

Not Your Father's Credit Union

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Proponents of the credit union industry have viewed credit unions as especially well-suited to making small-value, uncollateralized consumer loans since the time the first United States credit union was formed in 1909. At that time, other financial institutions such as banks and savings and loans were focused on alternative types of lending, specifically lending to businesses as well as to consumers with collateral. For consumers who lacked real estate or other simple-to-value collateral—in other words for *unsecured borrowers*—borrowing options were limited, at least for loans from depositories.

The high fixed costs of extending a small-value loan, and the significant risk of making an unsecured consumer loan to a borrower about whom the lender had little information on creditworthiness, meant that a lofty interest rate was necessary in order for the lender to cover costs. Such rates often exceeded usury ceilings, maximum interest rates set by state laws. Still, many borrowers were willing to pay high rates, even if it meant illegal borrowing. A 1911 estimate indicated that in larger towns and cities, one in five workers borrowed from illegal lenders (Calder 1999, 118).

Credit unions developed in this environment, allowing individuals to borrow at fairly low interest rates (Whitney 1922, 40–54). When consumers could band together into groups based upon a *common bond*—i.e., a shared characteristic such as working for the same company—they could substitute their knowledge of one another's creditworthiness for collateral. Credit unions offered creditworthy borrowers the opportunity to differentiate themselves from less creditworthy individuals in an era before the advent of nationwide credit bureaus. Credit union members were differentiated from unknown

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borrowers because of in-depth information among the group of members about the character and economic prospects of one another. In 1932, the average size of a U.S. credit union was only 187 members, so intimate knowledge among the membership was feasible in the early decades of the industry (U.S. Department of Health, Education, and Welfare 1965, 1).

With this knowledge in hand, the credit union loan committee could make a low-risk and, therefore, low-interest loan to a credit union member. Borrowing members received low interest rate loans, and the owners of the credit union—also members—were repaid with interest, which then was returned to members in the form of interest (also called dividends) on deposits (also called shares) in the credit union. Since members knew one another, and failure to repay a loan harmed fellow members and damaged the defaulting member's reputation in the group, there was social pressure to repay, thus reducing the likelihood of default, and consequently providing another explanation for low interest rates on loans from credit unions.

The advent of nationwide credit bureaus, which provided in-depth information on the creditworthiness of most consumers, and the growth of credit card lending as well as loan products that allowed borrowers to inexpensively employ real estate collateral for small loans—for example, home equity lines—the necessity of credit unions as producers of common bond-driven information on creditworthiness declined. In order to continue to prosper and grow, which many did successfully, credit unions were required to evolve from their original structure. To do so, the industry shifted toward mortgage and credit card lending and, to a smaller degree, toward business lending. The industry was also granted liberalized membership rules by its regulator and later by statute.

As the credit union industry evolved and many credit unions became more bank-like in their product offerings, the banking industry expressed growing concern over a perceived credit union advantage. Specifically, credit unions are exempt from federal income taxes, while banks pay such taxes. Credit union proponents have responded that the tax exemption remains appropriate because credit unions continue to be nonprofit, member-owned financial institutions, and because they face restrictions not placed on banks. The significance of the controversy was illustrated in November 2005 when congressional hearings were held to examine the credit union tax-exemption and its justifications in the face of changes to the credit union industry (U.S. House of Representatives 2005).

How do banks and credit unions differ, and what is the history behind these differences? How have these differences changed over time and why? Observers of the credit union tax exemption controversy might ask such questions. This article provides a history of the evolution of credit unions and the market forces behind the evolution, without taking a stand on the merits of either side of the tax debate.

1. EARLY HISTORY OF THE CREDIT UNION INDUSTRY

The first credit union in the United States, St. Mary's Cooperative Credit Association, was chartered in Manchester, New Hampshire, in 1909 (National Credit Union Administration 2006a). This and other similar credit unions developed to fill a niche in the loan market that was largely unfilled by existing banks and savings institutions. The niche that they filled was that of unsecured, small dollar, consumer loans—for example, for the payment of a medical bill or to purchase a home appliance.

Lending institutions along the lines of United States credit unions first developed in Europe. Cooperative banks or people's banks appeared in Germany in the 1850s (Moody and Fite 1984, 1–10). These spread to a number of other countries, and then to Canada, at the turn of the 20th century, before coming to the United States.

