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Credit Union Structure, Growth and Regulatory Problems

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THIS PAPER IS CONCERNED with credit union structure, the current status of the industry and the evolving nature of the institutions with regard to market forces and regulations. In particular, the emphasis throughout is on the ability of credit unions to absorb risk given recent statutory, regulatory and competitive changes.

Structure

At year end 1979, there were 12,738 Federal and 4,769 state chartered federally insured credit unions in the United States. Their assets were $36.5 billion and $18.5 billion, respectively.

The industry was the fastest growing of all financial intermediaries during the early to mid-1970s. Factors contributing to a growth rate of 18 percent from 1970 to 1978 were the absence of Regulation Q restrictions on CU dividend rates, tax exempt status of CUs, the advent of share insurance in 1970 and the impact of sponsor subsidies. However, during 1979, federal credit union savings grew by only 2.4%, which was more than 85% lower than in the preceding year and was the slowest annual growth rate on record. Indeed, since 1977, federal credit unions have gone from the fastest growing to the second slowest growing type of depository institution.

The reason for the changes in credit unions will be discussed after this section which provides background information on the structure of the industry. That structure has, historically led to a reduction in risk. The basic components of that structure are common bond and sponsorship.[1]

Common Bond

Credit unions are unique financial depository institutions in that they are consumer cooperatives and are limited to serving the market for consumer credit and savings. Generally, these institutions cannot do business with the general public due to charter limitations based on serving a membership that is characterized by a common bond. The common bond is based on occupation, association or residence. The only exceptions are generally found under state law and apply to state chartered institutions.

The common bond restriction on credit union membership is assumed to reduce the cost of gathering credit information, reducing bad debt losses and manifests

* National Credit Union Administration. The views expressed herein are those of the authors and do not necessarily reflect those of the National Credit Union Administration.

[1] An extensive review of the history of credit unions and the institutional structure is found in Melvin *et al.* [2]. A review of recent research on credit unions is in Cargill [1].

itself in many ways. There are credit unions that serve all employees of a national company, FCUs serving all employees at one plant of a national company and there are instances in which more than one FCU serves occupational groups within the same plant. Nevertheless, common bond is not so loosely defined that the bond could be "all residents of the United States." Yet, in some states, the only qualification for membership in a state chartered credit union is to be a resident of the state.

The common bond requirement is consistent with basic cooperative principles. Those principles include open membership to all that are within the potential membership, one vote per member, the financial education of members and the promotion of thrift.

Each member has one vote regardless of the amount of shares that the member holds.[2] The members elect the board of directors and the credit committee. The members also vote on charter amendments, proposals to merge and to convert the charter either from federal to state or state to federal. However, the NCUA has the authority to waive a merger vote under specified conditions.

The education of members may take the form of financial counselling and consumer seminars. Credit unions also provide group services such as insurance policies, group purchasing plans and legal services. Some credit unions sell money orders, travelers checks, savings bonds and food stamps.

Further, the cooperative principles also imply that members should pool their labor as well as their financial resources. Consequently, officers are prohibited from receiving any compensation with the exception of the treasurer, who is often a volunteer worker. Larger institutions have found that a full-time paid treasurer is necessary in order to manage the instituion efficiently. Consequently, some credit unions employ a full-time manager in addition to part-time volunteers.

Occupational common bonds generally apply to employment by the same employer. That employer often subsidizes the operation of the credit union.[3] For example, the sponsor may provide office space, payroll deduction, computer services and paid time off from work for the volunteers. Such subsidies reduce the cost of operating the credit union.[4]

A strong sponsor relationship is initially encouraged by the NCUA when the credit union is in the development stage. As the credit union matures, the subsidies are generally reduced although payroll deductions are often maintained. Payroll deductions minimize the cost of servicing accounts and collection costs. The reduction in operating costs enable credit unions to offer higher yields to member savers and lower interest charges to borrowers.

Sources and Uses of Funds

Credit unions obtain funds from members and nonmembers. Credit unions may offer share accounts, share certificates, tax sheltered retirement accounts and

[2] Credit union deposits are referred to as shares. Instead of making a deposit, the members purchase shares in the institution.

[3] See Wolken and Navratil [3].

[4] Subsidies are also furnished by the government in that credit unions are exempt from federal taxes while subsidies from the sponsor are deductible as business expenses.

share drafts to members. Borrowings from nonmembers are called certificates of indebtedness and are not insured. However, they are subject to the rules and regulations of the NCUA.

