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Credit Unions in a Rapidly Changing Financial Environment

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## Credit Unions in a Rapidly Changing Financial Environment

To an outside observer, the growth and role of credit unions in our financial system has been indeed impressive. The first American credit union was founded in 1909. In those early days of the 20th century, sources of funds for small personal loans were limited and lenders were scarce. The non-availability of personal credit was especially serious in urban areas where low income industrial workers, often newly arrived from rural areas and foreign countries, desperately needed short-term financial accommodation.

The early leaders of the credit union movement recognizing that character, even without assets, was a sound basis for the extension of limited amounts of credit concluded that self-help organizations, with individuals as both savers and borrowers, could meet many otherwise unsatisfied needs. In these groups thrift was encouraged and, with the pooled accumulations of small savings, low-cost loans were made to members whose character usually served as security. As the record shows, credit unions have gone far beyond the expectations of their founders.

Today, the number of credit unions has increased to over 22,000. The field of operations has expanded to all 50 States and the District of Columbia. Membership now totals nearly 17 million, and is increasing more than 5 times as rapidly as total population. Credit unions presently command assets in excess of \$10 billion, with loans outstanding to members accounting for \$8 billion.

While credit unions were extending their services to an ever widening segment of the consuming public, however, other financial institutions--as well as the vendors of consumer hard goods themselves--were also entering the business of providing personal loans and other forms of consumer credit. First, consumer finance companies and industrial banks; then sales finance companies and vendors;

and last, but potentially the most formidable competitor of all, the commercial banks began to realize the tremendous opportunities for profitable lending in the consumer credit area.

Today's \$90 billion of outstanding consumer credit attests to its widespread public acceptance and use. It also reflects the promotional efforts of lenders and vendors in their competitive drive to grow and prosper. Clearly, there is a big difference between the financial environment of 1909 and that of 1966.

This changed environment promises substantial opportunity for future expansion of consumer credit. But at the same time, intensified competition among the institutions involved in consumer lending poses a serious challenge. In the face of this challenge, I understand the members of your industry are of two minds. One group would seek to enlarge the role of credit unions--developing larger, more professionalized, organizations which would attempt to command an ever larger share of personal savings and provide an increasingly varied range of loan options to borrowers. The other group would emphasize the more traditional role of credit unions--continuing to provide an essentially small loan service to members of a more or less closely knit in-group.

As an outsider, I have no real basis for judging whether these projected roles are necessarily mutually exclusive alternatives nor--to the extent that they may be--which approach makes the most sense. As a Central Banker, however, I have been interested in the striking institutional changes occurring in recent years, both among the depositary-type financial intermediaries that compete for personal savings, and among the types of institutions that extend credit to consumers. Since credit unions necessarily compete in both the personal savings

and the consumer credit markets, they are affected by the more general institutional changes. Some of these will obviously tend to set limits on future opportunities for credit unions. A closer examination of recent developments in these two markets may, therefore, provide at least a few clues as to what may lie ahead for credit unions.

Let's look first at the market for personal savings. Over the past decade or so, the gross rate of household savings has changed little relative to disposable income. What has changed has been the form these savings have taken. Decisions to save by acquiring financial assets--and specifically earning assets of a depositary type--have experienced a significant increase.

The continuing competitive struggle for the personal savings dollar has two aspects; one involves choices by households between securities sold directly in capital and money markets on the one hand, and savings instruments offered by financial intermediaries on the other. The other involves choices among the alternative type of savings instruments available within markets for intermediated savings.

As you know only too well, the competitive efforts of particular types of financial intermediaries to attract savings inflows go on continuously. Although both contractual type intermediaries--such as life insurance companies and pension funds--and depositary-type intermediaries--commercial banks, savings and loan associations, mutual savings banks, and to a lesser extent credit unions--participate in these promotional efforts, the most intense competition occurs among the depositary-type groups themselves. This latter competition has to some extent taken the form of innovations in the maturity, denominations and liquidity of the savings instruments being offered. But recently promotional

efforts have been centered chiefly on their relative interest returns. As rate competition has intensified, households--as well as businesses--have become increasingly rate conscious, and rather large movements of funds between institutions have sometimes been stimulated by relatively moderate changes in rate relationships.

So long as the total flow of savings to all types of intermediaries is growing rapidly, the impact of rate competition among the different institutions involved is not too painful. For example, in 1962 when rates on commercial bank time and savings deposits were generally adjusted higher in response to an increase in the Regulation Q ceiling, the share of total depositary-type savings flowing to commercial banks rose by a record proportion, from 36 to 44 per cent, and that going to savings and loan associations shrank from 50 to 40 per cent. Yet over the same period, net flows to share accounts at the savings and loans showed an absolute growth of almost 10 per cent. This relatively favorable experience for both commercial banks and savings and loans reflected the fact that more than 100 per cent of the total 1962 increase in personal savings was going to financial intermediaries, because households engaged in substantial net liquidation of marketable securities.