Initial Leaders of the Credit Union Industry

A number of individuals are credited with the introduction and spread of credit unions in the United States. Three of the most important are Alphonse Desjardins, Pierre Jay, and Edward A. Filene.

Alphonse Desjardins, a Canadian journalist and politician, organized one of the first cooperative banks in Canada, *La Caisse Populaire de Levis*. *Caisse Populaire* loosely translates to people's credit society or people's bank (Moody and Fite 1984, 12–15). *Caisse*, located in the city of Levis, Quebec, opened for business in January 1901, and was modeled after European cooperative banks which Desjardins had been studying for years. *Caisses* grew rapidly in Canada, thanks to Desjardin's advocacy, numbering 150 by 1914 (Moody and Fite 1984, 17).

In late 1908, Desjardins helped organize the first credit union in the United States, at the request of the priest of St. Mary's Parish in Manchester. He also consulted with Pierre Jay and Edward Filene as they pushed forward the spread of credit unions in the United States following the formation of St. Mary's.¹

Pierre Jay, Banking Commissioner of Massachusetts, became familiar with the cooperative banking concept soon after 1900 (Moody and Fite 1984, 22–23). As banking commissioner, he recognized a lack of lenders willing to make small-value loans to consumers. His interest led him to contact Alphonse Desjardins. In July 1908, Jay traveled to Ottawa to meet with Desjardins and learn first-hand about les caisses populaires in Canada (Flannery 1974, 14). In April 1909, Jay persuaded the Massachusetts legislature to pass legislation that allowed cooperative banks, named credit unions, to be chartered in that

¹ While St. Mary's was created in late 1908, it did not receive a charter to operate from the legislature of New Hampshire until early 1909 (Whitney 1922, 16).

state. Then, as now, most states prohibited the gathering of deposits by firms lacking a charter that specifically grants it this power.

Edward Filene was a Boston merchant (of Filene's Basement fame) who traveled widely and witnessed successful agricultural cooperative lenders in India. These lenders gathered small deposits from Indian farmers, members of the lending cooperative, and made small-value loans to their members (Moody and Fite 1984, 21). Because of his business experience in the United States, Edward Filene, like Jay, perceived a dearth of small-value lenders and wished to bring the cooperative bank to the United States.

While Desjardins and Jay were responsible for the first steps in establishing credit unions, Filene created momentum to produce growth in the industry over the coming several decades. His efforts included lobbying legislators to pass credit union legislation, speaking frequently on the benefits of cooperative lending, and funding organizations to promote the expansion of credit unions.

Credit union growth was fairly slow between 1909, when the first U.S. credit union opened, and 1920 (Moody and Fite 1984, 32–72). Growth of credit unions began to pick up in the mid-1920s, as an increasing number of states passed credit union laws (Moody and Fite 1984, 73). By 1925, credit union laws had passed in 26 states. In 1925, there were 176 credit unions; this count had grown to 868 in 1929 (U.S. Bureau of the Census 1975, 1,049) and 2,500 by 1934, when the Federal Credit Union Act created federal credit union charters (U.S. Treasury Department 1997, 16). According to Moody and Fite (1984, 55–108), much of the legislation that made this growth possible was the result of Edward Filene's lobbying efforts or the result of efforts financed by him.

Beyond Credit Unions

Credit unions were not the only response to limited borrowing opportunities for consumers. The Russell Sage Foundation was formed, based on funding provided by Russell Sage's widow (Sage was a railroad baron who died in 1906). The foundation soon began advocating for the liberalization of usury laws for small-value loans. Low usury ceilings in a number of states meant that small-value consumer loans could not be made profitably. Out of this advocacy grew a movement to encourage all states to adopt uniform small-value loan regulations that would provide for fairly high usury ceilings on small consumer loans, while at the same time implementing consumer protection rules. Approximately two-thirds of the states passed the uniform laws by the time the Foundation ended its push for such laws in the 1940s (Carruthers, Guinnane, and Lee 2005).

