and thrifts operate. But credit union powers were largely unchanged. In general, credit unions have received less deregulation than either banks or thrifts. Most notably, credit unions face stricter limitations on both their lending and investing activities.

In Chapter 4 we demonstrated that the Credit Union Membership Access Act of 1998 (CUMAA) did not remove significant regulatory limitations from credit unions as the Gramm-Leach-Bliley Act did for banks and thrifts. To some extent, CUMAA imposed more limitations on credit union operations than it lifted.

In Chapter 5 we examine whether credit unions should be deregulated to the same extent as the other depository institutions. We evaluate the issue using a simple cost and benefits framework. As with other depository institutions, costs can be weighed in terms of safety and soundness issues. That is, the risk-calibrated cost placed on the respective depository insurance fund associated with the deregulated activities. The benefits from deregulation can be
measured in terms of increased economic efficiency in the financial system. This increased economic efficiency manifests itself in the form of decreased costs for financial services, increased consumer choice and financial product innovation, or a combination of both.

The cost/benefit analysis can be greatly simplified by the process of association. That is, if we can answer in the affirmative both of the two following questions, we can conclude that the deregulation of credit unions will have a similar positive economic impact on the financial system.

1. Did the deregulation of commercial banks and thrifts have a positive impact on our financial system? Our discussion in Chapter 1 suggests that the answer to this question is yes.

2. Do credit unions, as depository institutions, play a functional role in the U.S. financial system similar to the role played by commercial banks and thrifts? Even considering their distinctive governance structure and operating philosophy, the answer to this question is also yes.

We conclude that if credit unions are allowed to evolve, just as commercial banks and thrifts have been allowed to evolve, the overall economic impact will be positive. First, by removing barriers to greater efficiency and innovation, credit unions will be better able to serve their members. Second, the positive economic impact assumes that the likely increase in financial market competition because of more interaction between credit unions, thrifts, and banks will lead to a more efficient marketplace. This is a reasonable assumption.

In the next section, we discuss whether the benefits of deregulating credit unions will be similar to those gained by deregulating other depository institutions. We offer evidence on the general demographic similarity between credit union members (customers) and bank and thrift customers. We also offer evidence of the likelihood that the operational benefits for credit unions from deregulation will be similar to those for banks and thrifts. We then present six sections on particular activities in which deregulation of credit union powers is especially important. Those six areas are: (1) field of membership limitations; (2) business lending limitations; (3) capital raising limitations; (4) general
lending limitations; (5) investing limitations; and (6) incidental powers limitations.

SIMILAR BENEFITS FOR Deregulating CREDIT UNIONS

In Chapter 1, we discussed the rationale for deregulating depository institutions. Our conclusion was that Congress and the regulators deregulated the depository institution industry in response to fundamental changes in the industry. These fundamental changes were the result of three factors: (1) advances in technology; (2) increased competition; and (3) innovations in financial products and services. If these factors would result in similar fundamental changes to the operational environment of credit unions as they did for banks and thrifts, then the benefits from deregulating credit unions will be higher than the costs (as they were for banks and thrifts). It is reasonable to conclude that these factors would affect credit unions similar to the way they affected commercial banks and thrifts. This is because the main function of credit unions, commercial banks, and thrifts is very similar. As financial intermediaries, their function is to produce valuable financial products and services for consumers.

Because credit unions, commercial banks, and thrifts use a similar type of production technology, advances in technology related to information processing would present similar opportunities and challenges for all of them. Increases in competition would have similar effects on credit unions, commercial banks, and thrifts because they often operate and compete in the same geographic markets. And because they serve consumer credit members with generally similar – though not identical – demographic profiles (see page 70 for details on demographic profiles), innovations in financial products and services present similar challenges and opportunities for credit unions, commercial banks, and thrifts.

What distinguishes credit unions from commercial banks and thrifts is their cooperative structure and mission, not their operational characteristics. Thus, the same trends in technological advancement, competition, and financial product innovation that have affected commercial banks and thrifts would have similar impacts on credit union operations.
Advances in technology, increased competition, and innovations in financial products and services changed the depository institution industry. Deregulation allowed commercial banks and thrifts the flexibility to react to the changes. Banks and thrifts reacted by offering a wider array of products and services, over a broader geographic market area, at a lower cost, and with less risk (because of diversification).

Will credit unions react to deregulation in a similar manner? The answer is likely to be yes, because credit unions face market demands similar to those faced by banks and thrifts. The next section presents evidence of the similarities and differences in the demographic profile of credit union members versus bank and thrift customers.

Profile of credit union membership

Lee and Kelly (2001) point out that previous studies comparing credit union members to nonmembers have created significant misunderstandings about who credit union members are and what their financial status is. Such misperceptions can lead to improper public policy.

The report by Lee and Kelly (2001) goes beyond comparing credit union “members” with “nonmembers” or comparing “credit union members” with “bank customers.” Simple, two-category comparisons give an incomplete view of how households use financial institutions, overlooking the facts that: (1) some households use no depository institution; and (2) some households use both banks and credit unions (Lee and Kelly, 2001).

To overcome these shortcomings, Lee and Kelly divided the surveyed households into five categories:

1. Bank only (59% of households) – These households use banks and are not members of credit unions (banks and thrifts are referred to as the “bank” category).

2. Predominantly bank (16%) – Households that use both banks and credit unions, but have more of their savings in banks than in credit unions.

3. Predominantly credit union (12%) – Households that use both banks and credit unions, but have more savings in credit unions.
4. Credit union only (6%) – Credit union households that do not patronize banks.

5. Unbanked (7%) – Households that use neither banks nor credit unions.

This five-category approach has obvious advantages over a two-category approach for evaluating public policy issues.

Following is a broad summary of the results from the Lee and Kelly (2001) report. A more complete summary can be found in Table 5. Key findings compare the demographic characteristics of bank users with credit union users. Those comparisons suggest that:

- Credit union users tend to be younger than bank users.
- Credit union users have slightly lower average incomes than bank users.
- Credit union users have lower levels of net financial wealth and net worth than bank users. (These differences are fairly substantial when comparing the only credit union user group to the only bank user group.)
- Credit union users and bank users tend to have similar educational levels.
- Credit union users are a little less likely to be unemployed or retired.
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<td><strong>Net Financial Wealth</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Median</td>
<td>0</td>
<td>7,100</td>
<td>31,080</td>
<td>34,000</td>
<td>14,100</td>
<td>15,000</td>
</tr>
<tr>
<td>Mean</td>
<td>10,438</td>
<td>53,508</td>
<td>94,875</td>
<td>110,328</td>
<td>166,569</td>
<td>131,222</td>
</tr>
<tr>
<td>Standard error</td>
<td>2,065</td>
<td>2,234</td>
<td>3,317</td>
<td>6,917</td>
<td>11,284</td>
<td>7,727</td>
</tr>
<tr>
<td><strong>Net Worth</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Median</td>
<td>300</td>
<td>25,920</td>
<td>110,720</td>
<td>108,670</td>
<td>77,000</td>
<td>71,980</td>
</tr>
<tr>
<td>Mean</td>
<td>29,357</td>
<td>118,104</td>
<td>202,875</td>
<td>251,600</td>
<td>356,548</td>
<td>284,036</td>
</tr>
<tr>
<td>Standard error</td>
<td>2,065</td>
<td>2,234</td>
<td>3,317</td>
<td>6,917</td>
<td>11,284</td>
<td>7,727</td>
</tr>
<tr>
<td><strong>Education</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Less than high school</td>
<td>21.5</td>
<td>5.0</td>
<td>3.6</td>
<td>7.1</td>
<td>62.9</td>
<td>100%</td>
</tr>
<tr>
<td>High school graduates</td>
<td>6.2</td>
<td>5.3</td>
<td>13.5</td>
<td>15.5</td>
<td>59.5</td>
<td>100%</td>
</tr>
<tr>
<td>Some college</td>
<td>2.7</td>
<td>7.3</td>
<td>14.5</td>
<td>18.0</td>
<td>57.5</td>
<td>100%</td>
</tr>
<tr>
<td>BS or more</td>
<td>1.2</td>
<td>6.0</td>
<td>15.0</td>
<td>20.1</td>
<td>57.7</td>
<td>100%</td>
</tr>
<tr>
<td><strong>Occupation</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Unemployed</td>
<td>14.1</td>
<td>4.4</td>
<td>6.0</td>
<td>10.8</td>
<td>64.7</td>
<td>100%</td>
</tr>
<tr>
<td>Retired</td>
<td>1.8</td>
<td>2.9</td>
<td>9.6</td>
<td>13.8</td>
<td>72.0</td>
<td>100%</td>
</tr>
<tr>
<td>Service</td>
<td>8.2</td>
<td>8.9</td>
<td>12.3</td>
<td>15.6</td>
<td>55.0</td>
<td>100%</td>
</tr>
<tr>
<td>Crafts</td>
<td>6.4</td>
<td>3.7</td>
<td>14.1</td>
<td>20.0</td>
<td>55.8</td>
<td>100%</td>
</tr>
<tr>
<td>Professional</td>
<td>1.5</td>
<td>5.7</td>
<td>16.2</td>
<td>19.6</td>
<td>57.1</td>
<td>100%</td>
</tr>
<tr>
<td><strong>Race/Ethnicity</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>White</td>
<td>4</td>
<td>6</td>
<td>13</td>
<td>17</td>
<td>60</td>
<td>100%</td>
</tr>
<tr>
<td>African-American</td>
<td>20</td>
<td>6</td>
<td>9</td>
<td>17</td>
<td>48</td>
<td>100%</td>
</tr>
<tr>
<td>Hispanic</td>
<td>19</td>
<td>7</td>
<td>8</td>
<td>9</td>
<td>57</td>
<td>100%</td>
</tr>
<tr>
<td>Other non-white</td>
<td>8</td>
<td>6</td>
<td>11</td>
<td>18</td>
<td>57</td>
<td>100%</td>
</tr>
<tr>
<td><strong>Gender-Head of Household</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Male</td>
<td>5.0</td>
<td>5.3</td>
<td>14.0</td>
<td>18.0</td>
<td>57.7</td>
<td>100%</td>
</tr>
<tr>
<td>Female</td>
<td>11.4</td>
<td>7.7</td>
<td>8.4</td>
<td>11.3</td>
<td>61.2</td>
<td>100%</td>
</tr>
<tr>
<td><strong>Marital Status</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Married</td>
<td>3.2</td>
<td>4.9</td>
<td>15.6</td>
<td>19.5</td>
<td>56.9</td>
<td>100%</td>
</tr>
<tr>
<td>Separated</td>
<td>23.2</td>
<td>3.7</td>
<td>9.9</td>
<td>12.9</td>
<td>50.4</td>
<td>100%</td>
</tr>
<tr>
<td>Divorced</td>
<td>7.4</td>
<td>10.2</td>
<td>11.6</td>
<td>14.2</td>
<td>56.6</td>
<td>100%</td>
</tr>
<tr>
<td>Widowed</td>
<td>6.8</td>
<td>3.8</td>
<td>4.9</td>
<td>7.8</td>
<td>76.7</td>
<td>100%</td>
</tr>
<tr>
<td>Never married</td>
<td>12.9</td>
<td>7.5</td>
<td>8.9</td>
<td>13.4</td>
<td>57.3</td>
<td>100%</td>
</tr>
<tr>
<td>All Households</td>
<td>6.8</td>
<td>6.0</td>
<td>12.4</td>
<td>16.1</td>
<td>58.7</td>
<td>100%</td>
</tr>
</tbody>
</table>