The share account is analogous to a passbook savings account. Its return is referred to as a dividend, although it is treated as interest for individual income tax liability purposes. Share certificates are comparable to certificates of deposit at other financial institutions.[5] Share drafts are third party transfers, which are similar to checking accounts. Members can use share drafts for transactions. The unique feature is that the drafts are truncated. The member retains a duplicate, as a record of transaction, but the original is not returned.

Although credit union assets are primarily consumer loans, they are permitted to make real estate loans, home improvement loans and loans to members for business purposes. Other assets include U.S. Government and agency securities, loans and deposits at other financial institutions.

In a credit union, member savers are also borrowers. However, it could be that in some credit unions, there are different profiles for savers and borrowers. Indeed, some credit unions are referred to as borrower-dominated while others are saver-dominated. The profile of the credit union has implications for the disposition of earnings. There would be interest refunds in borrower-dominated credit unions and increased dividends in saver-dominated institutions. However, increased dividends would not be forthcoming if the credit union were already declaring the maximum dividend allowable.

Government Regulation

Federal regulations explicitly recognize the unique characteristics of credit unions. For example, Federal credit unions are not subject to the branching restrictions of the McFadden Act and may branch across state lines.[6] The NCUA is not bound by the actions of the Depository Institutions Deregulation Committee (DIDC) even though the Chairman of the NCUA is a voting member of that Committee.[7] Also, credit unions are not subject to Regulation Q.

Regulation Q limits the interest return on accounts at all other depository institutions. The maximum return allowed by NCUA regulations has, historically, been higher than Regulation Q rates. Currently, the Regulation Q rate is 5¼ percent on commercial bank passbook savings while the NCUA rate on share accounts is 7 percent. In addition, Federal credit unions are subject to a statutory maximum ceiling of 15 percent per annum on all loans.

Recently, government regulation has increasingly emphasized consumer protection. That may place credit unions at a disadvantage. Most of their dealings are in consumer credit. Given that credit union resources are smaller than those of other financial institutions and that their lending to consumers is proportionately greater, the cost burdens imposed by the regulations on credit unions could

[5] All shares are considered equity capital. Technically, the creditors of the credit union will have priority over the members in the event of a liquidation. However, members savings are insured to $100,000 by the NCUA Share Insurance Fund.

[6] Some state chartered credit unions have converted to federal charters in order to branch across state boundaries.

[7] Public law 96-221, Title II, Section 208.

be greater than the burdens on other institutions. Nonetheless, it could also be argued that credit unions are at an advantage in that their expertise is in consumer lending, to the detriment of competing institutions.

The NCUA is an independent agency financed by assessments from the credit unions under its jurisdiction. The agency is under the direction of a three person Board, one of which is designated by the President to be Chairman. Each Board member serves a six year term and is appointed by the President with the advice and consent of the Senate. The NCUA has six regional offices, a central office with seven divisions and a Central Liquidity Facility. The NCUA has fewer examiners per institution than any other regulatory agency.

As credit unions are different and unique financial institutions, the NCUA is also a different and unique supervisory agency, in that it has traditionally helped organize Federally chartered credit unions. For example, in 1979, NCUA staff members organized 74 of the newly chartered Federal credit unions.

The Central Liquidity Facility is a mixed ownership, government corporation within the NCUA, originally established by the National Credit Union Central Liquidity Facility Act. It is owned by its member credit unions and managed by the NCUA Board. The purpose of the Facility is to improve general financial stability by providing member credit unions with a source of funds to meet their liquidity needs and, thereby, encourage savings and support consumer and mortgage lending. Banks and savings and loan associations have long had access to loans from the Federal Reserve System discount window and the Federal Home Loan Banks, respectively, to meet their liquidity needs. Until 1979, there was no similar government sponsored source of funds available to credit unions.

The Central Liquidity Facility was established by Congress to fill this void. The Facility began operation on October 1, 1979. Membership within the Central Liquidity Facility is available to all credit unions regardless of charter source. There are two types of membership; regular and agent membership. Regular membership is available only to natural person credit unions. In order to become a regular member of the Facility, a credit union must submit an application and a copy of the most recent annual Financial and Statistical Report to the NCUA. It must also subscribe to the capital stock of the Facility. The amount of the required subscription is one half of one percent of the credit union's paid in and unimpaired capital and surplus. One half of the subscription is paid directly to the Facility. The other half is invested in specified liquid assets which may be called by the NCUA Board at any time. Agent membership is, by statute, available only to a credit union or a group of credit unions primarily serving other credit unions. This provision is reflected in the fact that a single central credit union or a group of central credit unions can apply to become an agent member of the Facility.[8] Agent members must also subscribe to the capital stock of the

[8] There are two types of central credit unions: officer centrals and corporate centrals. Officer centrals have as their members the officers, directors and committee members of natural person credit unions. Historically such persons were prohibited from borrowing more than the amount of shares they had in their credit unions. Consequently, officer centrals were chartered to serve these individuals. Corporate centrals are defined as federal credit unions operating with the primary purpose of serving corporate accounts. These credit unions must have a total dollar amount of outstanding corporate loans plus corporate share holders equal to or in excess of 75% of total outstanding loans plus shareholdings.