In addition to the effort of the Russell Sage Foundation, Morris Plan banks were formed around the country based on a bank founded in Norfolk, Virginia. The original Morris Plan bank was chartered by Virginia in 1910 at

the request of Arthur J. Morris. It gathered deposits from and made small-value unsecured installment loans to consumers. Morris lowered losses and, therefore, was able to charge fairly low interest rates, by requiring several cosigners for all consumer loans. Further, he sidestepped usury ceilings to some degree by charging loan fees and deducting interest payments from the loan when it was initially made (Giles 1951, 81–86). Ultimately, Morris Plan banks were called industrial banks, which remain today in the form of industrial loan corporations, one of the few bank types that can be owned by commercial firms (Walter 2006).²

2. COMMON BOND LENDING

Given existing lenders' focus on other types of lending, the early 20th century consumer lending market was ripe for the development of financial institutions that could act as low-cost providers of small-value, unsecured consumer loans. Commercial banks, mutual savings banks, and savings and loans focused their lending efforts in other directions.

Pierre Jay noted the absence of providers of small-value, *unsecured* loans in Massachusetts, and foresaw the operating characteristics of credit unions:

What are known in Massachusetts as “cooperative banks,” are excellent examples of the success of cooperation between savers and borrowers in an important but limited field. Their members are almost entirely salary and wage earners, who have joined together for systematic saving and for the owning of their homes. But inasmuch as all of their loans are secured, either on real estate or on the cash value of their shares, there is no need for selecting the members, no scrutiny is made of the object of loans made on the cash value of shares, and but little interest is taken by the members in the management of the institution. Furthermore they are of no service to those who have neither real estate nor shares as security, many of whom undoubtedly have legitimate need for loans. (quoted in Moody and Fite 1984, 24–25)

² The early 20th century saw not only the development of the credit union industry, but also the growth of other cooperative business organizations, i.e., organizations in which customers are also owners or members. For example, agricultural cooperatives, which began to spread in the United States in the 1870s, grew rapidly between 1890 and 1920. The number of agricultural cooperatives peaked, at 14,000 in the 1920s (Frederick 1997). Consumer cooperatives gained popularity in the 1920s, and cooperatives also formed to provide rural electric and telephone service, encouraged by the Rural Electrification Administration, which passed in 1935 (Frederick 1997).

Relationships As a Substitute for Collateral and Credit Ratings

Credit unions were small, with, as noted earlier, on average only 187 members in 1932. Further, they were formed based on a common bond, where members knew one another. In other words, members of a common bond likely knew, at least better than other potential lenders, the economic prospects of the borrowers who were fellow members.

Alphonse Desjardins noted the benefit of common bond lending when discussing exceedingly low loan losses at La Caisse Populaire. He claimed that losses were low because, “The main security is the fact that the association is working within a small area and that everybody knows each other” (Moody and Fite 1984, 16). Pierre Jay had an eye toward the members of a common bond, monitoring one another while discussing the lack of such monitoring when loans are secured by real estate or deposits (shares), when he said, “there is no need for selecting members, no scrutiny is made of the object of loans.”

At the time, nationwide consumer credit rating agencies did not exist, though there were credit rating agencies in some of the larger cities. Because of the lack of these agencies, it was difficult for lenders to differentiate between creditworthy and non-creditworthy consumers. The common bond acted as a substitute, allowing its members to differentiate good credit risks from poor credit risks.

Monitoring Within the Common Bond

Not only were members of small credit unions, or the credit committee, likely to know something of the financial circumstances of their fellow members, they had incentive to deny loans to poor credit risks and to monitor borrowers. Federal deposit insurance coverage was not granted to credit unions until 1970. A few states had state insurance schemes for credit unions, but in general, depositors were subject to losses when borrowers failed to repay (Flannery 1974, 26). Depositors faced the danger that if losses were large enough they might lose principal on their deposits.

The view that common bond lending contained this monitoring advantage was expressed by Alphonse Desjardins when he noted that “a second security [in addition to members’ knowledge of one another’s creditworthiness] is that everybody is interested by being a shareholder” (Moody and Fite 1984, 16).

In effect, common bond lending used social pressure from associates instead of the threat of confiscation of collateral, to ensure loan repayment. Since these associates suffered loss due to a member’s default, the social pressure to repay was likely significant. The borrower knows that if he does not repay, he is costing his associates lost interest earnings and perhaps lost principal.