Taken together, these demographic data suggest that the socioeconomic range of credit union users is somewhat broader than that of bank users. This is probably related to explicit attempts by credit unions to serve low-income households. And, even though households that use credit unions only have less wealth and income on average than households that use banks only, credit union users on average tend to be more educated. Overall, these demographic differences are not substantial enough to suggest that credit union members are significantly different in their use of financial services.

Since they have similar demographic characteristics, it is reasonable to conclude that credit union users are about as financially sophisticated as bank users. Therefore, the demand for financial products and services by credit union members is likely to be as intense and varied as the demand by bank users. It is reasonable to conclude that if credit unions are allowed greater flexibility in the provision of financial services, their members will reap the benefits. Members will have access to a wider array of financial services.

**FIELD OF MEMBERSHIP LIMITATIONS**

Limitations on field of membership are among the most restrictive types of regulations credit unions face. In chapters three and four, we presented a detailed discussion of credit union field of membership restrictions, emphasizing that credit unions (in general) can only serve their members. Only individuals that are covered by a well-defined common bond (e.g., occupation, employer, association, or geographic area) may become members of credit unions. Some credit unions are restricted to just one common bond for their entire field of membership range. Table 6 shows that over 60% of credit unions at yearend 2001 serve only one common bond group. CUMAA has codified a federal credit union’s ability to serve more than one group. However, for any given credit union, the number of people it can serve in its market is much more restricted than is the potential customer base of a similarly situated bank.
Although the idea of a common bond was fundamental to the historical development of the credit union movement, regulatory restrictions limiting a credit union’s ability to define its own common bonds do not make sense in today’s dynamic marketplace.

**Cost and benefits of field of membership limitations**

In theory, all firms focus to some extent on serving particular market segments. For example, commercial banks often focus on lending to certain consumer or commercial groups. Banks usually make this decision based on their core competencies and considering the competitive market conditions they face. However, commercial banks (or thrifts) may change their market focus as competitive market conditions change. Commercial banks are also free to choose their market segment focus, and whether they will concentrate on individual or overlapping market segments. In the abstract, the “common bond” declared by credit unions is a “focus” on a particular market segment. But credit unions are not allowed to freely change their common bond (or market focus) as market conditions change.

### Table 6 – Credit Union Distribution by Field of Membership (2001)

<table>
<thead>
<tr>
<th>Field of Membership</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Residential</td>
<td>11.3%</td>
</tr>
<tr>
<td>Associational</td>
<td>10.2%</td>
</tr>
<tr>
<td>Occupational</td>
<td></td>
</tr>
<tr>
<td>Manufacturing (Chemical &amp; Oil)</td>
<td>40.9%</td>
</tr>
<tr>
<td>Manufacturing (Metal, Machines &amp; Cars)</td>
<td>2.2%</td>
</tr>
<tr>
<td>Manufacturing (Food, Electronics &amp; Other)</td>
<td>3.4%</td>
</tr>
<tr>
<td>Governmental &amp; Military</td>
<td>7.3%</td>
</tr>
<tr>
<td>Education &amp; Healthcare</td>
<td>11.1%</td>
</tr>
<tr>
<td>Transportation, Communication &amp; Utilities</td>
<td>8.7%</td>
</tr>
<tr>
<td>Finance, RE, Trade &amp; Misc. Services</td>
<td>6.0%</td>
</tr>
<tr>
<td>Multiple Group</td>
<td></td>
</tr>
<tr>
<td>Primarily Manufacturing</td>
<td>35.3%</td>
</tr>
<tr>
<td>Primarily Government &amp; Military</td>
<td>8.5%</td>
</tr>
<tr>
<td>Primarily Service</td>
<td>8.1%</td>
</tr>
<tr>
<td>Other (Mixed &amp; Associational)</td>
<td>13.3%</td>
</tr>
<tr>
<td>Low Income</td>
<td>2.2%</td>
</tr>
</tbody>
</table>

*Source: CUNA Web page (www.cuna.org)*
These costly restrictions reduce the efficiency of the financial system by limiting the ability of credit unions to respond to the needs of a dynamic marketplace. Furthermore, these restrictions increase the overall risks associated with credit union operations by limiting their opportunity to diversify their membership base. These restrictions often limit a credit union’s growth possibilities. Some credit unions may benefit from growth opportunities because of economies of scale and scope.

In previous chapters, we demonstrated that optimal regulatory policy must continually weigh the costs and benefits of its restrictions on the operating policies of those regulated. When the costs of the restrictions exceed their benefits, it is time to reconsider the regulatory policy. The restrictions on credit unions field of membership are essentially the same today as they were over sixty years ago. Multiple groups are permitted, but a credit union’s field of membership is still limited. But our economy is very different today than it was sixty years ago. Because of advances in technology, increases in market competition, and innovations in financial products and services, today’s financial markets bear little resemblance to those of sixty years ago.

Hundreds of thousands of jobs exit our economy every week, and hundreds of thousands of new jobs are created to replace them (Greenspan, 1993). Likewise, a myriad of firms and products continually enter and exit the economic marketplace each week. As a consequence, today’s economy is much more dynamic. These dynamics mean that today’s jobs and firms are much less stable. Obsolescence of products, firms, or entire industries occurs much more rapidly.

In today’s marketplace, restricting a credit union’s ability to adjust the market segment it serves as the market changes is very costly regulation. This is why field of membership regulations credit unions face today must be changed. For example, consider the difficulty faced by credit unions serving employees of Enron or WorldCom. Their strategies are limited because they may serve the employees of only one firm. Details of how to change these regulations may require policy negotiations, but the general economic principles to guide the changes are clear.
The costs of field of membership limitations are very high. They reduce consumer choice and competition, and they increase the overall risk of the credit union industry. The benefits of field of membership limitations are probably very small. For example, consider a world in which field of membership limitations did not exist. In such a world, credit unions would choose their common bonds, or market segments, based on their competitive abilities to offer superior products and services. It is unlikely that credit unions would attempt to serve all market segments or abandon the concept of common bonds. But, like commercial banks, credit unions would have the ability to choose which common bonds best fit their individual philosophy and operations.

This discussion leads to a recommendation that credit unions be allowed to freely define their own fields of membership. At a minimum, they should be allowed to mix community groups, occupational groups, and association groups within their service area. And the presumption that a group over a certain size should form a separate credit union (and thus sacrifice potential economies of scale and scope benefits) should be eliminated.

Adopting either of these fields of membership deregulations would lead to more efficient credit unions with better-served members and greater consumer choice.

**BUSINESS LENDING LIMITATIONS**

In Chapters 3 and 4, we described the regulatory limitations placed on credit union business lending. A summary of those limitations includes:

1. A credit union’s member business lending is limited to the lesser of either 1.75 times net worth or 12.25% of total assets.
2. A credit union’s loans can only be made to credit union members.
3. Member business loans generally require the personal guarantee of the borrower.
4. Member business loans generally must be fully collateralized.
These are very restrictive regulations. In this section we argue that the costs of these restrictions are greater than their benefits. We examine what would happen if one of the four restrictions listed above were removed, and the likely outcome of eliminating the requirement limiting a credit union’s member business lending to the lesser of either 1.75 times net worth or 12.25% of total assets (similar outcomes would likely result from eliminating each of the other restrictions).

Reducing the limitations on member business lending would allow credit unions to diversify their asset portfolios. This diversification benefit may serve to reduce the overall risk of credit union loan portfolios. Reducing the limitations on member business lending may well allow credit unions to serve business clients that would otherwise receive no credit. To investigate this possibility we provide evidence on the business clientele serviced by credit union member business lending. The evidence suggests that those who would benefit from an increase in credit union member business lending are small businesses and low- to moderate-income individuals.

**Small business credit and member business lending**

A recent survey by the U.S. Department of the Treasury (2001a) reports that 59% of credit union member business loans have balances less than $50,000 and that only 2% have balances greater than $500,000. These loans amount to 14% and 17%, respectively, of the total outstanding principal balance of all U.S. credit union member business loans reported. For all member business loans reported, over half are collateralized with non-agricultural real estate, and another 23% are collateralized with taxicab medallions. Agricultural collateral backs 12% of the loans.

Over 50% of the member business loans reported were made to businesses with assets under $100,000. About 86% of all loans were made to businesses with total assets less than $500,000. Loans to service-oriented businesses and for rental property made up nearly 55% of the total number of loans.

Looking at the total dollar value of member business loans outstanding, the survey showed that over 70% went either to service providers (38.8%) or for rental properties (32.9%). It appears that the figures for service providers largely reflect the loans made for taxicab medallions. Nearly half of the unpaid
principal balance of member business loans outstanding was to businesses with total assets between $100,000 and $500,000. Cumulatively, almost 70% of the value of member business loans was made to businesses with total assets less than $500,000.

