
FRBSF WEEKLY LETTER

December 11, 1987

Growing Pains

In the last three years, credit unions have been the fastest growing type of depository institution. The growth of their assets and deposits has significantly outpaced that of the much larger bank and savings and loan industries. For example, credit union assets rose by more than 25 percent in both 1985 and 1986 when assets at all depository institutions grew an average of about 10 percent per year. In 1987, the credit union industry continues to show strong deposit and asset growth; assets recently passed the \$175 billion level. However, while the volume of business is rising for the nation's nearly 16,700 credit unions, there has been substantial consolidation within the industry, and the number of credit unions in operation has fallen from nearly 22,000 in 1980.

These recent trends point to a number of challenges facing the industry. Deregulation in general, and specifically, the removal of interest rate ceilings on consumer loans and deposits, has increased price competition. Moreover, tax reform and increasing competition from other depository institutions make it imperative for credit unions to price their growing array of deposit and loan products competitively.

The industry

The credit union industry is distinguished by the "common bond" of each institutions' members. That common bond typically takes the form of a common employer, union, industry, organization, or locality, and gives credit unions a strong affiliation with their customers or "membership". Membership now numbers about 55 million persons nationally.

Credit unions also are nonprofit cooperative organizations, and thus are not subject to income taxes. In many cases, credit unions also benefit from volunteer labor and subsidies of labor, office space, etc. from sponsoring groups. More importantly, for many credit unions, the close affiliation with their borrowers may give them better information with which to evaluate lending risks. These stylized facts are consistent with the history of credit unions as low cost producers of consumer banking services that have

enjoyed lower loan loss ratios than other retail lenders.

Compared to other depository institutions, credit unions typically are small, averaging only about \$10 million in assets. However, recent consolidation is resulting in a trend towards fewer, albeit larger, credit unions. While most credit unions remain small, the nation's largest, with nearly \$3 billion in assets, is larger than most banks and thrifts.

Services and pricing

Most credit unions provide households with retail banking deposit products such as share draft checking accounts, savings deposits, and savings certificates. Interest is paid to depositors on "share" accounts or certificates in the form of "dividends to members."

Historically, the funds deposited with credit unions have been lent to credit union members in the form of personal and automobile loans. In recent years, the scope of lending operations has been broadened to include real estate-related lending and credit cards. Earnings from their lending operations allowed credit unions to pay the "dividends" on their deposit liabilities, cover operating and overhead costs, as well as generate capital — through retained earnings.

The industry typically has paid deposit interest rates higher than bank or thrift rates while offering loan rates that were lower. This pattern appears to be changing, however. Credit unions on average continue to pay higher interest rates on deposits. However, National Credit Union Association data indicate that, since 1985, the average loan rate for credit unions has been higher than the comparable loan rate for banks (Chart 1). This reversal of the traditional pricing relationship has been accompanied by slower loan growth as compared to deposits after 1984 (Chart 2).

Cooperative objectives

To help understand the changes that have occurred in the industry's pricing practices, we need to examine credit unions' operating objec-

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tives. Since credit unions are nonprofit cooperative organizations, their goals and objectives may differ from those of for-profit banks or thrifts.

The behavioral model normally assumed for banks is that they price deposits and loans to maximize stockholder wealth. Analysts and regulators have argued that credit unions would be better off by lowering both deposit interest rates and loan rates because they could then maintain or improve interest rate spreads and earnings. This argument assumes that the supply of deposits is relatively inelastic and the demand for loans is relatively elastic with respect to interest rates. Lower deposit rates would reduce costs, while the combined effect of lower loan rates and greater loan volume would increase revenues. Together, the effects would increase interest-rate spreads and, consequently, earnings.

The fact that the industry has not embraced the recommendations of the regulators and industry groups suggests that credit unions may have objectives that take precedence over aggregate wealth-maximization. One alternative objective is to let borrower members capture the benefits of credit union operation through "below market" loan rates. Although this was the case in the past, since deregulation removed the 12 percent usury ceiling on federal and some state-chartered credit union loan rates in the early 1980s, credit unions have charged *higher* interest rates on autos and unsecured personal loans than banks. (Credit card loans, which are a much smaller portion of total lending, though, are still generally available with lower rates and smaller fees at credit unions than at banks.)