A 1922 Department of Labor study of early credit unions reported that loans were typically made without collateral, but with careful scrutiny of

the character of the borrower by the credit committee—typically the loan decision-making body in credit unions (Whitney 1922, 33). Small loans were made on the signature of the borrower only, while loans over \$50 required the endorsement of two other credit union members. According to this 1922 study, typical interest rates charged by credit unions ranged from 6 to 12 percent per annum (Whitney 1922, 40–54).³

Still, the incentive of any individual member to keep an eye on another borrower is somewhat muted. The cost of one member's efforts to monitor another member's financial condition is borne only by that member, but the benefit if loans are properly denied, or remedial action is taken, is shared by all members in the form of higher returns on their credit union deposits.⁴

Reputational Incentive to Repay

While members' incentive to monitor one another's loans in order to protect credit union earnings may be muted, there is another reason to expect borrowers within a common bond group to repay. Members of a credit union are likely to have many valuable interactions with one another, outside of interactions through the credit union. Failure to repay a loan is likely to damage the reputation of the defaulting borrower and undercut these interactions.⁵

For instance, members of a credit union who share the common bond of working for the same company may worry that defaulting on a credit union loan will decrease their opportunities for advancement. Their co-workers, including supervisors, would be likely to learn of the default, undercutting the defaulting worker's reputation.

Further, a credit union member who shares a close common bond with fellow members might be concerned that his default could damage his reputation and limit social interactions with members. For example, the credit union borrower might believe that members will view a default as a sign of dishonesty and, therefore, be less willing to include him in confidences.

³ The author of the 1922 study notes that some credit union loans were made on collateral such as deposits in the credit union, stocks, or real estate collateral (Whitney 1922, 40).

⁴ Group lending, whereby loans are made to members of a group and all members of the group are jointly liable for each other's debts, can provide strong incentive to members to monitor and discipline one another to ensure repayment. Group lending, which, like common bond lending, uses social connections to encourage repayment, has received wide attention as a means of inexpensively lending to individuals for whom little formal information on creditworthiness is available. Group lending and a number of interesting examples as practiced in developing countries are discussed and explored in Prescott (1997).

⁵ Besley and Coate (1995) develop a model which is used to explore the ways "social connectedness" can encourage debt repayment.

Members of a common bond will be aware of the potential damage to one's reputation. As a result, they will be less likely to default because of the potential damage to other interactions with fellow members of a common bond.

3. FACTORS DIFFERENTIATING CREDIT UNIONS FROM OTHER DEPOSITORIES

Credit unions share many features common to all depository institutions: they gather savings and transaction deposits, make various types of loans, and employ branch networks, ATMs, telephone service departments, and Web sites to provide services to their customers. They are insured by an agency of the federal government, receive a charter to operate, and are closely regulated. Beyond these similarities, credit unions are distinct. They differ from most depositories in that they are mutually owned, rather than stockholder-owned. Another distinction is their greater concentration on unsecured lending, though the growth of credit card lenders has meant that credit unions are less distinct here. While other depositories take deposits from and make loans to anyone meeting creditworthiness requirements, credit unions face restrictions limiting whom they may accept as customers. Last, credit unions have the unique advantage of being exempt from federal taxes.

Mutual Ownership

State credit union laws and the Federal Credit Union Act require that credit unions be cooperative or mutually owned organizations. This implies that a credit union's members, meaning its depositors, are also its owners. As a result, depositors have the right to vote for the members of the board of directors of the credit union, who, in turn, hire managers who run the day-to-day operations of the credit union.

Credit unions do not raise equity by selling shares in the equity markets, as do nonmutual corporations. Instead, credit unions raise equity by retaining earnings. Credit union depositors, as owners, are due not only the repayment of their deposits and any interest owed to them, but also the credit union's equity, meaning funds that might remain after all liabilities are repaid if the credit union is dissolved. Consequently, credit union depositors are the residual claimants to the credit union's assets, like corporate shareholders, explaining

why credit union deposits are often called “shares.” Depositors in most other depository institutions are due only the repayment of deposits plus interest.⁶

Uncollateralized Consumer Lending

Beyond their ownership, credit unions were originally set apart from other depositories by their emphasis on small-value, nonmortgage loans to individuals and households, meaning uncollateralized loans for household expenses and the purchase of consumer durables. For example, in the early 1920s, the average size loan made by credit unions in Massachusetts and New York—two states in which numerous credit unions operated—was \$272 (\$3,092 in current dollar terms) in Massachusetts and \$169 (\$1,720) in New York (Whitney 1922, 55).