Facility. The subscription is one half of one percent of the paid in and unimpaired capital and surplus of *all* the natural person credit unions which are members of the applicant central credit union or any central credit unions within the group.

When a group of central credit unions applies for agent membership, one central credit union in the group must be designated as the agent group representative. The agent group representative must subscribe to the capital stock of the Facility. In order to prevent double stock subscriptions, agent members do not have to consider the paid in and unimpaired capital and surplus of any of their members which choose to join the Facility as regular members. Also, any natural person credit union which is a member of more than one agent will designate through which agent it desires to access the Facility. Only the designated agent will have to subscribe to the capital stock based on the capital and surplus of the natural person credit union. As in the case of regular members, only one half of the required stock subscription must be paid to the Facility while the remainder is on call by the NCUA Board. Although central credit unions are eligible for membership in the Facility, the Facility is authorized to meet the liquidity needs of natural person credit unions which they serve. The fact that a natural person credit union is a member of a central credit union which is an agent does not prevent that credit union from choosing regular membership and dealing directly with the Facility.

The Central Liquidity Facility was established to provide a source of lending funds to meet liquidity needs for natural person credit unions. Those liquidity needs are met through three types of loans which the Facility is authorized to make. Short term adjusted credit, which is credit to meet a temporary shortage of funds due to a large withdrawal or a delay in the receipt of payroll deduction funds from a sponsor. Seasonal credit, which is designed to meet a forseeable shortage of funds, such as especially large share withdrawals during the summer from a teacher credit union. Protracted adjusted credit is extended in order to offset a long term shortage due to major changes in a local economy, such as the closing of a factory, resulting in the unemployment of members. The major constraint of CLF lending is a statutory prohibition against loans that are simply intended to expand credit union portfolios.

As of May 1980, the CLF served about 3,200 credit unions either directly or through the seven corporate centrals which are agent members. The aggregate total assets of these credit unions is almost $22 billion, or one-third of all credit union assets. Moreover, a major group of corporate centrals has recently applied for membership. If they are accepted, the CLF will serve over 50% of the total assets of the credit union industry.

The Current Status of the Industry

As stated above, the purpose of the Central Liquidity Facility is to provide loans to meet the liquidity needs of natural person credit unions. The Facility has played an important role in aiding credit unions during periods of severe liquidity pressure.

Credit union liquidity declined significantly from 1971–1978 (see Table 1). However, as interest rates increased to record high levels, CU liquidity has recently improved as loans have declined.

Table 1

Liquid Asset and Capital to Asset Ratios at Federally-Insured Credit Unions, 1970–79

Year	Liquid asset[a] as a percent of: Total shares	Total liabilities[b]	Total capital as a percent of total assets[c]
1970	14.8	13.8	8.0
1971	15.8	14.9	7.5
1972	15.6	14.7	7.2
1973	13.8	12.8	7.0
1974	14.5	13.4	7.0
1975	15.9	14.7	6.6
1976	14.1	13.0	6.3
1977	11.5	10.6	6.0
1978	9.2	8.3	5.9
1979	12.3	11.4	6.3

[a] Liquid assets represent the sum of cash, common trust investments, and shares, deposits, and certificates in other credit unions and financial institutions.

[b] Represents total shares plus notes and accounts payable and all other liabilities.

[c] Total capital represents the sum of total reserves and retained earnings.

That downward trend in lending during 1979 is evidenced by a reduction of $425 million in December 1979. Growth in Federal credit union loans outstanding fell from 22.3% in 1978 to 3.7% in 1979. This reduction was the result of the reduced rate of aggregate savings activity, periodic outflows of savings, a 12% loan ceiling and the high cost of funds.[9]

The slow growth of loans and savings in 1979 has persisted thus far in 1980. In January 1980, Federal credit unions experienced a new savings outflow of $187 million on a seasonally adjusted basis; about 1% of total savings.