Moreover, since the rate of growth in flows to contractual-type intermediaries tends to change quite gradually, most of this striking expansion in the total of intermediated savings occurred at the depositary-type institutions.

During 1965 and 1966 the commercial banks have again increased their relative share of over-all savings flowing to depositary intermediaries--from 34 per cent in 1964 to 47 per cent in the first quarter of 1966. This change

has occurred in the wake of further increases in the Regulation Q rate ceilings, made effective in November 1964 and December 1965. But starting in the late summer of 1965, yields on marketable securities have experienced a sharp rise relative to returns on savings instruments at depositary-type institutions. As a result, the mix of savings flows being allocated between accounts at depositary-type intermediaries and securities purchased directly in the market has changed significantly in favor of the latter. With savings flows to commercial banks still relatively larger than those at other depositary-type institutions and with the growth of total flows to all intermediaries showing a marked shrinkage, savings and loans and the mutual savings banks have been seriously affected--particularly the savings and loans where flows in the quarter just ending have apparently showed no growth at all.

This recent experience contrasts sharply with earlier periods of high interest rates. In 1959, for example, when high yields on marketable securities were also cutting heavily into the share of total savings going to depositary-type institutions, commercial banks had less interest rate leeway to compete, and the lion's share of the shrinkage in flows occurred at banks.

It is apparent from these illustrations that intermediaries in a period of monetary restraint are especially vulnerable to monetary action accompanied by rising interest rates. Today some commercial banks in order to "buy" more funds are issuing individuals certificates of deposit and savings bonds or certificates and finding that they are draining more funds, by far, from their own passbook savings accounts than they are attracting from savings and loan associations and mutual savings banks. And today banks' negotiable certificates of deposit to corporations, State and local governments, and other

large money market investors are continuously exposed, under regulatory ceilings or ceilings that Congress may impose, to the threat of unmeetable money and capital market competition.

The savings and loan associations, on the other hand, without ceilings, by and large, are able in a legal sense to meet the competition of the banks and the market but refrain from doing so. This is because their policy of borrowing short and lending long freezes their interest income but not their interest cost. Given prevailing practices most would, in order to meet present competition, have to pay the new rate for all the funds they are now borrowing, but they would be able to increase their return only on new loans and refinancings.

Banks have a somewhat different philosophy and portfolio position. They have a larger run-off and some have a portfolio of salable securities and they all have better established sources for short-term borrowed funds. Thus they can maneuver more easily in the earlier stages of monetary restraint. And they have the incentive to do this in a strong sense of responsibility toward meeting the demands of their best and continuing customers. But as, and if, monetary restraint deepens banks will be little better off than any other intermediary. Market rates with no statutory or regulatory restraints will enable those borrowers who can use the money and capital markets to attract funds there that neither the banks nor other intermediaries can reach. And in this environment goes a drying up in the flow of short-term funds that can be borrowed by intermediaries. Ultimately monetary action comes into its own when all intermediaries have to pass along restraint--with the words "no," "not now," or "not that much."

Growth in share accounts at credit unions has been less exposed to shifting of monetary environment and hence has shown less year-to-year variation than flows to other depositary-type intermediaries. In fact, credit unions have experienced a steady absolute year-to-year growth, ranging between 3 and 4 per cent of the more volatile total flow of personal savings to all depositary-type institutions. Undoubtedly, this greater stability in the rate of growth of credit unions is partly a reflection of the close working relationship and familiarity that typically exists between many credit union members and their management.

A working relationship of this type obviously tends to insulate credit unions to some extent from the competitive struggle.

Even if they were not so insulated, the relatively high rates which credit unions can pay on their shares still give them a marked competitive advantage over other forms of depositary saving. At the end of 1965, almost 40 per cent of credit unions reported dividend payments of 5 per cent or more. Likewise, the maximum rate of 6 per cent for Federal credit unions and 8 to 9 per cent for State-chartered groups still compares favorably with the top rate of 5 per cent offered by some savings and loans, 4-1/2 per cent by mutual savings banks, 4 per cent on passbook savings, and as much as 5-1/2 per cent on savings certificates and bonds offered by a few commercial banks.