The vast majority of credit union member business lending goes to small businesses. Policies that increase credit union member business lending are likely to increase available credit to small business borrowers.

**Meeting the needs of low- and moderate-income individuals**

To what extent does member business lending help to meet the financial services needs of low- and moderate-income individuals? The Treasury (2001a) survey reports that 25% of credit union member business loans were made to members with household income of less than $30,000. These loans totaled about 13% of the outstanding member business lending balances. Another 20% of the loans (with 15% of the outstanding loan balance) went to households with incomes between $30,000 and $50,000. Thus, about 45% (28% in dollar terms) of all credit union member business lending goes to low and moderate income individuals. Policies that increase credit union member business lending are likely to increase available business credit to low and moderate income individuals.

**Member business loans may be less risky**

Credit union member business loans are generally loans to individuals for business purposes. Because an individual (or group of individuals) is personally liable for the debt, member business loans tend to be smaller and less risky than typical business loans made by banks and thrifts. Credit union member business loans share many characteristics of consumer loans. They are generally smaller and fully collateralized, and borrower risk profiles are more easily determined. As a result, the credit risk associated with member business loans may be lower than the credit risk for most bank and thrift commercial loans.

Table 7 provides information on business loan delinquencies and charge-offs for credit unions, banks, and thrifts. Credit unions define loan delinquency somewhat differently than do banks and thrifts, so comparisons of delinquency rates should be interpreted
Ongoing delinquencies are lower for credit unions than for banks and thrifts. Credit unions’ mid-year 2000 loan charge-off rate of 0.03% was much lower than that for either commercial banks (0.60%) or thrifts (0.58%).

### Table 7 – Delinquencies and Charge-Offs as a Percent of Total Business Loans (6/30/00)

<table>
<thead>
<tr>
<th></th>
<th>Recent Delinquencies&lt;sup&gt;4&lt;/sup&gt;</th>
<th>Ongoing Delinquencies&lt;sup&gt;5&lt;/sup&gt;</th>
<th>Net Charge-offs&lt;sup&gt;6&lt;/sup&gt;</th>
</tr>
</thead>
<tbody>
<tr>
<td>All Credit Unions&lt;sup&gt;1&lt;/sup&gt;</td>
<td>1.52%</td>
<td>0.32%</td>
<td>0.03%</td>
</tr>
<tr>
<td>All Commercial Banks&lt;sup&gt;2&lt;/sup&gt;</td>
<td>0.85%</td>
<td>1.41%</td>
<td>0.60%</td>
</tr>
<tr>
<td>Banks with total assets less than $100 million</td>
<td>1.43%</td>
<td>1.33%</td>
<td>0.36%</td>
</tr>
<tr>
<td>Banks with total assets between $100 million and $1 billion</td>
<td>1.25%</td>
<td>1.19%</td>
<td>0.36%</td>
</tr>
<tr>
<td>All Savings Institutions&lt;sup&gt;3&lt;/sup&gt;</td>
<td>1.42%</td>
<td>1.25%</td>
<td>0.58%</td>
</tr>
<tr>
<td>Thrifts with total assets less than $100 million</td>
<td>1.79%</td>
<td>1.94%</td>
<td>0.44%</td>
</tr>
<tr>
<td>Thrifts with total assets between $100 million and $1 billion</td>
<td>1.31%</td>
<td>0.90%</td>
<td>0.56%</td>
</tr>
</tbody>
</table>

<sup>1</sup> Credit union business loans are defined as total member business loans.

<sup>2</sup> Commercial bank business loans are defined as total commercial and industrial loans. It also includes “all other loans” for institutions with fewer than $1 billion in total assets.

<sup>3</sup> Savings institutions include both savings associations and savings banks. For savings institutions, business loans are defined as total commercial and industrial loans.

<sup>4</sup> Recent delinquencies are defined as those less than 60 days past due for a credit union loan and less than 90 days past due for bank and thrift loans.

<sup>5</sup> Ongoing delinquencies are defined as those more than 60 days past due for a credit union loan and more than 90 days past due for bank and thrifts loans.

<sup>6</sup> Charge-offs less recoveries.


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<sup>37</sup> Term of delinquency categories vary between credit unions, on one hand, and banks and thrifts on the other due to differences in reporting. Credit unions report recently delinquent loans as those 60 days or less past due; banks and thrifts report recent delinquencies as 90 days or less past due. Credit unions report ongoing delinquencies as more than 60 days past due whereas banks and thrifts report such delinquencies as more than 90 days past due.
Because credit union member business loans are less risky than comparable loans at banks or thrifts, it is unlikely that increasing member business lending at credit unions will increase risk in the overall financial system as much as the risk associated with increases in bank or thrift business lending. Reducing the restrictions on member business lending may lead to higher levels of average risk in the member business loan portfolios of credit unions. But, given the cooperative philosophy and culture of credit unions, this increase in risk is likely to be less than the risk associated with increases in bank or thrift business lending.

Thus, reducing the restrictions on credit union member business lending is likely to lead to more lending to small businesses and more lending to low and moderate income individuals, without adding significant additional risk into the U.S. financial system.

**CAPITAL RAISING LIMITATIONS**

With the passage of The Credit Union Membership Access Act of 1998 (CUMAA), credit unions became subject to similar prompt corrective action regulations as commercial banks. These new regulations formed the basis for the current capital requirements that apply to credit unions. The capital requirements for credit unions were set at a significantly higher level than those for banks. The rationale for setting a higher capital requirement for credit unions was based in part on the inability of credit unions to quickly raise capital by issuing securities, as banks are able to do.

An alternative approach to higher capital requirements for credit unions would be to give credit unions the ability to raise capital by issuing capital-like securities. Thus, instead of holding excessive amounts of capital, credit unions would be able to raise capital when needed. This approach seems much more efficient given that excessive capital requirements restrict the ability of the financial system to provide the optimal amount of credit to potential borrowers.

Next we offer a review of two of current proposals to change the regulations for credit union capital requirements. Some combination of these two proposals would provide credit unions with the flexibility needed to function effectively in the financial system.
A reasonable measure of flexibility is one of the main public policy goals of credit unions. A recent report to the Credit Union National Association (CUNA) Board stated: “Credit unions need flexibility to adapt to members’ changing needs. Credit unions do not want to be banks. They want to remain cooperative, not-for-profit financial institutions, controlled by volunteer boards. They just want to continue to be a viable financial alternative, providing value to their members and keeping prices lower for all consumers.”

\textit{A review of reform proposals for credit union net worth requirements}\footnote{Report to the CUNA Board, CUNA Renaissance Commission, June 2001.}

Capital requirements and net worth requirements exist to ensure that potentially troubled institutions do not become insolvent and impose costs on the deposit insurer and taxpayers. To achieve that goal in the case of undercapitalized credit unions, (1) restrictions may be placed on the choices and activities available to management; (2) management may be replaced; or (3), if necessary, the institutions may be closed. However, under current capital and net worth requirements, commercial banks faced with profitable opportunities and low capital ratios find it easier than credit unions to simultaneously expand and reach their capital targets.

Banks may, on relatively short notice, issue common stock, subordinated debt, or a variety of debt-equity hybrids that qualify towards their capital requirements. In contrast, credit unions have no flexibility on the choice of instruments that may be used to meet net worth requirements. In effect, current regulations limit the ability of credit unions to serve their members on a timely basis if their net worth ratios approach their net worth requirements. Several proposals have been made over the last few years seeking to correct this situation. These proposals seek to expand the range of instruments credit unions may use to meet their net worth requirements. Most of these proposals fall within one of two categories: (1) proposals that advocate raising secondary capital by offering some type of uninsured deposit (or security) to current credit union members; and (2) proposals that suggest raising secondary capital in the broader financial marketplace by issuing an instrument functionally equivalent to subordinated debt.

\footnote{The following subsections are based in part on James A. Wilcox, \textit{“Subordinated Debt for Credit Unions,”} Filene Research Institute, 2002.}
Raising capital from credit union members

Many credit unions require their members to maintain a small minimum in their accounts (typically between $5 and $100). These amounts can only be withdrawn upon terminating membership. However, if credit unions with inadequate net worth levels had the legal option to refuse to pay out these minimum balances, those balances would act as a form of capital (an uninsured cushion for the share insurer) that could not flee in times of distress. These balances would be excluded from share insurance. Proponents argue that these minimum amounts should be recognized as “membership capital shares” and that their sum should qualify towards a credit union’s net worth requirements. If this proposal were approved, credit unions could adjust their account minimums to raise capital.

Credit unions could also offer their members securities with long term maturities (or no maturity), offering higher rates than regular insured accounts, and partially or fully uninsured. Being uninsured, these accounts (or some portion of them) would provide the deposit insurer with a cushion in the case of failure. This security would be similar to preferred stock. Under this proposal, members could make withdrawals from their accounts or sell their securities back to the credit union. But they would have to provide extended prior notification to do so. These funds could not be withdrawn on short notice due to fear of problems at the credit union.

Using subordinated debt to meet credit union net worth requirements

Like other alternative net worth instruments, subordinated debt has advantages and disadvantages. Credit unions are not served best by the introduction of a single alternative net worth instrument. Different types of credit unions (large, small, complex, traditional, high-growth, or stable) should have a range of options, permitting each credit union to use the instruments that are most appropriate to its current circumstances.

40 Any security with very similar properties to subordinate debt could be substituted here. For example, trust preferred stock – a non-maturing security with predetermined payments set at regular intervals – could also be used here.
Relative to other alternatives, the potential advantages of selling subordinated debt to non-members include (1) facilitating raising larger amounts of net worth from outside the credit union industry on relatively short notice and (2) shifting the risk of institutional failure to parties external to the credit union movement. Potential disadvantages include (1) the perception of loss of managerial control due to the existence of a new type of external creditors; (2) the difficulties associated with marketing these instruments; and (3) the greater interest cost involved in subordinated debt relative to traditional deposits.

**Advantages of the use of subordinated debt for credit union regulators**

Subordinated debt could serve five regulatory objectives: (1) direct market discipline; (2) indirect market discipline; (3) improving transparency and disclosure; (4) increasing the size of the financial cushion provided to the federal deposit insurer; and (5) reducing supervisory forbearance.

