Credit Unions: Theory, Empirical Evidence and Public Regulation: Discussion
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Since my complaints about the paper are more on sins of omission than commission, let me note a few of the questions that, if they could be answered, would give us important insights into the future of credit unions:

1. Will credit unions be able and willing to provide rewards sufficient to attract the quality of management necessary for survival?
2. Can credit unions effectively handle the vast amount of consumer legislation—Truth in Lending, Fair Credit Billing, etc.? (A study of the impact that these regulations have had on credit unions thus far would be useful.)
3. Will credit union members be satisfied with truncated share drafts drawn on distant banks in a world where there will be NOW account competition and where float pricing may lead to discrimination against instruments drawn on out-of-territory points? If not, the cost of handling share drafts will rise substantially.
4. Is there still such a thing as the "credit union movement?" Do members retain enough loyalty to continue dealing with a credit union if it no longer offers higher deposit rates or lower loan rates?

DISCUSSION

MARK J. FLANNERY*: The papers by Navratil and Black and Dugger serve as an excellent backdrop for the theoretical model of Smith, Cargill, and Meyer (SCM). The credit union (CU) sector's extraordinary growth between 1965 and 1978 resulted primarily from the relatively lax deposit (share) rate ceilings imposed by their Federal regulator. Credit union shares and other deposit types are close substitutes, and consumers proved highly responsive to the explicit interest rate differential. Navratil's econometric estimates document this cross elasticity. Black and Dugger's assessment of CU's current status further emphasizes their competition with other intermediaries. CU have long possessed a comparative advantage in providing depositors (members) with geographic convenience and payroll deduction plans. In the future, EFT innovations and the increased importance of explicit deposit rate competition among intermediaries will tend to erode these historic advantages, and the CU sector should shrink relative to its competitors.

The SCM paper develops an innovative micro model of the CU as a particular type of intermediary. The paper's primary shortcoming is its failure to incorporate some important theoretical and empirical results available for the closely related cases of bank and thrift institution retail competition. I emphasize this at the outset because I believe CU are financial firms competing with and in most respects similar to other depository intermediaries. Prior CU researchers have too often viewed credit union firms as somehow unique (perhaps because the credit union "movement" was initially social and political as much as financial), and I feel this perspective has interfered with good economic analysis.

SCM's primary conceptual contribution is an objective function that allows

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explicit weights to be attached to saver welfare versus borrower welfare. Their analysis considers four stylized types of credit unions:

1. Profit maximization
2. Saver domination
3. Borrower domination
4. Neutral (saver and borrower welfare weighted equally).

The profit maximizing case is directly comparable to that of a commercial bank or a stock savings and loan association, and is best viewed as a helpful comparison for economists unfamiliar with the literature on cooperative firms.

The authors' analysis and policy discussion emphasize the impact of regulation and taxation on a saver dominated CU. In such a firm, the savers act as profit maximizers vis-á-vis borrowers, then distribute the profits among themselves. (When compared to a profit maximizing CU, this one appears to have "too much" share liabilities and pays "too high" a savings rate.) SCM claim that a binding deposit rate ceiling prohibits the saver dominated CU from distributing its earnings to the saving members. With complete saver domination ($\lambda = 0$), this problem reduces to that of mutual savings banks and mutual savings and loan associations: with a binding Regulation Q ceiling, how does management distribute the firm's earnings to its owners? Much of the post-1965 competition for retail deposit balances reflects implicit interest competition as the primary response to rate ceilings. Unable to raise explicit interest rates, intermediaries have offered "free" services, bank-by-mail, Snoopy dolls, additional branch facilities, and so forth. Credit unions also offer such services, plus some that are peculiarly their own: "free" life insurance and share drafts.

SCM claim that a saver dominated CU would respond to binding deposit rate ceilings by retaining an "excessive" amount of earnings. (Savers' current return cannot be raised, but future returns are thereby made safer.) Their rather provocative policy observation is that taxing these additions to surplus should lead saver dominated CU to take a more neutral or borrower-oriented stance.

In response to this I wonder, first, why policy makers should prefer saver dominated CU over borrower dominated (or vice-versa). It seems there is a value judgment being made here that deserves to become more explicit. More fundamentally, I doubt the saver dominated credit union's primary response to deposit rate ceilings would be an increase in surplus. Most CU should be able to distribute their earnings via some combination of implicit interest payments and the introduction of higher-yielding certificate accounts. Unless the CU *already* values borrower welfare to some extent, taxation would not affect the loan rate.

SCM spend less time discussing borrower dominated or neutral CU. Deposit rate ceilings and taxation are less troublesome to these firms, which are more inclined than saver dominated CU to distribute excess earnings via loan rate reductions. This observation emphasizes the empirical importance of determining the dominant type of CU motivation in order to assess the impact of regulation on this sector.

The authors leave the impression that their model is intended to motivate an extensive empirical investigation of the CU sector. While I am anxious to see their results, I harbor some serious reservations about the ability of this model to generate discriminating testable hypotheses. The certainty model contains their basic insights to credit union operations, but the essence of the financial intermediation problem incorporates uncertainty about interest rates, deposits flows, loan defaults, etc. The uncertainty model contained in Section III of this paper appears too ad hoc and naive to be relied upon in its current form.

The model's sole source of uncertainty is fluctuations in the market interest rate (r_{DM}), yet the share supply and loan demand schedules do not depend on market rates. Recent disintermediation experiences—including those of credit unions—indicate the cross-elasticities between market rates and deposit rates cannot reasonably be ignored. Omitting these effects implies (incorrectly, I believe) that CUs are qualitatively different from other financial firms. In discussing the relation between taxes and optimal surplus under uncertainty, SCM are also incomplete. Higher taxation lowers the optimal surplus and thereby induces a riskier CU (i.e. higher probability of bankruptcy). Simultaneously, however, the members receive offsetting current benefits in the form of a higher deposit or a lower loan rate. Normative judgments about the effect of taxation require a more complete evaluation of the change in shareholder welfare then the authors have provided.

Overall, the authors have presented an important contribution toward rigorously modelling credit unions as financial firms. They have correctly emphasized the theoretical importance of alternative objective functions in determining credit unions' behavior and their response to regulatory change. I look forward to their progress in testing the incidence of these various objective functions within the credit union sector, and expect that their findings will contribute to our understanding of this growing and dynamic industry.