Looking ahead, some forecasters expect real GNP to grow at an average annual rate of 4 per cent in the next decade. If this growth materializes and depositary-type institutions are able to capture about half of the total flow of personal savings into financial assets, as they did on the average between 1962 and 1965, then the total annual personal savings pie available for



distribution among all depositary-type institutions should grow from a little less than \$25 billion in 1965 to about \$35-\$37 billion over the next decade.

A question of obvious interest to you is whether credit unions can expect to continue to pre-empt about 3-1/2 per cent or more of this greatly enlarged flow? A large part of the answer to this question will undoubtedly hinge upon the size of the spread maintained between yields offered to savers by other depositary institutions and the dividend rates paid on membership shares. Although, as has been indicated, this spread relationship continues to favor credit unions, it should be noted that the size of the spread has narrowed appreciably in response to the intensified competitive pressure of recent years. Since the relative ability to compete is probably determined by nominal rates at the margin, changing relationships between these maxima are important. Over the last ten years--while the maximum dividend rates paid by credit unions have remained about the same--other institutions have made significant upward adjustments, thus compressing the whole yield structure. The greatest change since 1956 has come from commercial banks where the maximum rate offered has increased 1-1/2 percentage points on passbook savings and 3 percentage points on time deposits. All except 1/2 percentage point of this mark-up has come since 1961, but savings and loans and mutual savings banks have acted to narrow the gap by only 1/4 percentage point over this same 5-year period.

Recent changes in the allocation of personal savings, both among financial intermediaries and between them and directly-purchased marketable securities, indicate that large holders of assets are the most sensitive to changing yield spreads, as one would expect. A sample of Federal credit unions

at year-end 1965 showed that although somewhat over half of the accounts surveyed amounted to less than \$100, around three-quarters of the dollar volume of accounts held shares totaling \$1,000 or more, and one-fifth of the accounts held shares of \$5,000 or more. In short, with both their relative yield advantage narrowing and a substantial share of their accounts held in amounts large enough to be interest sensitive, there is no guarantee that the future growth of credit unions will be as insulated from the effects of the recently intensified competition for personal savings as has been the case over the past decade.

Let's turn now to the other side of the credit union balance sheet and look at recent changes in the loan markets where credit unions compete. While credit unions make loans for a variety of purposes, I think it is fair to say that virtually all of these are in some form of consumer instalment credit. The one exception is mortgage lending in which some larger credit unions occasionally participate, but the total amount of such loans is a very small proportion of total credit union assets.

One very important feature of the total market for consumer instalment loans has been its rapid growth. In 1950, instalment debt was not quite \$15 billion, or roughly 7 per cent of disposable personal income that year. By 1955, such debt had almost doubled, and over the next ten years it more than doubled again. Last month, instalment debt outstanding was close to \$69 billion, or almost 15 per cent of disposable income. Population growth, expanding national income--centered particularly in the growing middle income group--a general absence of cyclical instability and rapidly rising sales of consumer durables have all contributed to this debt expansion. But a change in attitude about personal debt should not be overlooked. Consumer credit has become respectable;

"buy now, pay later," or "save as you earn" has become a way of life for a growing number of families.

Within this expanding market for instalment loans, there have been significant shifts between types of credit. The financing of automobiles now accounts for the largest segment of instalment debt--about 40 per cent of the total during recent years. This is followed by personal loans, the fastest growing type of instalment credit; other consumer goods paper is a slightly smaller component, and repair and modernization loans comprise the remaining 5 per cent.

Within this market, the relative position of credit unions has been improving in recent years. Thus, while instalment credit supplied by financial institutions of all types has expanded about 60 per cent since 1960, growth of such credit at credit unions has amounted to about 90 per cent, raising the relative share of the total provided by such institutions from 9 per cent in 1960 to 11 per cent in 1965.

By far the most significant improvement in competitive position within consumer credit markets has occurred at commercial banks. It was not until the late 1930's that banks became seriously interested in instalment lending. With business loan demand slack at that time, bankers began looking for other ways to turn their ample supply of excess reserves into earning assets. By 1939, banks held about \$1 billion of instalment debt, less than one-quarter of the total.

Those banks that experimented with instalment credit discovered that it was profitable, however, and that loss experience was favorable. Responding to these promising beginnings, other banks have entered the market since

World War II and their share of total instalment debt has grown to more than 40 per cent. In fact, banks have become the largest holders of automobile loans and rank third in credit financing of other consumer goods. Moreover, they are the dominant supplier of both repair and modernization loans, and personal instalment loans, providing two-thirds and one-third of such loans, respectively.