1. **Direct market discipline**
   Direct market discipline would be enhanced if an institution’s expected cost of issuing subordinated debt became more directly related to the purchaser’s perceptions of the riskiness of that institution. The anticipation of higher funding costs due to increased risk would be an incentive for the issuing organization to refrain from taking excessive risk.

2. **Indirect market discipline**
   Indirect market discipline would be enhanced if secondary market prices for an institution’s debt were related to the institution’s risk. Discipline would be exerted if investors interpreted a rise in secondary market yields as a signal of increased risk, leading them to reduce their exposure to the financial institution. Supervisors could also use the increase in yields as a signal of potentially increased institutional risk and take prompt corrective action (PCA) to address that possibility.

3. **Transparency and disclosure**
   Transparency and disclosure would be enhanced since subordinated debt holders would not purchase debt unless
a clear picture of an institution’s riskiness was forthcoming.

4. **Increased size of the financial cushion provided to the deposit insurer**

   The financial cushion provided to the deposit insurer could be increased since holders of subordinated debt would be compensated only after the deposit insurer was fully compensated (out of sales of existing assets). The smaller the share of insured funds out of assets, the smaller the risk to deposit insurers.

5. **Reducing supervisory forbearance**

   Prompt corrective action (PCA) schedules empower (and eventually require) supervisors to place greater and greater restrictions on an institution’s operations as its capital (or net worth) ratio falls below certain levels. These restrictions may range from limits on particular activities to the removal of management and eventually the closure of the institution. The purpose of PCA is to reduce (if not eliminate) supervisory forbearance (i.e., to prevent supervisors from delaying excessively in taking necessary actions against troubled institutions and thus to avoid larger losses).

If a financial crisis occurs, the PCA system will likely help to (1) reduce the number of institutions with negative net worth at the time of closure and (2) replace earlier the management teams associated with poor performance. However, the PCA system does not remove all discretion from regulatory supervisors. Holders of subordinated debt could encourage supervisors to exercise their discretion earlier, to prevent troubled institutions from accumulating larger losses and further depleting the value of outstanding subordinated debt.

Currently, credit unions can not issue securities to raise capital. They must raise capital slowly over time through the accumulation of retained earnings. The capital requirements for credit unions were set at a significantly higher level than those for banks partially because of their inability to quickly raise capital by issuing securities.

We have presented the two main proposals to change the regulations for credit union capital requirements in this section.
Some combination of these proposals would give credit unions the flexibility needed to function effectively in the financial system.

**GENERAL LENDING LIMITATIONS**

Many of the current statutory and regulatory limitations on credit union lending practices are not necessary for safety and soundness. It is important to determine what constraints are truly necessary for the protection of members and the deposit insurance fund, and then to eliminate unnecessary restrictions. A few unnecessary restrictions are: (1) the 12-year maturity on loans in general; (2) the low dollar threshold requiring an appraisal on real estate loans; (3) the inability of credit unions to participate in loan syndications; (4) the maximum maturity on second mortgages and mobile homes; (5) the current restriction on mortgages to “principal dwelling or future principal dwelling;” and (6) the loan rate ceiling (usury law) to allow credit unions to more effectively compete against payday lenders.

Adjusting the restrictions on usury laws to allow credit unions to compete against payday lenders is an important social issue of the day.

**Payday lending and credit unions**

In a recent paper on the economics of payday lending, Caskey (2002) draws on a variety of sources to establish what is known about the operations of payday lenders; who uses payday loans and why they choose to do so; and the extent to which customers become frequent users of these loans. Caskey also discusses how credit unions should respond to the rise of the payday loan industry.

**What is payday lending?**

Payday lending is a relatively new business that has grown explosively over the past decade. At the beginning of the 1900s, there were probably fewer than two hundred payday loan offices nationally. By mid-2001, that number had risen to about 10,000, many of which operate as part of large multi-state chains.

In a traditional payday loan, a customer writes a personal check made out to the lender. The lender agrees to hold the check for a specific period of time, usually until the customer's next payday or
for up to about two weeks, before depositing it. In exchange, the lender advances a cash payment to the customer that is somewhat less than the amount of the check. The difference, which is the “finance charge,” in combination with the maturity of the loan determines the annualized interest rate. In a typical transaction, for example, a borrower might write a check for $235 that the lender agrees to hold for two weeks. The lender provides the borrower with a $200 cash advance.

Prior to the maturity of the loan, the borrower can pay the lender the face value of the check in cash. If the borrower does not repay the loan prior to its maturity, the lender deposits the customer’s check. Assuming the check clears, the loan is fully repaid and the transaction is complete.

In many cases, borrowers can renew their loans rather than paying them off. One method is a “rollover.” In a rollover, the borrower pays the lender the finance charge due at maturity and the lender agrees to hold the check for another specific period of time, usually about two weeks.

Interest on payday loans is paid with each renewal, so there is no compounding of interest. This makes the calculation of the annual percentage rate simple. For example, the annual percentage interest rate on a two-week $200 loan for which the lender charges $35 is 455% (17.5% for two weeks multiplied by 26). Given the short maturity of the loans and the size of the finance charge relative to the size of the loan, the annual percentage interest rates on payday loans are frequently 400% or more (Caskey, 2002).

Who are payday loan customers?

Most payday loan customers are from lower-middle to middle-income households. In one survey, about half of the customers reported household incomes of between $25,000 and $50,000. The remaining customers were almost equally divided between those with household incomes under $25,000 and those with incomes over $50,000. Payday loan customers tend to be younger than the general adult population and more likely to have children. They are substantially less likely to have a college degree, although relatively few have less than a high school degree. Over 40% of customers report that they own their homes and 57% report that they have a bank credit card. Somewhat over half of payday loan customers are female (Caskey, 2002).
Why do people borrow from payday lenders?

Interviews with payday lenders and data from surveys suggest that people borrow from payday lenders because they believe that this is the best way to meet an immediate need for a cash advance of $100 to $500. Many payday loan customers apparently do not have access to lower cost credit from banks or credit unions because they have already reached the limit of the credit available from these sources. They have “maxed out” their credit cards and other lines of credit. Others do not have access to lower cost credit because they have severely impaired credit histories. They do not want to ask family members or friends for a cash advance because they might be judged harshly for doing so, or because they have exhausted their access to such informal alternatives. They could address their cash shortfall by making payments using a check that they know will bounce or by delaying paying some bills. But because of substantial fees for late payments, over-limit charges, and NSF and returned check charges, such steps can be even more costly than a payday loan.

As an alternative or supplemental explanation for the use of payday loans, some critics of the product argue that many customers may not understand just how expensive payday loans are. Survey data indicate that at least three quarters of payday loan customers remember to a reasonably accurate degree the dollar cost of the most recent cash advance they received. The vast majority of payday loan customers, however, either report that they do not know the annual percentage rate on their loans, or they report unrealistically low rates (Caskey, 2002).

Does payday lending trap borrowers?

Defenders of payday lending argue that the industry provides a beneficial service to people who have no better alternatives. Imagine, for example, someone who has no savings and no quick access to comparatively low-cost credit. Suppose this person’s car breaks down and she might lose her job if she cannot get it repaired quickly. It is perfectly reasonable for her to pay $35 to take out a two-week $200 loan to fix the car rather than lose her job, write checks that bounce, or incur late payment fees on a variety of other bills. Payday lenders acknowledge that their loans appear to be outrageously expensive when stated in terms of the annual percentage rate. But they argue that this is misleading
because payday advances are intended to be very short-term loans.

Critics of payday lending argue that most customers do not use payday loans as an occasional short-term emergency source of credit. A customer may borrow initially to meet an unexpected emergency. In many cases, however, when the next pay period comes the customer faces a difficult choice. He can use his available cash to repay the loan. If he does, given his limited income for discretionary expenditures, he is likely to run short of funds before the next pay period, and returns to the payday lender to seek a new loan. Alternatively, upon the maturity of the loan he can simply pay the finance charge in cash and extend the term of the loan until his next pay period. Under either approach, when the next pay period arrives he faces the same set of choices. In this way, a short-term emergency loan evolves into a persistent debt.

Critics of payday loans allege that such an outcome is inherent in the design of the product. They argue that people who use payday loans have modest incomes, almost all of which goes for necessities and the service of previous debts. If a person in this situation has car trouble and must obtain a $200 loan for repairs, she is unlikely to be able to repay the loan plus finance charges out of one paycheck. Rather, she needs to repay the principal in small amounts from several future paychecks. But since payday loans are structured as “balloon” payments, where all principal is repaid at once, they do not facilitate this process. Thus, critics view payday loans as providing short-term help, but frequently at the cost of trapping the borrower in a long-series of costly debt payments.

While advocates for the industry and its critics disagree about the benefits of payday loans, the data indicate that most payday loan customers are frequent users of this product. Data from payday lenders in North Carolina, for example, show that almost 35% of their customers had more than ten payday loan transactions over the course of 1999. Somewhat more than 50% of the customers of a typical payday loan office had more than seven transactions. The study by Caskey (2002) performs analysis of data from a random sample of the loan files of 322 payday loan customers gathered by regulatory authorities in Wisconsin, and finds that the average customer had 12 loan transactions over the course of a year. Only
26% of clients had fewer than six loan transactions while 18% had more than 20.

These data likely understate the average number of loan transactions among payday loan customers, for two reasons. First, survey data indicate that about half of the customers use more than one payday loan firm over the course of a year. So, while a customer of any one lender may have borrowed 10 to 12 times from that lender, the customer may have also borrowed from other lenders in the same year (Caskey, 2002).

**How should credit unions respond to the rise of payday lending?**

Advocates for payday lending argue that these loans are the best quick solution to the short-term financial crises payday loan customers’ face. That may well be true considering the alternatives realistically available to most customers. But it is also true that payday loans are not an attractive solution to financial emergencies. They are far more costly than credit available to people with relatively good credit histories. Moreover, many payday loan customers, perhaps a majority, are frequent customers who pay well more in finance charges over the course of a year than their average cash advance.

It is natural for credit unions to want to address this issue. The earliest credit unions were founded so that people could build savings and avoid high-cost lenders, and many credit unions still place a high priority on those goals. The question is: What should they do?

