



CREDIT UNIONS MAKE FRIENDS— But Not with Bankers

By William R. Emmons and Frank A. Schmid



Despite the rather low profile and mundane operations of the vast majority of credit unions, these institutions have long been a source of controversy in the United States, primarily in the banking community. For decades, bankers have objected to the tax breaks and sponsor subsidies enjoyed by credit unions and not available to banks. Because such challenges haven't slowed down the growth of credit unions, banks continue to look for other reasons to allege unfair competition.

Public awareness of the long-simmering credit-union debate was piqued about five years ago by a Supreme Court case pitting commercial banks against credit unions and their federal regulator.¹ The court found in favor of banks and their trade association, ruling that the regulator of federal credit unions, the National Credit Union Administration (NCUA), must not allow them to expand by combining more than one field of membership, or common bond among members. In other words, the Supreme Court ruled that each credit union should

remain focused on a single membership group—employees of a company, members of a fraternal or religious organization, or residents of a neighborhood, to cite a few examples. Less than six months later, however, President Bill Clinton signed into law new legislation that essentially reversed the Supreme Court's ruling. Thus, credit unions now may expand by merging multiple (unrelated) fields of membership.

But the feud continues. The American

Bankers Association (ABA) sued the NCUA in 1999, alleging that the NCUA violated the intent of Congress in implementing the new credit-union legislation. The ABA's complaint was dismissed by a U.S. Appeals Court in late 2001. Still, the ABA continues to document and comment on all sorts of issues related to credit unions.²

Most of the bankers' attacks are waged on three fronts. First, bankers believe it is unfair that credit unions are exempt from federal taxation while the taxes that banks pay represent a significant fraction of their earnings—33 percent last year. Second, bankers believe that credit unions have been allowed to expand far beyond their original purpose. The third major battleground concerns how credit unions are regulated and the financial services they are allowed to offer. For example, banks are subject to the Community Reinvestment Act (CRA), which requires banks to make specified amounts of loans in the communities in which they take deposits. Credit unions are exempt from the CRA. As for the services, credit unions have been allowed to increase the amount of business lending they do; this frustrates bankers, who believe that credit unions should focus on households.

Credit Unions Today

Credit unions are regulated and insured financial institutions dedicated to the saving, credit and other basic financial needs of selected groups of consumers. By law, credit unions are cooperative enterprises controlled by their members under the principle of "one person, one vote." In addition, credit union members must be united by a "common bond of occupation or association, or [belong] to groups within a well-defined neighborhood, community, or rural district," according to the Federal Credit Union Act of 1934.

Credit unions numbered 10,041 at the end of last year, serving more than 80 million members. At the same time, there were 7,887 FDIC-insured commercial banks and 1,534 insured thrift institutions (savings and loan associations and mutual savings banks). Most credit unions are very small, though: Credit-union assets totaled \$575 billion, compared to \$7,075 billion held by commercial banks and \$1,359 billion held by thrifts.³

The deposits (or, technically, "shares") of virtually all credit unions are now federally insured by the NCUA, regardless of the type of charter they hold. Federal credit unions are regulated by the NCUA, while state-chartered credit unions are regulated by an agency of the chartering state.

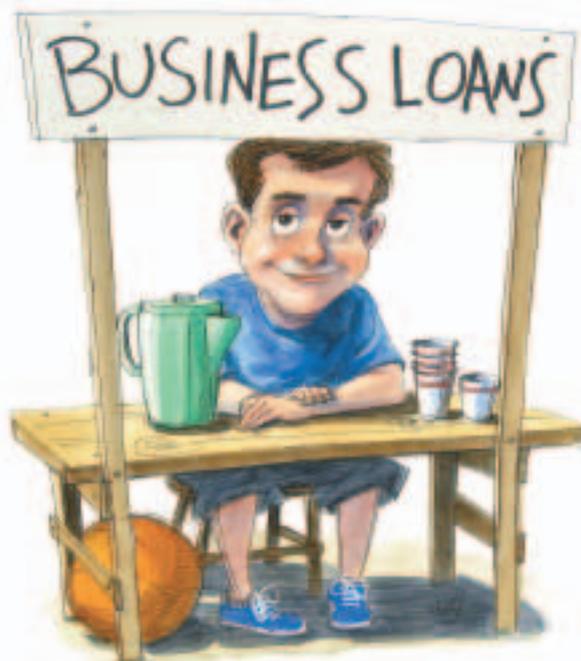
Every credit union is organized around a field or fields of membership shared by the members. A field of membership can consist of any one of the following:

- a single group of individuals who share a common bond;
- more than one group, each of which consists of individuals sharing a common bond (not necessarily the same type in each group); or
- a geographical community.

