Research Department
Federal Reserve
Bank of
San Francisco

June 16, 1978

FRBSF Weekly Letter

Financial Co-ops

In times past, credit unions operated on the fringes of the financial marketplace, quietly distributing dividends on shares (that is, passbook savings) at rates ranging up to 6 or 7 percent. But now these member-owned financial institutions are moving into the mainstream, with the help of Congressional legislation which permits them to offer a broader range of services. Indeed, they are gaining increased attention both from the competition and from the Internal Revenue Service, with that high dividend rate becoming a special target.

New powers

Credit unions (CU's) gained their added powers only a little over a year ago. Today, they may offer variable-rate share certificates, which are similar to bank CD's, as well as share-draft accounts, which are tantamount to interest-bearing demand deposits. In addition, CU's may establish self-replenishing lines of credit, make mortgage loans on one-to-four-unit residential property (with maturities up to 30 years), and offer home-improvement and mobile-home loans (with maturities up to 15 years). Further, Congress is now considering the possibility of setting up a Central Liquidity Fund to provide CU's with lendable funds in periods of credit stringency—similar to the support which the Federal Home Loan Bank System provides to thrift institutions.

But credit unions were doing quite well even before they gained these new powers. At the end of 1977 their deposits, in the form of shares and share certificates, amounted to $47 billion—admittedly, a relatively small (4.7 percent) share of consumers' total savings deposits. But more importantly, they held $37 billion in consumer installment credit—17.0 percent of the total market, compared to only a 4.0-percent share in 1950 and a 12.9-percent share as late as 1970.

Equal groundrules?

Because of their standing as financial cooperatives, owned by the people who put their savings in share accounts, credit unions enjoy non-profit status and thus are not taxed as their competitors are. Industry spokesmen believe that this situation should continue, even with the new powers granted to CU's by Congress. Their competitors think otherwise, and this view has been reflected in the Administration's tax-reform legislation, which would impose a tax on CU net income (after dividends and interest refunds).

The National Credit Union Administration (NCUA) estimates that a tax hike of this type would force 29 percent of the 12,743 Federal credit unions to reduce dividends within the first year, and an even larger proportion to reduce dividends in later years. The average CU dividend rate, which is now almost 6 percent, in that case could approach the 5 and 5¼ percent ceiling rates which banks and S&L's, respectively, are permitted to pay on passbook savings. Consequently, CU's are anxious to see this feature of the tax-reform legislation deleted.

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Bank competition
Commercial banks, in contrast, would like to see CU's operate under the same rate ceilings which now govern bank savings deposits. Above all, they would like to see the demand-deposit rate ceiling – zero – apply to CU share drafts, which are practically equivalent to bank demand deposits. Share-draft balances can earn the current CU dividend rate – a considerable competitive advantage in the struggle for the depositor's dollar. During the first quarter of this year, Federal credit unions processed more than 15 million drafts and held about $462 million in share-draft accounts. This is modest indeed in terms of commercial-banking activity, but the potential for expansion is there.

Many big money-center banks have actually cooperated with CU's by becoming "payable through" banks – banks designated to present share drafts to Federal credit unions for payment. (Individual credit unions must maintain balances at these designated banks to cover their share-draft transactions.) But many small banks, especially those dealing with large credit unions, are reluctant to participate in such transactions. In fact, the NCUA Administrator has asked the Federal Reserve to investigate the actions of some small banks which allegedly have impeded the clearing of share drafts.

Banks and CU's remain sharply divided on the issue of share drafts. The American Bankers Association recently lost a suit against the NCUA, challenging the legality of these check-like instruments, and is now appealing that decision. The Independent Bankers Association is preparing to bring suit on similar grounds. Some states, although granting state-chartered credit unions the right to offer such instruments, have imposed liquidity reserve requirements on share-draft balances, equivalent to those imposed on bank deposit balances. In Idaho, for example, credit unions must hold a liquidity reserve equal to 6 percent of shares, CD's and borrowings, and equal to 15 percent of share-draft balances.

S&L competition
Savings-and-loan associations have shown less concern about credit unions' ability to operate outside normal rate ceilings on passbook accounts, perhaps because of their own desire to maintain the one-quarter percentage point differential they themselves hold over commercial banks. Moreover, S&L's apparently don't feel threatened by the modest toehold which CU's are gaining in the residential-mortgage business. In fact, they have been generous with advice to their sister thrift institutions regarding the pitfalls of unbalanced maturity structures of assets and liabilities, and regarding the expertise needed to do business in the secondary-mortgage market.