Some credit unions may decide that their most important contribution is to become involved in advocating changes in regulations governing payday lending. In advocating regulatory changes, however, credit unions should proceed cautiously. If a credit union backs regulatory or legal changes that would make payday lending illegal or unprofitable, it should do so only after it becomes convinced that most or all payday loan customers would truly be better off without legal access to these loans.

Another possible approach to the rise of payday lending is for credit unions to undercut payday lenders by offering low-cost small-value loans to payday loan customers. This approach is unlikely to be successful. If a federal credit union were to charge
payday loan customers its top allowable loan rate of 18% APR for a short-term small-value loan, it would not be able to cover its costs. For example, a $200 two-week loan at 18% APR would generate $1.38 in interest, not enough to cover even the origination cost. The high annual interest rates on payday loans is largely the result of the costs associated with making very small-value, very short-term loans.

Some credit unions recognize this reality, but make payday loans anyway. As these credit unions can not make enough in interest to cover the origination cost of the loans, they lose money on every loan. They do this as part of their social service to their members and the local community. However, if credit unions were allowed to charge a small loan origination fee (say $5 to $15) or allowed an exception from usury laws on small-value, short-term loans, they would be able to compete with payday lenders on a major scale. This would provide a significant benefit for the average payday borrower. For example, suppose that the average payday borrower makes 12 loans a year at a fee of $35 per loan for a total of $420 a year. If a credit union can provide those same loans at a fee of $10 per loan to the payday borrower, then the payday borrower will save $300 ($420-$120) a year. And, that $300 a year could be placed in a savings account. This is another area where credit unions could help.

For instance, credit unions often offer savings products designed to help members, especially those living paycheck to paycheck, build savings. As indicated in previous studies published by the Filene Research Institute, many credit unions already make special efforts in this regard, and other credit unions are often willing to learn from these initiatives. A household that maintains even only a few hundred dollars of savings has a financial margin of safety that can eliminate or greatly reduce its need for payday loans. More important, households with modest cushions of savings are less likely to miss paying bills or engage in other behavior that creates seriously impaired credit records, so they remain eligible for lower-cost sources of credit. Payday borrowers that have access to the lower payday loan fees that credit unions would offer could build a cushion of savings within two or three years based on payday borrowing fee savings alone, given a little help with their personal financial management routine.
Credit unions can (and do) help in this area. Many credit unions already have programs in place to promote consumer education initiatives that help people address credit problems, set savings goals, and adopt good personal financial management practices. And, many other credit unions that may not offer these programs directly, work closely with other organizations that do provide these types of services. Studies by the Filene Research Institute provide information on some of the programs offered by credit unions across the country.41

**INVESTING LIMITATIONS**

In order to be competitive in the marketplace, credit unions should have a wide range of investment alternatives available to them. The current statutory and regulatory constraints on credit unions’ allowable investment products are shocking. In most cases, credit unions can only invest in U.S. government securities and the deposits of other depository institutions. Commercial banks and thrift may choose from a very wide variety of investment products.

Credit unions should be permitted to invest in a wider range of securities, such as asset-backed securities; corporate debt securities (e.g., commercial paper, notes and bonds); non-agency mortgage-backed securities; and real estate investment trusts.

Credit unions should also be allowed to invest in an expanded array of derivative securities. Relaxing this restriction on derivative securities investing would also aid credit unions in developing more effective risk management processes.

41 See www.filene.org.
INCIDENTAL POWERS LIMITATIONS

The Gramm-Leach-Bliley Act of 1999 (GLBA) expanded the principles for determining the permissible activities of a bank from “closely related to banking” to “financial in nature.” Activities specifically determined as “financial in nature” are securities brokerage and underwriting, insurance agency and underwriting, and the ability to make merchant capital investments. GLBA provided the federal bank regulators with the ability to designate additional activities as “financial in nature.” But GLBA did not expand the permissible set of activities for credit unions.

Credit unions should be allowed to offer new financial products and services to their members because other depository institutions will be allowed to do so for their customers. Credit unions should be given parity with other federally insured financial institutions in the areas of incidental powers. Credit union members should have the same access to consumer financial services as customers of other depository institutions.

Optimal regulatory policy implies that credit unions be encouraged to offer services, even to nonmembers, whenever such services serve a recognized social policy objective. Two services that might meet these criteria are check cashing and payday lending services. Payday lending services were discussed in the section on general lending limitations in this chapter. Both payday lending and check cashing services fit the culture of credit unions. For example, in referring to check cashing services Caskey (2001) suggests that “our basic message is simple. Many lower-income households – those who can least afford it – pay high fees for financial services in the alternative financial sector. Credit unions can provide most of these services at lower cost, while charging fees consistent with their long-term financial well-being. By reaching out to these households, credit unions can introduce them to products and services that will help them build financial savings, reduce debt burdens, and clean up impaired credit records. These efforts require entrepreneurship, commitment, and creativity. But the potential payoff is enormous. Credit unions, working together, can make a positive contribution to the financial well-being of thousands of lower-income households.”
AN ASIDE: CONSOLIDATION AND CREDIT UNIONS

Removing restrictions on credit union operations would allow credit unions to become more efficient. It would also allow credit unions to grow larger, especially through consolidation, if they decided that growing larger was in the best interest of their membership.

If credit unions are allowed to grow larger through consolidation, as banks and thrifts have been allowed to do, would that likely lead to benefits for credit union members? Will larger credit unions likely be more cost efficient, provide a wider variety of financial services, and be less risky? The evidence from Tables 8 and 9 suggests that the answer to all of these questions is yes. Table 8 provides a selection of credit union financial performance ratios by size categories. One of these ratios, operating expenses/average assets, is considered a standard measure of overall credit union efficiency. The ratio decreases as credit union asset size category increases. A decreasing ratio is a sign of increasing efficiency. The ratio indicates the dollar amount of expenses necessary to support one dollar of average assets. For example, the smallest credit unions require about 4.7 cents of expenses to support one dollar of average assets. But, the largest group of credit unions requires only about 2.8 cents in expenses to support one dollar of average assets. Thus, large credit unions are able to support a larger amount of average assets per dollar of expenses, and therefore tend to be more efficient.
### Table 8 – Operating Ratios by Credit Union Asset Size

<table>
<thead>
<tr>
<th>($ millions)</th>
<th>$0-$2</th>
<th>$2-$5</th>
<th>$5-$10</th>
<th>$10-$20</th>
<th>$20-$50</th>
<th>$50-$100</th>
<th>$100-$200</th>
<th>$200-$500</th>
<th>$500+</th>
<th>All CUs</th>
</tr>
</thead>
<tbody>
<tr>
<td>Loans Outstanding/Savings</td>
<td>54.2%</td>
<td>64.8%</td>
<td>70.9%</td>
<td>75.6%</td>
<td>75.3%</td>
<td>72.0%</td>
<td>72.3%</td>
<td>72.6%</td>
<td>72.6%</td>
<td>74.6%</td>
</tr>
<tr>
<td>Loans Outstanding/Assets</td>
<td>42.2%</td>
<td>52.2%</td>
<td>58.2%</td>
<td>62.7%</td>
<td>63.8%</td>
<td>61.7%</td>
<td>62.6%</td>
<td>63.5%</td>
<td>64.2%</td>
<td>65.6%</td>
</tr>
<tr>
<td>Investments/Assets*</td>
<td>57.6%</td>
<td>48.1%</td>
<td>42.4%</td>
<td>39.1%</td>
<td>37.4%</td>
<td>37.9%</td>
<td>35.7%</td>
<td>33.7%</td>
<td>31.7%</td>
<td>30.0%</td>
</tr>
<tr>
<td>Savings/Assets</td>
<td>77.9%</td>
<td>80.5%</td>
<td>82.1%</td>
<td>82.9%</td>
<td>84.7%</td>
<td>85.7%</td>
<td>86.5%</td>
<td>87.5%</td>
<td>88.0%</td>
<td>87.9%</td>
</tr>
<tr>
<td>Net Capital/Assets*</td>
<td>19.9%</td>
<td>19.0%</td>
<td>17.1%</td>
<td>16.1%</td>
<td>14.5%</td>
<td>13.4%</td>
<td>12.6%</td>
<td>11.8%</td>
<td>11.2%</td>
<td>10.9%</td>
</tr>
<tr>
<td>Share Drafts/Savings*</td>
<td>0.0%</td>
<td>0.2%</td>
<td>0.5%</td>
<td>1.1%</td>
<td>4.2%</td>
<td>7.1%</td>
<td>9.7%</td>
<td>11.6%</td>
<td>12.0%</td>
<td>13.3%</td>
</tr>
<tr>
<td>Certificates/Savings*</td>
<td>0.3%</td>
<td>2.4%</td>
<td>6.3%</td>
<td>10.4%</td>
<td>16.6%</td>
<td>19.6%</td>
<td>22.5%</td>
<td>25.2%</td>
<td>27.1%</td>
<td>27.8%</td>
</tr>
<tr>
<td>Operating Exp/ Average Assets</td>
<td>4.7%</td>
<td>4.3%</td>
<td>4.2%</td>
<td>4.1%</td>
<td>4.0%</td>
<td>3.9%</td>
<td>3.9%</td>
<td>3.9%</td>
<td>3.7%</td>
<td>3.7%</td>
</tr>
<tr>
<td>Net Chargeoffs/ Gross Income*</td>
<td>11.1%</td>
<td>7.7%</td>
<td>7.9%</td>
<td>5.8%</td>
<td>5.7%</td>
<td>4.4%</td>
<td>4.2%</td>
<td>4.0%</td>
<td>3.6%</td>
<td>4.0%</td>
</tr>
<tr>
<td>Savings Growth</td>
<td>-3.6%</td>
<td>3.3%</td>
<td>6.8%</td>
<td>8.5%</td>
<td>11.7%</td>
<td>13.1%</td>
<td>13.5%</td>
<td>13.5%</td>
<td>14.2%</td>
<td>14.5%</td>
</tr>
<tr>
<td>Loan Growth</td>
<td>-5.6%</td>
<td>-4.1%</td>
<td>-3.8%</td>
<td>-2.8%</td>
<td>-1.4%</td>
<td>-0.7%</td>
<td>0.4%</td>
<td>2.0%</td>
<td>4.7%</td>
<td>6.1%</td>
</tr>
<tr>
<td>Asset Growth</td>
<td>-4.4%</td>
<td>2.6%</td>
<td>5.6%</td>
<td>7.0%</td>
<td>10.2%</td>
<td>11.6%</td>
<td>12.1%</td>
<td>12.3%</td>
<td>13.1%</td>
<td>13.6%</td>
</tr>
<tr>
<td>Members/Potential Members*</td>
<td>20.5%</td>
<td>16.5%</td>
<td>18.7%</td>
<td>12.5%</td>
<td>23.3%</td>
<td>24.8%</td>
<td>19.1%</td>
<td>16.0%</td>
<td>16.0%</td>
<td>14.6%</td>
</tr>
<tr>
<td>Savings/Members</td>
<td>$ 563</td>
<td>$1,106</td>
<td>$1,590</td>
<td>$2,026</td>
<td>$2,575</td>
<td>$3,068</td>
<td>$3,587</td>
<td>$4,079</td>
<td>$4,691</td>
<td>$4,952</td>
</tr>
<tr>
<td>Loans Outstanding/ Members</td>
<td>$ 305</td>
<td>$ 717</td>
<td>$1,128</td>
<td>$1,531</td>
<td>$1,939</td>
<td>$2,210</td>
<td>$2,593</td>
<td>$2,960</td>
<td>$3,425</td>
<td>$3,693</td>
</tr>
<tr>
<td>Avg Loan Made in 2001*</td>
<td>$2,094</td>
<td>$2,858</td>
<td>$3,612</td>
<td>$4,208</td>
<td>$4,974</td>
<td>$5,640</td>
<td>$6,037</td>
<td>$6,734</td>
<td>$7,697</td>
<td>$8,006</td>
</tr>
</tbody>
</table>