Common bonds are either occupational (the employees of a firm), associational (members of an association, such as a religious or fraternal organization) or geographical (all individuals who live, work, attend school or worship within a defined community).⁴

By size, most credit unions (57 percent of federally insured institutions) had less than \$10 million in assets in mid-2000. Large credit unions exist, however, and they are an important part of the sector. For example, the 15 percent of credit unions with more than \$50 million in assets (1,554 institutions) accounted for 79 percent of total credit-union assets.⁵

Credit unions play a limited role in the U.S. financial system. More than 95 percent of all federal credit unions offer automobile and unsecured personal loans. A similar proportion of large credit unions (more than \$50 million in assets)



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also offer mortgages; credit cards; loans to purchase planes, boats or recreational vehicles; ATM access; certificates of deposit; and personal checking accounts.⁶ Only about 14 percent of credit unions have business loans outstanding.⁷

Very small credit unions typically offer a limited range of services, rely on members to volunteer as staff and are likely to receive free or sponsor-subsidized office space. Sometimes, one or more firms (not necessarily in the same industry) may sponsor an occupational credit union, providing office space, paid time off for volunteer workers and perhaps other forms of support as a fringe benefit to employees. Larger credit unions offer a broader array of services, may employ some full-time workers (including the manager) and are more likely to pay a market-based rent for office space.

Historically, members of credit unions were drawn from groups that were underserved by traditional private financial institutions; these consumers tended to have below-average incomes or were otherwise not sought out by banks. Today, the demographic characteristics of credit union members have become more like those of the median American. In fact, current members are over-represented by the upper middle-income strata, defined as household incomes between \$30,000 and \$80,000 in 1987.

Here are a few more numbers about credit unions:

- Only 1 percent of the U.S. adult population aged 18 or over belonged to a credit union in 1935, but about 38 percent of the adult population had joined by 2001.
- According to a 1987 credit-union survey, 79 percent of all Americans who were eligible to join a credit union had done so.⁸
- Given the prominent role of occupational credit unions, a majority of members of all credit unions are in the prime working ages of 25-44.

Overall, it appears that credit unions, banks and thrifts are more direct competitors today than when credit unions first appeared.⁹

Legislative History

The predecessors of American credit unions were cooperative banking institutions of various sorts in Canada and Europe in the 19th century. The first credit union in the United States was formed in Manchester, N.H., in 1909.¹⁰ Soon thereafter, Massachusetts created a charter for credit unions. From there, the credit-union movement swept across the United States, meeting with particular success in the New England and upper Midwestern states.

These early cooperative financial institutions often had a social, political or religious character in addition to their explicit economic function. While the social and political aspects of the cooperative movement were acknowledged and accepted by Congress, the Federal Credit Union Act (FCUA) of 1934 was focused more narrowly on the economic potential of credit unions.

The legislation itself was modeled closely on state credit-union statutes that had appeared in the early decades of the 20th century in the Northeast and upper Midwestern states. The FCUA clearly reflected congressional intent to create a class of federally chartered financial institutions that would operate in a safe and sound manner:

... the ability of credit unions to "come through the depression without failures, when banks have failed so notably, is a tribute to the worth of cooperative credit and indicates clearly the great potential value of rapid national credit union extension." (Supreme Court, 1998, p. 17, citing the FCUA)

The likelihood that federal credit unions would serve consumers not served by banks was an additional element in congressional deliberations:

Credit unions were believed to enable the general public, which had been largely ignored by banks, to obtain credit at reasonable rates. (Supreme Court, 1998, p. 17)

Credit unions are exempt from federal taxation because Congress views them as "true" member cooperatives and, therefore, quite different from banks and thrifts. The major benefit of tax exemption is that credit unions can retain earnings tax-free. Advocates argue that this is justified because credit unions cannot raise equity in a public offering; so, they must be able to build capital internally. Opponents believe this is an unfair subsidy.