Alternatively, the primary credit union objective may be to maximize returns to savers/depositors. If so, then we may expect to see credit unions offering relatively high deposit interest rates (or dividends) to reward "member" savers. Anecdotal evidence supports the idea that credit unions pass benefits to depositors — the "owners" of the cooperative. The industry continues to offer higher interest rates on its deposit products than banks or savings and loans. Moreover, credit unions offer a higher proportion of free or low cost checking accounts (share drafts) than banks or savings and loans.

Investment shift

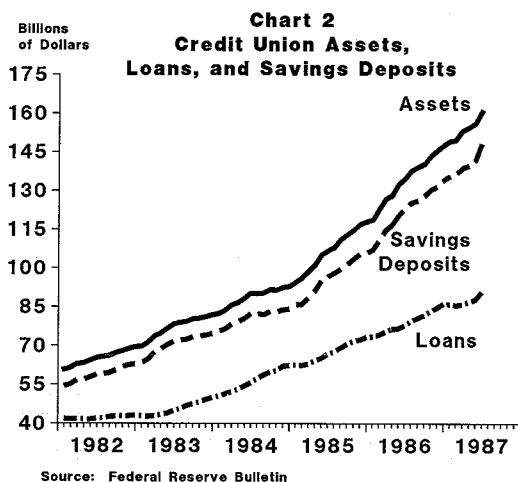
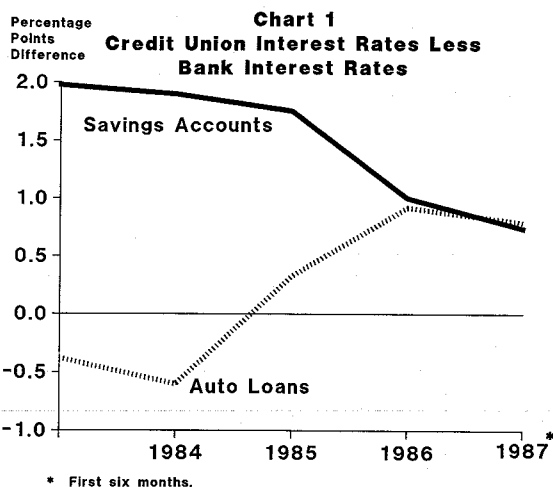
Attractive rates and fees have resulted in a rapid net inflow of deposits that has sharply raised liquidity in credit unions. "Surplus" funds (measured as the difference between assets and loans to members in Chart 2) totaled nearly 40 percent of assets at the end of 1986, up from only 31 percent in 1984.

Credit unions now face the decision of how to invest those surplus funds. Most of the surplus funds are now invested in a wide array of liquid money market assets, including jumbo CDs, repos, federal funds, and government securities, or are lent to corporate central credit unions, which invest them in the money markets. But there is some question as to the long-term viability of such a strategy.

The appropriate choice of investment strategies will depend on the source of credit unions' pricing advantage. On the one hand, if the source were simple operating and tax cost savings, then credit unions could in essence serve as low cost, mutual-fund-like conduits between savers and open securities markets. They would offer the additional competitive advantage over mutual funds of providing insured deposits that do not decline in value.

On the other hand, if their pricing advantage derives primarily from advantages in the credit evaluation of borrowers, then the shift away from lending activity would be self-limiting. As they replace their loan portfolio with open market securities, credit unions will find it difficult to support their more generous deposit rate (dividend) policy.

This difficulty may already be apparent in the financial performance of credit unions. For example, credit unions earned an average of 12.31 percent on their \$97 billion loan portfolio during the first quarter of 1987. By contrast, the investment yield on their \$60 billion in surplus funds was only 6.75 percent, which is only slightly above the 6.32 percent average cost of total savings balances for the industry. Thus, the growing surplus has reduced the industry's net spread and placed pressure on some credit unions to invest in higher return, but more risky financial instruments.