*Based on 10,206 reporting CUs (NCUA 5300 FOIA 12/2001 + ASI CUs not on FOIA + 2)

All ratios are aggregate ratios not average ratios—See "Year-End 2001 Operating Ratios and Spreads" published by CUNA & Affiliates for details.

<table>
<thead>
<tr>
<th>Size Category</th>
<th>$0-$2</th>
<th>$2-$5</th>
<th>$5-$10</th>
<th>$10-$20</th>
<th>$20-$50</th>
<th>$50-$100</th>
<th>$100-$200</th>
<th>$200-$500</th>
<th>$500+</th>
<th>All CUs</th>
</tr>
</thead>
<tbody>
<tr>
<td>Once a member, always a member</td>
<td>84.9%</td>
<td>83.8%</td>
<td>89.9%</td>
<td>91.6%</td>
<td>95.9%</td>
<td>96.5%</td>
<td>97.6%</td>
<td>98.1%</td>
<td>97.1%</td>
<td>98.8%</td>
</tr>
<tr>
<td>Common bond includes family members</td>
<td>85.7%</td>
<td>93.5%</td>
<td>93.4%</td>
<td>96.7%</td>
<td>97.6%</td>
<td>98.1%</td>
<td>98.2%</td>
<td>99.2%</td>
<td>98.9%</td>
<td>100.0%</td>
</tr>
<tr>
<td>Multiple groups including SEGs</td>
<td>2.7%</td>
<td>5.0%</td>
<td>10.3%</td>
<td>16.6%</td>
<td>24.7%</td>
<td>38.4%</td>
<td>48.1%</td>
<td>56.6%</td>
<td>64.9%</td>
<td>75.9%</td>
</tr>
<tr>
<td>Common bond includes community</td>
<td>33.3%</td>
<td>33.3%</td>
<td>34.8%</td>
<td>34.6%</td>
<td>33.0%</td>
<td>36.1%</td>
<td>36.9%</td>
<td>47.7%</td>
<td>56.6%</td>
<td>65.2%</td>
</tr>
<tr>
<td>Service packages for retirees</td>
<td>5.3%</td>
<td>0.0%</td>
<td>1.1%</td>
<td>1.6%</td>
<td>2.6%</td>
<td>9.5%</td>
<td>19.6%</td>
<td>31.2%</td>
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<td>49.6%</td>
</tr>
<tr>
<td>Special program for youth</td>
<td>12.3%</td>
<td>7.9%</td>
<td>6.2%</td>
<td>6.2%</td>
<td>11.4%</td>
<td>21.1%</td>
<td>34.2%</td>
<td>47.5%</td>
<td>59.0%</td>
<td>68.5%</td>
</tr>
<tr>
<td>Stock/bond brokerage</td>
<td>0.0%</td>
<td>0.0%</td>
<td>0.3%</td>
<td>0.6%</td>
<td>1.2%</td>
<td>4.9%</td>
<td>9.8%</td>
<td>21.1%</td>
<td>37.6%</td>
<td>60.1%</td>
</tr>
<tr>
<td>Mutual funds</td>
<td>1.1%</td>
<td>0.4%</td>
<td>0.3%</td>
<td>0.9%</td>
<td>0.7%</td>
<td>3.7%</td>
<td>7.6%</td>
<td>18.1%</td>
<td>35.1%</td>
<td>60.0%</td>
</tr>
<tr>
<td>Savings bonds</td>
<td>0.0%</td>
<td>1.3%</td>
<td>0.8%</td>
<td>2.6%</td>
<td>5.3%</td>
<td>10.6%</td>
<td>18.3%</td>
<td>29.0%</td>
<td>41.7%</td>
<td>53.9%</td>
</tr>
<tr>
<td>Life savings insurance</td>
<td>51.1%</td>
<td>65.8%</td>
<td>58.4%</td>
<td>61.5%</td>
<td>57.1%</td>
<td>54.8%</td>
<td>51.9%</td>
<td>51.0%</td>
<td>41.5%</td>
<td>38.8%</td>
</tr>
<tr>
<td>Direct Deposit</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Federal recurrent payments</td>
<td>7.5%</td>
<td>8.2%</td>
<td>18.6%</td>
<td>31.1%</td>
<td>57.0%</td>
<td>77.2%</td>
<td>87.1%</td>
<td>91.2%</td>
<td>92.5%</td>
<td>94.4%</td>
</tr>
<tr>
<td>Net pay</td>
<td>7.8%</td>
<td>23.7%</td>
<td>27.3%</td>
<td>36.5%</td>
<td>60.6%</td>
<td>81.2%</td>
<td>88.2%</td>
<td>91.8%</td>
<td>94.1%</td>
<td>94.3%</td>
</tr>
<tr>
<td>Home Banking</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Audio Response</td>
<td>3.5%</td>
<td>7.5%</td>
<td>4.8%</td>
<td>7.0%</td>
<td>11.4%</td>
<td>34.4%</td>
<td>64.7%</td>
<td>87.6%</td>
<td>96.3%</td>
<td>98.1%</td>
</tr>
<tr>
<td>PCs</td>
<td>1.2%</td>
<td>0.5%</td>
<td>0.6%</td>
<td>1.9%</td>
<td>5.6%</td>
<td>14.4%</td>
<td>31.6%</td>
<td>57.2%</td>
<td>79.3%</td>
<td>93.2%</td>
</tr>
<tr>
<td>Have Web Site</td>
<td>3.3%</td>
<td>1.4%</td>
<td>3.5%</td>
<td>6.0%</td>
<td>18.1%</td>
<td>33.6%</td>
<td>61.1%</td>
<td>83.7%</td>
<td>92.7%</td>
<td>99.2%</td>
</tr>
<tr>
<td>Cashier's Checks</td>
<td>2.1%</td>
<td>2.1%</td>
<td>6.0%</td>
<td>10.7%</td>
<td>25.8%</td>
<td>45.4%</td>
<td>65.1%</td>
<td>76.8%</td>
<td>83.2%</td>
<td>89.4%</td>
</tr>
<tr>
<td>Travelers Checks</td>
<td>1.1%</td>
<td>2.1%</td>
<td>5.2%</td>
<td>15.8%</td>
<td>38.3%</td>
<td>62.1%</td>
<td>82.3%</td>
<td>93.2%</td>
<td>96.9%</td>
<td>98.0%</td>
</tr>
<tr>
<td>Safe deposit boxes</td>
<td>1.1%</td>
<td>0.0%</td>
<td>1.1%</td>
<td>0.2%</td>
<td>0.9%</td>
<td>2.7%</td>
<td>10.0%</td>
<td>29.1%</td>
<td>50.3%</td>
<td>64.2%</td>
</tr>
<tr>
<td>Credit Counseling</td>
<td>18.1%</td>
<td>16.0%</td>
<td>15.5%</td>
<td>18.9%</td>
<td>23.1%</td>
<td>35.9%</td>
<td>39.9%</td>
<td>43.7%</td>
<td>45.6%</td>
<td>53.9%</td>
</tr>
<tr>
<td>Formal financial planning</td>
<td>2.2%</td>
<td>2.1%</td>
<td>0.5%</td>
<td>1.3%</td>
<td>1.6%</td>
<td>3.6%</td>
<td>7.4%</td>
<td>16.2%</td>
<td>33.2%</td>
<td>52.9%</td>
</tr>
<tr>
<td>ATM cards</td>
<td>0.0%</td>
<td>0.0%</td>
<td>0.8%</td>
<td>3.7%</td>
<td>23.1%</td>
<td>53.5%</td>
<td>79.3%</td>
<td>90.8%</td>
<td>92.1%</td>
<td>97.7%</td>
</tr>
<tr>
<td>Credit cards</td>
<td>0.0%</td>
<td>0.0%</td>
<td>1.9%</td>
<td>4.0%</td>
<td>18.9%</td>
<td>43.9%</td>
<td>69.4%</td>
<td>87.2%</td>
<td>91.8%</td>
<td>96.5%</td>
</tr>
<tr>
<td>Size Category</td>
<td>$0-$2</td>
<td>$2-$5</td>
<td>$5-$10</td>
<td>$10-$20</td>
<td>$20-$50</td>
<td>$50-$100</td>
<td>$100-$200</td>
<td>$200-$500</td>
<td>$500+</td>
<td>All CUs</td>
</tr>
<tr>
<td>-----------------------</td>
<td>-------</td>
<td>-------</td>
<td>--------</td>
<td>---------</td>
<td>---------</td>
<td>----------</td>
<td>-----------</td>
<td>-----------</td>
<td>-------</td>
<td>--------</td>
</tr>
<tr>
<td>Share drafts</td>
<td>0.0%</td>
<td>0.0%</td>
<td>5.4%</td>
<td>14.7%</td>
<td>45.2%</td>
<td>74.8%</td>
<td>90.0%</td>
<td>96.6%</td>
<td>95.0%</td>
<td>98.8%</td>
</tr>
<tr>
<td>Visa/Mastercard debit cards</td>
<td>0.0%</td>
<td>0.0%</td>
<td>1.2%</td>
<td>2.7%</td>
<td>19.0%</td>
<td>41.1%</td>
<td>65.3%</td>
<td>72.2%</td>
<td>85.2%</td>
<td>93.7%</td>
</tr>
<tr>
<td>Certificates</td>
<td>4.1%</td>
<td>11.8%</td>
<td>24.4%</td>
<td>40.3%</td>
<td>58.2%</td>
<td>78.8%</td>
<td>94.2%</td>
<td>95.7%</td>
<td>98.7%</td>
<td>98.4%</td>
</tr>
<tr>
<td>IRAs</td>
<td>1.0%</td>
<td>2.5%</td>
<td>7.3%</td>
<td>17.4%</td>
<td>35.3%</td>
<td>58.0%</td>
<td>90.3%</td>
<td>97.7%</td>
<td>99.5%</td>
<td>100.0%</td>
</tr>
<tr>
<td>SEP IRAs</td>
<td>0.0%</td>
<td>0.0%</td>
<td>1.4%</td>
<td>4.8%</td>
<td>9.1%</td>
<td>18.9%</td>
<td>24.9%</td>
<td>32.8%</td>
<td>36.4%</td>
<td>43.9%</td>
</tr>
<tr>
<td>ROTH IRAs</td>
<td>0.0%</td>
<td>0.8%</td>
<td>5.1%</td>
<td>9.9%</td>
<td>24.4%</td>
<td>45.3%</td>
<td>68.0%</td>
<td>85.1%</td>
<td>92.9%</td>
<td>96.1%</td>
</tr>
<tr>
<td>Business checking</td>
<td>0.0%</td>
<td>0.0%</td>
<td>1.8%</td>
<td>5.3%</td>
<td>14.1%</td>
<td>24.2%</td>
<td>34.3%</td>
<td>43.5%</td>
<td>47.0%</td>
<td>42.4%</td>
</tr>
<tr>
<td>First mortgages</td>
<td>4.1%</td>
<td>0.4%</td>
<td>5.7%</td>
<td>9.3%</td>
<td>15.8%</td>
<td>31.6%</td>
<td>56.2%</td>
<td>78.3%</td>
<td>94.9%</td>
<td>97.5%</td>
</tr>
<tr>
<td>Stock secured loans</td>
<td>2.1%</td>
<td>8.1%</td>
<td>7.9%</td>
<td>8.3%</td>
<td>8.8%</td>
<td>13.5%</td>
<td>25.0%</td>
<td>44.8%</td>
<td>49.6%</td>
<td>52.5%</td>
</tr>
<tr>
<td>Plane/boat/R.V loans</td>
<td>13.5%</td>
<td>47.5%</td>
<td>60.6%</td>
<td>72.3%</td>
<td>82.2%</td>
<td>87.7%</td>
<td>95.5%</td>
<td>97.5%</td>
<td>96.9%</td>
<td>96.9%</td>
</tr>
<tr>
<td>Guaranteed student loans</td>
<td>0.0%</td>
<td>0.4%</td>
<td>1.6%</td>
<td>2.6%</td>
<td>4.4%</td>
<td>14.5%</td>
<td>23.1%</td>
<td>33.2%</td>
<td>43.5%</td>
<td>38.1%</td>
</tr>
<tr>
<td>Other Student Loans</td>
<td>2.1%</td>
<td>3.9%</td>
<td>6.6%</td>
<td>5.8%</td>
<td>7.9%</td>
<td>15.3%</td>
<td>20.8%</td>
<td>26.5%</td>
<td>33.2%</td>
<td>34.0%</td>
</tr>
<tr>
<td>Balloon Auto loans</td>
<td>1.0%</td>
<td>2.1%</td>
<td>3.8%</td>
<td>4.4%</td>
<td>6.5%</td>
<td>11.2%</td>
<td>21.3%</td>
<td>31.1%</td>
<td>41.4%</td>
<td>49.4%</td>
</tr>
<tr>
<td>Auto Leasing</td>
<td>2.1%</td>
<td>0.9%</td>
<td>0.3%</td>
<td>0.7%</td>
<td>2.3%</td>
<td>6.3%</td>
<td>8.6%</td>
<td>18.0%</td>
<td>25.0%</td>
<td>25.3%</td>
</tr>
</tbody>
</table>