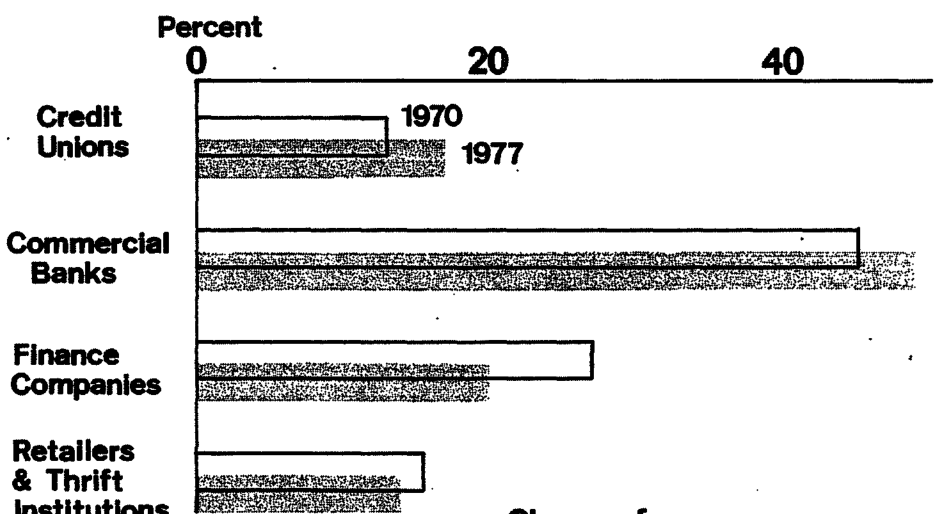
On the other hand, S&L's have long advertised their intention to engage in consumer installment lending – the mainstay of credit-union business – if they are forced to operate in a world without rate ceilings and S&L rate differentials. They would undoubtedly provide formidable competition in this field. S&L costs may be no more than half CU operating costs per dollar of assets, reflecting the small average size of credit unions, as well as the cost difference between the large long-term loans made by S&L's and the small short-term loans made by CU's. Increased competition between the two types of thrift institutions could be expected to reduce this cost spread, to the detriment of some institutions' balance sheets, but presumably to the benefit of consumer borrowers.

Can CU's compete?

Fewer than 7 percent of the 22,400 credit unions in the U.S. hold assets greater than $5 million. These larger institutions led the campaign to become full-service consumer financial centers, and the future growth of the industry depends primarily on their success with the expanded powers they have gained. Smaller CU's apparently lack the resources or the membership base to offer new services, so future growth may be less explosive than some industry spokesmen have suggested.

Nonetheless, credit unions will continue to play a major role in the consumer-finance field. Traditionally, CU's have argued that they have a responsibility to make small high-cost consumer loans—filling a gap which many commercial banks are unwilling to fill—and to educate consumers about ways of handling money. To emphasize this point, Congressman St. Germain (Chairman of the House Banking Subcommittee on Financial Institutions) recently stated that credit unions will retain their congressional support only as long as they demonstrate that they are motivated by service to their membership—and not by interest-rate spreads.

Joan Walsh



Share of Consumer Credit Market

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BANKING DATA—TWELFTH FEDERAL RESERVE DISTRICT
(Dollar amounts in millions)

Selected Assets and Liabilities Large Commercial Banks	Amount Outstanding 5/31/78	Change from 5/24/78	Change from year ago Dollar	Change from year ago Percent
Loans (gross, adjusted) and investments*	111,875	+ 1,072	+ 14,396	+ 14.77
Loans (gross, adjusted)—total	89,488	+ 729	+ 14,480	+ 19.30
Security loans	1,803	− 177	− 242	− 11.83
Commercial and industrial	27,735	+ 549	+ 3,827	+ 16.01
Real estate	30,076	+ 160	+ 6,479	+ 27.46
Consumer instalment	15,754	+ 77	+ 3,070	+ 24.20
U.S. Treasury securities	8,146	+ 171	− 1,125	− 12.13
Other securities	14,241	+ 172	+ 1,041	+ 7.89
Deposits (less cash items)—total*	108,968	+ 1,210	+ 12,970	+ 13.51
Demand deposits (adjusted)	29,061	+ 594	+ 2,018	+ 7.46
U.S. Government deposits	264	+ 40	+ 34	+ 14.78
Time deposits—total*	77,531	+ 5	+ 11,083	+ 16.68
States and political subdivisions	7,039	− 143	+ 1,218	+ 20.92
Savings deposits	31,649	− 12	− 226	− 0.71
Other time deposits‡	35,889	+ 142	+ 8,925	+ 33.10
Large negotiable CD's	17,598	+ 128	+ 7,585	+ 75.75

Weekly Averages of Daily Figures	Week ended 5/31/78	Week ended 5/24/78	Comparable year-ago period
Member Bank Reserve Position			
Excess Reserves(+)/Deficiency (−)	+ 28	+ 60	+ 13
Borrowings	254	44	8
Net free(+)/Net borrowed (−)	− 226	+ 16	+ 5
Federal Funds—Seven Large Banks			
Interbank Federal fund transactions			
Net purchases (+)/Net sales(−)	− 385	+ 509	− 378
Transactions with U.S. security dealers			
Net loans (+)/Net borrowings (−)	+ 144	+ 26	+ 214

*Includes items not shown separately. ‡Individuals, partnerships and corporations.

**Editorial comments may be addressed to the editor (William Burke) or to the author. . . .
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