It is clear from the legislative history surrounding the passage of the FCUA in 1934 that Congress saw the common-bond requirement as critical to the success of credit unions. The common-bond requirement:

... was seen as the cement that united credit union members in a cooperative venture, and was, therefore, thought important to credit unions' continued success. ... Congress assumed implicitly that a common bond amongst members would ensure both that those making lending decisions would know more about applicants and that borrowers would be more reluctant to default. (Supreme Court, 1998, pp. 17-18)



1998 Act Made Expansion Easier for Credit Unions

PRESIDENT BILL CLINTON SIGNED THE CREDIT UNION MEMBERSHIP ACCESS ACT ON AUG. 7, 1998, FOLLOWING APPROVAL IN THE SENATE ON JULY 28 AND IN THE HOUSE ON AUG. 4. The act substantially reverses a Supreme Court ruling handed down on Feb. 25, 1998, that would have barred federally chartered credit unions from accepting multiple membership groups, each with its own common bond. This landmark credit-union legislation represented a major defeat for the top lobbying group representing commercial banks, which had argued successfully at the Supreme Court that credit unions with multiple common bonds violated both the letter and the spirit of federal legislation dating from 1934. The subsequent legislative response in support of multiple common bonds at credit unions was swift and overwhelming, passing both chambers with large majorities.

The 1998 act contains three provisions upholding the rights of federal credit unions to serve membership groups encompassing multiple common bonds. First, all federal credit unions that already included multiple common bonds before Feb. 25, 1998, were allowed to continue operating without interruption. Second, all federal credit unions were given the right to accept additional membership groups with multiple common bonds so long as the group to be acquired had fewer than 3,000 members. Third, the act gives the National Credit Union Administration the right to grant exemptions to the 3,000-member limit under certain circumstances, such as when the group in question could not reasonably support its own credit union.

The act also:

- requires annual independent audits for insured credit unions with total assets of \$500 million or more,
- authorizes and clarifies a federally insured credit union's right to convert to a mutual savings bank or savings association without prior NCUA approval,
- limits business loans to members to 12.25 percent of total assets,¹²
- establishes new capital standards for insured credit unions similar to those enacted for banks and thrifts in 1991,
- gives the NCUA authority to base deposit-insurance premiums on the reserve ratio of the insurance fund and
- directs the Treasury to report to Congress on differences between credit unions and other federally insured financial institutions, including the potential effects of applying federal laws—including tax laws—to credit unions. (This report is listed in the references as U.S. Treasury, 2001a.)

Hailing the new legislation, Clinton said, "This bill ensures that consumers continue to have a broad array of choices in financial services....and [makes] it easier for credit unions to expand where appropriate." Meanwhile, a spokeswoman for the American Bankers Association termed it "ironic" that the bill was presented as a measure to protect credit unions because in the long run, she said, it will dilute them, turning them into larger and larger institutions.¹³



The subsequent history of credit unions in the United States largely has fulfilled the promise envisioned by Congress in 1934. Credit unions have grown and spread across the country. Although hundreds of individual credit unions failed during the 1980s and early 1990s, the National Credit Union Share Insurance Fund (NCUSIF, formed in 1970) avoided accounting insolvency—in marked contrast to the Federal Savings and Loan Insurance Corp. and the Bank Insurance Fund of the Federal Deposit Insurance Corp.¹¹

The State of the Debate

The special status and comparative success of credit unions in recent decades, coinciding as it has with a period of stress on thrift and commercial-banking institutions, has led to political conflicts between advocates of credit unions and banks. This conflict reached its high point in a series of court decisions culminating at the U.S. Supreme Court in October 1997. The particular case at issue involved the AT&T Family Credit Union and the NCUA's interpretation of the 1934 FCUA allowing multiple common bonds of membership. Brought by several banks and the American Bankers Association, the case was ultimately decided in February 1998 (on a 5-4 decision) in favor of the banks that had sued to stop the NCUA from granting more multiple-group credit-union charters. The bankers' victory was short-lived, however, as Congress almost immediately drafted new legislation that enabled credit unions to continue growing much as before—including multiple common bonds within a single credit union. (The sidebar summarizes the key provisions of the act.)

Attacks on credit unions have stemmed from a wide range of viewpoints, including sometimes contradictory arguments. Some of the arguments used in the 1998 Supreme Court decision concerning the role of the common-bond requirement in credit unions reflect the unsettled nature of the debate. There are two main theoretical strands in the credit-union debate—one argument that stresses inefficient governance structures and another that stresses "unfair competition."

Some have argued that credit unions are inherently inefficient because of their one-member, one-vote governance structure. One might expect decision-making in a credit union to be of

poor quality because of a lack of professionalism (i.e., volunteer managers and workers), members' lack of interest in monitoring management, and weak incentives for members to intervene when action is needed to correct specific problems or deficiencies. According to this argument, credit unions may waste scarce economic resources and they may eventually impose significant costs on individual sponsoring firms or the economy as a whole.