*Data taken from December 2001 CUNA Yearbook Survey*
This increased efficiency is likely the result of economies of scale, or a decrease in the cost per unit of production as the production level increases. Larger credit unions tend to have a larger ratio of loans outstanding/assets. This means that larger credit unions, on average, make more loans per dollar of assets than small credit unions. From a financial system efficiency standpoint, this is a positive result for larger credit unions. Also, notice from Table 8 that larger credit unions tend to have a lower ratio for net charge-offs/gross income. This measure is an indication of the risk in credit union loan portfolios. Lower ratios are associated with less risk. Thus, Table 8 provides evidence that larger credit unions are more efficient and less risky.

Table 9 presents data on the variety of financial services credit unions provide by asset size category. The table shows that larger credit unions are more likely to provide a wider array of financial services than smaller credit unions. The increased variety is likely the result of economies of scope, or the ability of the credit union to affect cost savings by producing two or more outputs with the same basic inputs.

It appears that larger credit unions, using benefits derived from economies of scale, economies of scope, and diversification, achieve cost efficiencies, provide a wider array of financial services, and develop a less risky loan portfolio. Thus, if deregulation allows credit unions to grow larger, the net effect on our financial system is likely to be positive.

Even if credit unions do not choose to grow larger, they will still benefit substantially from deregulation. That is because deregulation will allow all credit unions the flexibility to choose a more efficient mix of inputs to produce at any given level of output. Deregulation will benefit small as well as large credit unions, and those that choose to grow larger as well as those that choose to maintain their current level of operations.
CHAPTER 6: The Optimal Regulatory Policy for Credit Unions

Optimal regulation should be based on at least four premises. First, they should be grounded in the general goals of U.S. economic policy. Second, they should be consistent with the objectives of overall depository institution regulation. Third, they should be informed by the resources and direction of the regulatory agency. And fourth, they should consider special characteristics of the industry that require more or less stringent treatment than other institutions.

GENERAL GOALS OF U.S. ECONOMIC POLICY

Three goals have long dominated economic policy in the Western world. The first and most ancient goal is to produce the largest possible output of goods and services. Maximum output has evolved, under the impact of social events and economic analysis, into a two-pronged goal: (1) to employ as fully as possible the resources at society’s disposal, and eliminate unnecessary unemployment of labor or capital; and (2) to employ these resources as efficiently as possible. No resource should be used in one place if it would produce more elsewhere. That is, it should be impossible to reallocate resources to achieve more goods without getting less of others (Stigler, 1975).

The second goal is the growth of the economy. Natural resources should be prospected, capital accumulated, and new products and technologies discovered. These activities pursue a steady rise in the level of income relative to population.

According to Stigler (1975), the last primary goal of economic policy is a comparative newcomer. It was still a vague sentiment when maximum output had been entrenched for centuries. That goal is a reduction in income inequality. The goal of equality has become one of the great forces of our times.

These three goals (maximum output, substantial growth, and optimal inequality of income) have provided the justifications for every important innovation in modern economic policy. Maximum output is the purpose of free trade in the U.S., the combating of monopoly, and various anti-depression measures. The growth of income is served by various conservation measures, much of

public education, our public land policy, and the current interest of the federal government in basic research. Minimum income inequality is the goal of the personal income tax, agricultural policies, public housing subsidies, unemployment insurance, and a host of other policies. It is oversimplification to identify a policy with only one goal. As Stigler (1975) states, “It is indeed a poor protagonist of an economic policy who fails to argue that it will serve all the goals of economic policy, and that it is also wholly in keeping with the Scriptures”.

Many of the policies we have adopted have failed to serve our stated goals. The farm program was adopted to help a class of families with low average incomes and possibly to conserve resources, but quite probably has increased income inequality within agriculture, and it is doubtful that any useful conservation of resources was achieved. But every society makes mistakes in achieving its goals; often it misunderstands the efficacy of a given policy in reaching a given goal, and often the announced goals are merely cloaks worn by particular groups seeking particular ends. But these aberrations and deceptions do not contradict the goals themselves.

In addition to the three economic policy goals above, Stigler (1975) suggests that the supreme goal for the Western world is the development of the individual. That is, “the creation for the individual of a maximum area of personal freedom, and with this a corresponding area of personal responsibility” (Stigler, 1975). Our concept of the humane society is one in which individual man is permitted and incented to make the most of himself. The self-reliant, responsible, creative citizen is the very foundation of democracy, of freedom of speech, of every institution that recognizes the dignity of man. This goal is the ultimate ethical value (Stigler, 1975).

The development of the individual suggests that one of the fundamental goals of regulation should be to increase consumer (individual) choice, not limit it. This has been recognized as a fundamental criterion for evaluating the regulation of depository institutions. This goal requires a very high cost to be placed on regulations that restrict financial innovation and the free flow of financial products and services to the marketplace. It places a high premium on providing the individual with more, not fewer choices. Taken together, these economic goals mandate that the
regulation of financial institutions be concerned with providing the greatest potential choices of financial products and services in the most efficient manner available to the widest possible group of consumers.

The optimal regulatory policy for credit unions must incorporate these economic goals. We offer three examples of how to incorporate these goals. First, the goals of efficient production and economic growth are served by eliminating any unnecessary restrictions on the ability of credit unions to operate at their most efficient levels. Second, the goal of reducing income inequality is supported by reducing the barriers that prevent consumer’s access to credit unions. This is because credit unions tend to take a special interest in helping low-income groups (Lee and Kelly, 2001). Third, the goal of increasing individual choice is served because credit unions provide an alternative financial services sector to meet the needs of consumers.