Capital

Credit union capital has been declining for a number of years. By year end 1979, the credit union capital asset ratio fell to 6.3% from 8.0% in 1970.[10] During the last quarter of 1979 and the first quarter of 1980, the ratio began to rise as lending was discouraged by the 12% usury ceiling on FCUs. This increase is only a small pause in the decline underway during the 1970s. Such a reduction in capital reduces credit union ability to withstand significant financial adversity.

It will be difficult for credit unions to rebuild their capital positions quickly, due to the slow runoff of the loan portfolio. Based upon monthly repayment data, the average maturity of credit union loan portfolios is approximately 18 months,

[9] The loan ceiling for credit unions has since been raised to 21 percent.

[10] Capital is defined as loss reserve and retained earnings.

which means that credit unions will be burdened by a substantial volume of loans at the 12% rate for some time to come. As a result, retained earnings will accumulate only slowly, if at all. Indeed, to relieve earnings pressures and to enable some credit unions to meet higher operating and dividend expenses, it was necessary for the NCUA Board to waive the statutorily required transfer to reserves for the past three accounting periods. Hopefully, the current lower interest rate levels will obviate the need for such action in the future.

The decline in credit union capital and liquidity from relatively ample levels at the beginning of the 1970s, is to a significant degree an understandable result of the introduction of share account insurance provided by a Federal agency in 1971. Prior to 1971, credit unions were required to insure themselves against financial market volatility. With the introduction of Federal share insurance, a major portion of portfolio risk could be shifted to the NCUA Share Insurance Fund. Not unexpectedly, credit unions adjusted to the availability of share insurance by taking on greater portfolio risks in the form of lower capital and liquidity levels and higher loan-to-share ratios. In 1971, there was one involuntary liquidation processed by NCUA of $1,200. In the current fiscal year, the number of involuntary liquidations is estimated at 200 with insurance payments of $55 to 60 million.

Though the downward trends in credit union capital and liquidity were observed to be within the range of acceptable responses to a changed statutory situation, the levels had, by 1978, reached unacceptably low levels. NCUA responded by imposing a liquidity reserve requirement mandating Federal credit unions to hold very liquid assets in an amount of not less than 5% of total assets. No similar action needed to be taken with respect to capital, because in late 1979 the 12% ceiling on credit union loan interest rates discouraged credit unions from extending further credit.

Credit Union Risk in a Changing Competitive Environment

Though the longer term trends were unmistakable in previous years, a significant turning point in the competitive circumstances of credit unions occurred with the introduction of the money market certificate (MMC) in June 1978. As a consequence, credit unions experienced enormous outflows of funds which have been discussed earlier. But this share volatility was only one dimension of the significantly changed nature of the U.S. savings market.

The original MMC ceiling rates were set at the six month Treasury bill rate plus 25 basis points for savings and loan associations, mutual savings banks and credit unions, and equal to the six month bill rate for commercial banks. In March 1979, the Federal Home Loan Bank Board and FDIC indicated their concern that sharply higher bill rates were severely depressing thrift institution earnings through their effect on MMC rates.

After extensive interagency meetings, the respective regulatory agencies eliminated the authority of thrift institutions to pay a rate of interest greater than that by commercial banks whenever the six month Treasury bill rate was nine percent or higher. The elimination of the MMC differential sharply increased the commercial bank share of the MMC market at the expense of savings and loan associations and mutual savings banks. This change in market shares reflected not only the elimination of an interest rate advantage long held by thrift institutions, it also clearly revealed the effects of public sensitivity to interest rate differentials and foreshadowed an increase in competitive pressures for all financial institutions.

The money market certificates authorized for banks and savings and loans in the summer of 1978, radically altered the competitive posture of credit unions with respect to the return that could be earned on large savings accounts. The same attributes that enabled market forces to be resisted by credit unions in previous years now made them vulnerable to credit tightening. Though also authorized to issue money market certificates in November 1978, credit unions found themselves in a freely competitive market consisting of strong new competitive elements in the form of money market mutual funds.

Because interest rates on MMCs rose above the maximum dividend rates paid by FCUs and since many credit unions were reluctant to use their new share certificate authority early in 1978, credit unions experienced a substantial amount of disintermediation in July and October 1978. Although FCUs were authorized to issue MMCs later in the year, growth in credit union savings fell considerably from July to December.

The impact of the rapid growth in money market mutual funds on CUs has not been thoroughly studied. However, a recent NCUA staff survey of member credit unions determined that shares have been withdrawn for the specific purpose of investing in those funds. Instead of regulating this new major force in the market, the position of the NCUA has been to encourage the elimination of regulatory constraints in order to allow effective competition.