The second prominent line of argument aimed at credit unions takes a nearly opposite view of their organizational effectiveness. This view presumes that credit unions operate efficiently enough to offer consistently better terms on savings and credit services than those offered by commercial banks and thrifts. Managers and owners of banks and thrifts often present this point of view in public discourse. To be sure, those arguing that credit unions represent unfair competition ascribe some or all of their competitive advantages to their tax-exempt status or to subsidies from sponsors rather than inherent efficiency.

Proponents of the first view—that credit unions are inherently inefficient—have a difficult time explaining why the number of credit unions and credit-union members continues to grow and why members express high levels of satisfaction with the services they receive. If most credit unions were very inefficient, one might expect their members to become disaffected and their role in the financial system to diminish over time.

On the other hand, proponents of the second view—that credit unions are unfair competitors due in part to tax exemption and sponsor subsidies—cannot explain easily why credit-union sponsors and governments are such strong supporters of credit unions. It is hard to understand why large net benefits or subsidies would be delivered to credit-union members indefinitely. Wouldn't we expect more opposition arising from constituencies that might be paying the subsidies, such as sponsors' shareholders or employees who do not belong to their firm's occupational credit union, or taxpayers who belong to no credit union at all? In fact, the most vocal complaints about subsidies for credit unions are heard from banks and thrifts, whose resentment of credit-union competition is hardly surprising. At the same time, banks and thrifts receive publicly provided benefits such as deposit insurance and entry restrictions.

Interestingly, both of these lines of attack against credit unions appeared in the argumentation of the Supreme Court majority that decided the AT&T Family Credit Union case in favor of commercial

banks. At one point in its opinion, the majority cited the legislative history surrounding the 1934 Federal Credit Union Act as support for the view that credit unions are a fragile—even flawed—type of institution, reasoning that:

Because, by its very nature, a cooperative institution must serve a limited market, the legislative history of Section 109 demonstrates that one of the interests "arguably...to be protected" by Section 109 is an interest in limiting the markets that federal credit unions can serve. (Supreme Court, 1998, footnote 6, pp. 8-9)

Thus, a credit union would become inefficient if it grew beyond its "limited market," as defined by its common bond.

At a different point in its opinion, however, the majority accepted the argument that credit unions with multiple groups of members would be *more* formidable competitors to banks and thrifts than single-group institutions were. The majority argued that an expansive interpretation of the 1934 act "would allow the chartering of a conglomerate credit union whose members included the employees of every company in the United States." In other words, credit unions would overwhelm banks and thrifts unless otherwise constrained.

The Future of the Debate

The irony inherent in the Supreme Court's majority opinion, of course, is that the court's extreme example of a hypothetical "conglomerate credit union" flies in the face both of its earlier reasoning and the legislative history of the 1934 act. The credit-union debate of 70 years ago, after all, had essentially predicted that such a huge credit union would not have been a safe and sound financial institution, nor consequently a viable one in the long run.

Thus, the long-running credit-union debate shows no signs of ending. The actors and the arguments may change, but the survival of credit unions in one form or another does not appear in doubt.

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ENDNOTES

- 1 Supreme Court, 1998.
- 2 The American Bankers Association web site provides a great deal of information about credit unions and why banks believe credit unions' regulatory and tax treatment should change. www.aba.com/Industry+Issues/Issues_CU_Menu.htm.
- 3 4,091 credit unions had state charters while 5,950 had federal charters. Credit Union National Association, 2003. www.cuna.org/download/us_totals.pdf. The data for commercial banks and thrift institutions are from the FDIC. www.fdic.gov/bank/statistical/stats/2002dec/industry.pdf.
- 4 U.S. Treasury, 2001a.
- 5 U.S. Treasury, 2001a.
- 6 U.S. Treasury, 1997.
- 7 U.S. Treasury, 2001b.
- 8 American Bankers Association, 1989.
- 9 A recent study found a tangible impact of credit unions on the deposit rates offered by banks and thrifts (Hannan, 2003).
- 10 U.S. Treasury, 1997.
- 11 Kane and Hendershott, 1996.
- 12 A Treasury Department study describes current credit-union business lending activity (U.S. Treasury, 2001b).
- 13 *BNA Banking Report*, 1998.

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- U.S. Treasury Department. *Credit Union Member Business Lending*, 2001b www.treas.gov/press/releases/report3071.htm.