Tax reform

Pricing issues and credit unions' move away from lending to members comes at a time when the industry faces other major challenges. Tax reform, for example, is likely to accelerate the shift away from traditional credit union installment loan products. (Today, over 20 percent of loans to members already are real estate-related.) The 1986 tax reforms will lead to the gradual phase-out of the personal interest deduction on consumer loans.

Since most credit union lending has been made in the form of consumer installment loans, credit unions already have begun to offer loan products that will provide borrowers with tax-deductible interest. The most typical form of these new products is a home equity loan or line of credit that allows homeowners to borrow, with some limitations, against equity in their homes. Indeed, a recent study indicates that nearly all credit unions either offer or plan to offer mortgage-related loan products, despite the fact that mortgage lending requires new expertise and increases the complexity and cost of credit union operations.

Competition and deregulation

Pricing has also been made more complex as other lenders have become more active in consumer lending. Substitute financing, especially from the "captive" finance companies operated by the major domestic automobile manufac-

turers, has played a major role in shifting households' automobile financing patterns. Finance companies' automobile installment lending has nearly doubled since 1984 as automobile manufacturers actively offered discount financing to promote sales. Commercial banks also have increased automobile financing and consumer lending dramatically to offset the prolonged slowdown in corporate borrowing.

Finally, deregulation has allowed savings and loans to offer consumers a wider array of consumer loan products, from automobile financing to credit cards, placing further pressure on the credit union industry's ability to maintain its consumer lending market share.

Conclusion

In an environment of declining interest rates and increased competition, credit unions as an industry appear "to have been slow to lower (deposit) costs and re-price their loans in response to changing market conditions," suggested Roger Jepsen, Chairman of the National Credit Union Administration. Hence, the credit union "movement" has been faced with a growing surplus and narrowing spreads. This *Letter* argues that this situation is consistent with the cooperative nature of credit unions, which may result in goals and objectives that are less market-driven than those of profit-maximizing firms.

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BANKING DATA—TWELFTH FEDERAL RESERVE DISTRICT

(Dollar amounts in millions)

Selected Assets and Liabilities Large Commercial Banks	Amount	Change	Change from	11/19/86
	Outstanding 11/18/87	from 11/11/87	Dollar	Percent ⁷
Loans, Leases and Investments ^{1 2}	208,611	- 447	2,239	1.0
Loans and Leases ^{1 6}	184,302	- 410	1,470	0.7
Commercial and Industrial	51,377	127	169	0.3
Real estate	72,309	46	5,260	7.8
Loans to Individuals	36,943	60	4,481	10.8
Leases	5,415	- 5	166	2.9
U.S. Treasury and Agency Securities ²	16,966	- 123	4,190	32.7
Other Securities ²	7,343	85	482	6.1
Total Deposits	206,591	- 1,137	951	0.4
Demand Deposits	51,470	- 688	2,070	3.8
Demand Deposits Adjusted ³	47,310	- 865	1,669	3.4
Other Transaction Balances ⁴	20,030	- 301	1,791	9.8
Total Non-Transaction Balances ⁶	135,091	- 148	672	0.4
Money Market Deposit				
Accounts—Total	44,318	72	2,600	5.5
Time Deposits in Amounts of				
\$100,000 or more	31,660	- 210	1,725	5.1
Other Liabilities for Borrowed Money ⁵	23,811	- 2,024	5,325	18.2
Two Week Averages of Daily Figures	Period ended 11/16/87	Period ended 11/2/87		
Reserve Position, All Reporting Banks				
Excess Reserves (+)/Deficiency (-)	18	86		
Borrowings	6	4		
Net free reserves (+)/Net borrowed(-)	12	81		

¹ Includes loss reserves, unearned income, excludes interbank loans

² Excludes trading account securities

³ Excludes U.S. government and depository institution deposits and cash items

⁴ ATS, NOW, Super NOW and savings accounts with telephone transfers

⁵ Includes borrowing via FRB, TT&L notes, Fed Funds, RPs and other sources

⁶ Includes items not shown separately

⁷ Annualized percent change