While commercial banks have been expanding their position in consumer credit markets, their growth has occurred to some extent at the expense of other institutions. Sales finance companies in particular have felt the force of commercial bank competition. Although instalment credit outstanding at finance companies has increased by about 40 per cent since 1960, their share of the market has declined from about 27 per cent to 23-1/2 per cent recently. Moreover, there have been reports of smaller companies liquidating, or being merged out of existence, and of larger companies making vigorous attempts to broaden their lending activities beyond the consumer credit area.

Looking to the future, it seems to me that banks will continue to offer the toughest competition in the consumer credit field. Banks are financial department stores, in effect, and can perform a number of financial services for their personal customers. They have professional and trained management for credit evaluation, asset management and efficient operation. And the great diversification of their assets enables them to pursue a fairly liberal loan policy since there is ample opportunity for spreading the risk. Most important, because of the scope of their operations, the most forward-looking banks are rapidly integrating the computer into their daily operating and decision-making processes. This will add greatly to their competitive

potential by reducing loan costs. In a recent speech to the American Economic Association, I described the possibilities for bank innovation opened up by automation as follows:

"With automation banks can offer a credit system which ties settlement accounting into quasi-automatic credit extension; this combination has great operating advantages over other arrangements available to vendors or independent consumer finance companies. A bank depositor credit card is of superlative convenience for the purchaser when he can use it anywhere and in doing so express his preference for cash payment, convenience credit, instalment credit or any combination of the three.

"The bank, in offering this service, can extend credit to seller or buyer, or both, on the basis of prearranged lines, lines that have been fixed with access to unparalleled sources of information on the customer's financial activity and responsibility. Moreover, the computer continuously updates this information and can alert the bank's credit department on a timely basis to the emergence of credit abuses by whatever standard the bank may choose to employ. Imagine the convenience of a continuing scrutiny of the customer's cash inflow and outflow in relation to use of bank credit, and all monitored by a sentry who reports instantaneously!

"Such a system would not be without losses to be sure, but they could be controlled by fixing maximum credit lines for various types of accounts. And loan limits could serve another purpose--that of fostering larger demand deposit balances. If a line of credit, for

example, were some multiple of the average daily balance it is quite likely that most depositors would gladly pay the 'commitment fee' for the convenience and prestige of bank credit. And still another advantage so far as banks are concerned is the conventional preference of many bankers for self-liquidating short-term credit, met in this instance by the rapid turnover of consumer and sales credit of the type envisioned."

In the face of this bank challenge, how are credit unions likely to fare in the period ahead? Up to this point credit unions have clearly had important competitive advantages in consumer credit markets. On the cost side they have consistently been able to underprice their competitors--due partly to their essentially tax-exempt status and to a larger degree to the subsidy built into their management and housing costs. In addition, loan risk exposure has been reduced by familiarity with the borrower and the availability of payroll deductions for loan amortization. At the same time, convenient access to loan facilities and the service provided by a friendly management has made credit unions' loans particularly attractive to member borrowers.

Even before the full exploitation of automation possibilities, some banks have been virtually matching credit union loan charges, hence the comparative advantage of credit unions in this regard is likely to be eroded further in the period ahead. Moreover, the changing composition of credit union membership adds a further dimension of exposure to bank competition. The typical member is no longer a low-income industrial worker with a few assets and no credit rating. A survey several years ago indicated that professional technical workers comprise the largest occupational group;

about two out of every five members have had some college training; about half of the units have income of \$7,500 or more and less than 5 per cent have income below \$3,000; most members had a record of steady employment; and, finally, almost two-thirds of credit union savings units owned their own home. Clearly, this type of membership would be highly eligible for the type of credit card and settlement accounting program which may develop through bank automation. And the convenience of such a system would be exceedingly attractive.

My purpose in speaking to you today was certainly not--as it may seem--to suggest that the outlook for credit unions is grim and gloomy. It may be that my fascination with the potentialities of automation in banking and my lack of familiarity with the specifics of your own industry have operated to weigh the balance of my story too heavily on the gloomy side. Certainly the credit unions can play a role in the credit structure of personal finance in the period ahead and in that role will undoubtedly continue to prosper. My main point is that the going in the future is likely to be much tougher than it has been--particularly regarding efforts to branch out from the traditional credit union specialization. Intentions to expand into new market areas are not, of course, confined to credit unions. In addition to the competitive drive of commercial banks, both mutual savings banks and savings and loan associations are currently seeking regulatory changes which would enable them to enter consumer loan markets in the search of higher earning assets and thus enable them to compete more effectively in markets for personal saving. The saying that goes "come on in, the water's fine" is not the aphorism for this situation; President Truman had a better one--"Stay out of the kitchen if you can't stand the heat."