Further evidence of competitive pressures is illustrated by the lack of CU resources to meet member loan demand in 1979. The consumer finance industry, traditionally a source of funds to the risky borrower while charging interest rates five to ten percentage points higher than those available from credit unions, was a direct beneficiary. The shift from credit unions to this higher cost lender is evident when examining the shift in market shares during the period. At the end of 1978, prior to the rapid increase in interest rates, the credit union share of the consumer loan market was 16.7%, while consumer finance companies had a share of 19.6%. Data for February 1980, however, indicate the credit union share has fallen to 15.1%, while the share of consumer finance companies has increased to 22.6%. The influx of low risk borrowers from credit unions helped consumer finance companies to maintain earnings in the face of a higher cost of funds.

Other Instances of Increased Risk

The rapid growth in CUs during the 1970s led many institutions to increase their risk exposure by investing in fixed assets and speculative investments in U.S. Government agency securities. The former was based on the assumption that 18% growth would continue indefinitely while the latter was a speculation involving the yield curve.

As the industry grew, more and more credit unions were faced with a decision of whether to rent, lease or buy more space in order to accommodate credit union growth. Similarly, as the volume of business activity increased, credit union officials turned to electronic data processing as a means of reducing the record-keeping burden.

Although in many cases these decisions were made only after careful and deliberate study, there was an increasing incidence of cases where the acquisition of fixed assets caused severe financial problems for Federal credit unions.

A fixed assets regulation was promulgated to ensure that the officials of FCUs have considered all relevant factors prior to committing large sums of member funds to the acquisition of fixed assets. This was accomplished by requiring FCUs to seek written approval of the NCUA for investment in fixed assets in excess of 5% of member shares. The form and content of such requests will contain sufficient information to establish the need for and the feasibility of the proposal and to determine the impact of the proposal on credit union operations.

As for speculative investments, these practices involved investment in forward contracts and then excessive borrowing to carry the securities. In addition, a number of cases of adjusted trading were uncovered. NCUA responded by implementing a regulation that prohibited such practices and strengthened the agency's examination procedures in this area. These actions by NCUA have eliminated such speculation. However, a number of credit unions will be required to work out their over-invested positions over the next few years. NCUA believes all major problems in this area have been identified, workout procedures have been implemented to remedy condition deficiencies caused by these practices and, most importantly, credit union management has been educated to avoid such problems in the future.

CONCLUSIONS

As a result of legislation passed in 1976, 1978 and 1980, credit unions were authorized to offer services in the form of longer loan maturities, lines of credit, higher loan ceilings, 30 year mortgage loans and 15 year home improvement loans. While these new powers have increased credit union competitive strength, they reduce the justification for the traditional competitive insularity of credit unions. As subsequent legislation was enacted, principally the Deregulation and Monetary Control Act of 1980, interest paying transaction accounts and consumer loan authorities for thrift institutions have added to the competitive capabilities of banks and savings and loan associations.

In the past, credit unions have been able to be assured of greater member loyalty as a result of their unique ability to serve member needs where they work and to receive payroll deductions from the sponsor. The rapidly evolving technologies associated with electronic funds transfer threaten both of these service capabilities of credit unions. Automated teller machines offered by savings and loan associations and commercial banks could eliminate the current advantage of credit unions ability to serve occupational and associational groups in their work environments. Similarly payroll deduction, a foundation stone of credit union share stability, could be threatened by EFT direct deposit programs offered by banks and savings and loan associations. This will have particularly adverse consequences for small credit unions because of their lack of data processing facilities.

In the past, the direct participation of members in the operations of a credit union have been a source of institutional strength. As popularity led to growth and new powers led to greater complexity, member control has diminished and professional managers have become increasingly responsible for credit union operations. Though strenuous efforts are being made to preserve the unique cooperative relationship between credit unions and their members, necessarily greater institutional complexity will erode the highly personal nature of credit union operations in the past. Additionally, increased complexity has reduced the proportion of volunteer labor which has tended to reduce credit union earnings.

As credit unions become more full service institutions, other sources of institutional strength are being threatened. For example, elimination of the tax exempt status of credit unions is under increasingly frequent consideration by the Congress. Additionally, the subsidies offered by credit union employee and associational sponsors are coming under increasingly frequent scrutiny as sponsor cost concerns mount in a recessionary environment. Consequently, the role of the NCUA is to provide an environment in order to enable credit unions to be competitive given changes in market forces.

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