**OBJECTIVES OF OVERALL DEPOSITORY INSTITUTIONS REGULATION**

How regulations impact the consumer is a fundamental question when considering the objectives of depository institutions regulation and deregulation. This is also true of supervision. As Federal Reserve Chairman Alan Greenspan has said, “…the prudent supervision of depository institutions must be forward looking, and consistent with the goals and objectives of optimal regulation. Any other approach will be at best counterproductive, and at worst may deter the innovation and risk-taking that are essential for a growing economy”. Chairman Greenspan also suggested that public policy should be concerned with the decline in the importance of depository institutions.

“To the extent that market forces are displacing the intermediation functions of depository institutions, economic efficiency is not being impaired. But to the extent that unnecessary laws and regulations are responsible for the decline, there is a significant reduction in allocative efficiency associated with preventing financial companies from fully exercising their abilities to underwrite and manage risk. As the non-banking sector expands relative to the depository institutions sector – because of artificial legal barriers to depository institution expansion –
human resources, physical assets, and capital must be reallocated to the non-bank sector. The ‘transaction costs’ of this reallocation are not trivial. Further, the depository institution sector loses the opportunity to fully diversify its activities in a way that may permit it to move toward the risk-return frontier rather than remain inside it.”

Finally, and most important, the consumers of financial services are denied the lower prices, increased access, and higher quality services that would accompany the increased competition associated with permitting depository institutions to expand their activities (Greenspan, 1993).

THE RESOURCES AND DIRECTION OF THE CURRENT CREDIT UNION REGULATORY AGENCY

Speaking at a recent workshop concerning the goal of financial independence for America’s 90 million people living in ‘underserved’ areas, the Chairman of the National Credit Union Administration (NCUA) Board, Dennis Dollar, stated that, “Credit unions can be that partner for many of these Americans in their goal for personal empowerment through financial self-sufficiency.”

Chairman Dollar went on to say, “Believing that credit unions can be a part of the solution to this growing need in our country, NCUA has developed an initiative we call ‘Access Across America’ which is designed to facilitate the extension of low-cost credit union services to millions of these citizens. Today, over 90 million Americans reside in census tracts designated by the US Treasury Department’s Community Development Financial Institutions (CDFI) program as underserved. These are folks who have largely been abandoned by traditional financial institutions during the merger-mania years and have been left to the mercy of the check cashers and pawn shops which proliferate in their neighborhoods. Although NCUA as a government agency cannot guarantee that they will choose to join a credit union or take advantage of a credit union’s services if offered, we can make it

43 Remarks by Dennis Dollar, NCUA Chairman, Access Across America, Colonias Initiative Workshop; at the Embassy Suites Hotel; El Paso, Texas; Wednesday, September 4, 2002.
easier for visionary, well-managed credit unions to adopt those underserved neighborhoods into their fields of membership and to extend many of the needed services to those who live there.”

Chairman Dollar also said, “Make no mistake about it. Even though I am a strong proponent of government remaining in its proper role and limiting its arm from over reaching into many areas where excessive regulation creates more problems than it solves, I do believe that government has some clear responsibilities which it should do and do them well. Ensuring safety and soundness with a regulatory process which has integrity and is effective without being excessive is one of those responsibilities. Being an agent of access and opportunity for those who desire a better life is another from which we must not waiver. Access Across America is an initiative founded in both of these responsibilities.”

He also said, “We encourage credit unions under Access Across America to think outside their present comfort zones and to see the opportunities available in many of these underserved areas. As they examine the possibilities of extending service to these neighborhoods as a part of their outreach-oriented business plans, NCUA is turning an approval process which once took over a year into one which can be completed in less than two months. Without sacrificing standards but by prioritizing streamlined process, NCUA has removed the biggest single deterrent to credit unions reaching out to adopt these underserved areas – regulatory hurdles.”

Chairman Dollar continued, “We will never be fully successful in furthering Access Across America if we do not continue to make our field of membership rules and process more open where it is allowable under the law and more user-friendly when both credit unions, employer groups, associations, communities, faith-based organizations and, most importantly, members try to take advantage of its purpose to extend lower-cost financial services to more Americans. We want to facilitate greater credit union access in every way that the law allows when it is built upon the solid foundation of safety and soundness.”
These remarks demonstrate that the NCUA is ready and willing to be an innovative regulator that will allow credit unions to serve expanded memberships and offer an expanded array of financial products and services within the confines of a safe and sound regulatory system. However, the NCUA can not do this on its own.

The NCUA, and Chairman Dollar, need new deregulatory legislation to pave the way toward a more efficient and effective set of rules for regulating credit unions. This legislation should address the full set of operational restrictions currently in place for credit unions. And this legislation must be developed within a process that continually considers the objectives of optimal regulatory policy toward credit unions. As with other depository institutions, the main objective of this deregulatory legislation should be to assist the financial markets in providing as much financial innovation, and thus consumer choice, as possible within a safe and sound financial system.

SPECIAL CHARACTERISTICS OF THE CREDIT UNION INDUSTRY

Chapter 1 discussed how credit unions are different from other depository institutions. For example, credit unions are member-owned, member-directed depository institutions. Credit unions do not issue capital stock. Credit unions rely on unpaid, volunteer boards of directors elected by, and drawn from, each institution’s membership. And credit unions do not operate for profit. This last characteristic of credit unions is of special interest to consider as optimal regulatory policies are developed. Because credit unions seek more than profit – or, maximized shareholder value – they may require less regulation on certain issues. Two of these issues are risk-taking and investing in public policy initiatives.
Risk-taking

For a given risk level that best serves the public interest in balancing risk and market goals, should credit unions and banks be treated differently, and if so, how and why? This question is important because banks and credit unions should be regulated in the same way only if their risk-taking behavior is the same. And their risk-taking preferences may be different because they have different governance structures.

Economic theory suggests that credit unions take less risk than banks (Smith, 1984). This prediction is based on the incentives generated by the governance structure, which is the primary difference between credit unions and banks. In the governance structure of banks, authority for hiring and managing the CEO rests with a board of directors elected by shareholders, based on share holdings in the bank. There’s no guarantee that either the board or the CEO will represent the interests of shareholders perfectly, but we can assume that the CEO has an incentive to maximize bank profits. In doing so, shareholders have a well-diversified portfolio of stocks, so their investment risk is buffered by the range of stocks in the portfolio.

Deposit insurance also affects the level of risk to shareholders. When a bank increases the risk of its assets, it can expect a higher average return, but it does not have to pay its depositors more to reflect this increased risk, because deposit insurance insulates it from its increased risk. The economics and finance literature has long recognized that the combination of a profit-maximizing orientation and insured deposit funding encourages more risk taking.

The governance structure of credit unions produces very different risk incentives. The authority to hire and manage the relationship with the CEO also rests with the board. However, the board is elected by the members of the credit union on a one-person, one-vote-basis, and board members are not usually compensated for their service. Their primary incentive is to satisfy members,

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44 This subsection is based on: Smith, David M. and Stephen A. Woodbury, (2001), “Difference in Bank and Credit Union Capital Needs” Filene Research Institute, Madison, WI
which creates multiple objectives, instead of a single goal to generate profits.

A credit union could increase its net income by assuming more loan risk with a higher expected return, and depend upon federal insurance to avoid a higher cost of funds. However, its gains would not be concentrated among a small group of investors, as they are in a bank.

Credit unions have no separate group of stockholders, and no ability to use stock options to motivate management to take potentially profitable risks. For these reasons, economic theory predicts that credit unions would take less risk than banks.

If economic theory is correct, then the implication is that credit unions and banks should be regulated differently. If we consider a key regulatory issue like the level of capital that credit unions should maintain relative to banks, the conclusion is that credit unions need not hold as much capital as banks because they are likely to behave in a less risky manner. Recent research, such as Kane and Hendershott (1996) and Smith and Woodbury (2001), supports this conclusion. However, in practice, credit unions are subject to higher capital requirements than banks.

**Investing in public policy initiatives**

There are good reasons that credit unions tend to make *special efforts* to help low and moderate-income households build financial savings and reduce unnecessary debts. Two of these reasons relate to credit unions’ historical mission, and their special ability to make a fruitful contribution. Credit unions serve a very broad socioeconomic spectrum of members. But they tend to go out of their way to serve those of very modest means – recognizing that many low-income individuals may be apprehensive about financial institutions. Part of this commitment to those of modest means is based on the historical development and cooperative culture of credit unions. And many affluent credit union members were probably of modest means when they joined their credit union years ago.

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46 This subsection is based on; Caskey, John P. and David B. Humphrey (1999), “Credit Unions and Asset Accumulation by Lower-Income Households” Filene Research Institute, Madison, WI.
Optimal regulation should take into account the work of credit unions to make special efforts to meet the financial services needs of low- and moderate-income households. Such efforts are not only consistent with the philosophical basis for the credit union movement, but also with current public policy. Two important areas where credit unions seek to help meet the special financial needs of low-income households are (1) payday lending services, and (2) check cashing services. The ability and willingness of credit unions to assist low-income households with these types of products could help these households build savings, reduce debt, and restore impaired credit. This work has the potential for an enormous societal payoff. Credit unions could make a positive contribution to the financial well being of innumerable lower-income households.

These socially positive activities must be included in the evaluation of optimal regulatory policies for credit unions.

**CONCLUSIONS**

Our basic question remains: Are the costs of current regulatory limitations for U.S. credit unions outweighed by the benefits? The benefit of regulatory limitations is to enhance the safety and soundness of the credit union industry. The costs of regulatory limitations are their detrimental impact on consumer choice caused by stifled financial innovation.

Optimal public policy dictates that the regulatory limitations on credit unions be adjusted whenever their costs exceed their benefits. Currently, the costs of regulatory limitations exceed any reasonable measure of their benefits. In the final analysis, credit union regulation should seek to provide as much consumer choice as possible by promoting a competitive and innovative financial marketplace, while insuring a safe and sound financial system. Recent deregulatory legislation by Congress has not gone far enough in removing the restrictions that limit credit unions’ ability to provide the products and services that their members’ (consumers) need and demand.
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