With the exception of some securities investments, credit union assets were devoted almost completely to loans to individuals. The earliest data on the types of loans credit unions made comes from a 1948 survey of federally chartered credit unions conducted by the Bureau of Federal Credit Unions. The survey indicated that the largest categories were loans for the purchase of automobiles to consolidate loans for current living expenses and medical expenses (U.S. Bureau of Federal Credit Unions 1948, 4).

In contrast to credit unions, savings and loans and savings banks focused on mortgage lending and commercial banks on business lending. In the case of mutual savings banks, as of 1910, mortgages and investments in securities accounted for 89 percent of assets (U.S. Bureau of the Census 1975, 1,046). Figures on types of lending by savings and loans is reported starting with 1929, when mortgages accounted for 75 percent of all assets (U.S. Bureau of the Census 1975, 1,047). Data on types of loans and assets for commercial banks are reported beginning with 1939. During that year, 91 percent of bank assets were accounted for by loans to businesses, securities investments, cash holdings, and mortgage lending (Board of Governors 1959, 34–35). In each of these cases, uncollateralized loans to individuals were no more than 25 percent of assets.

Until 1977, federal credit unions were largely prohibited from making real estate loans, though some states allowed such lending by state-chartered credit

⁶ Another group of depository institutions, mutual savings banks, which traditionally focused on home mortgage lending, are like credit unions, also owned by depositors.

The advantages and disadvantages of mutual ownership relative to stockholder ownership have been studied widely, especially in the insurance industry, where both types of ownership are prevalent. Generally these studies find that the choice is driven by conflicts of interest between owners and managers on one hand, and owners and customers on the other. Examples of such studies are Mayers and Smith (2002), Mayers and Smith (1986), and Fama and Jensen (1983).

unions. The shift into mortgage lending after 1977 contributed to growth in loan size at credit unions, such that in March 2006 the average credit union loan was \$10,903 (National Credit Union Administration 2006b).

During the 1940s, credit unions had little opportunity to compete for mortgage loans (as discussed later), but by 2006, such loans accounted for 32 percent of all assets. Nevertheless, credit unions continue to exhibit considerably greater emphasis on nonmortgage loans to individuals, which as of March 2006, accounted for 31 percent of all of their assets, compared to 8 percent for commercial banks, savings banks, and savings and loans (Federal Deposit Insurance Corporation 2006, 5).

Restricted Customer Base

An additional important factor differentiating credit unions from other depositories is that they have traditionally been required by state and federal law to choose their members from one group. Specifically, a credit union must focus on a group sharing one of three forms of affinity: (1) a common bond of association such as a fraternal or religious organization, (2) an occupation, or (3) residence in a single community, neighborhood, or rural district. In other words, unlike banks, savings and loans, and savings banks, credit unions face restrictions that limit with whom they may do business.

The apparent goal of this limitation is to protect the health of credit unions, as members are more likely to repay loans given that failure to repay harms fellow members of their own group (Robbins 2005, 3). While this repayment benefit may flow from the common bond requirement, there is also a serious disadvantage. Credit unions bound to accept members only from one employer or community are likely to suffer from a severe lack of diversification. Limited diversification may have contributed to high failure rates among small credit unions in the late 1970s and 1980s (Wilcox 2005, 2–3).

Tax Exemption

Tax exemption is the final, and most controversial, difference separating credit unions from other depositories. Credit unions are free from federal income taxes. All of a credit union's net earnings, meaning earnings after paying expenses, will be paid out to its owners (depositors) as interest and dividends or retained by the credit union as capital; none goes to federal taxes. In contrast, before a bank can make dividend payments to its owners (shareholders) or retain capital, it must pay a portion of its net earnings as federal income taxes.⁷

⁷ Since credit unions do not raise capital by issuing equity to investors, they are at a disadvantage compared to banks, which can quickly raise additional capital in the equity markets.

While commercial banks have never been tax exempt and mutual savings and loans and mutual savings banks lost their tax-exempt status in the Revenue Act of 1951, credit unions remain tax exempt even though this status has been questioned by representatives of other portions of the financial services industry.

Section 501(c)(1) of the Internal Revenue Code grants tax-exempt status to federal credit unions. Section 501(c)(14) of the Code does the same for state-chartered credit unions as long as they do not have capital stock, are mutuals, and are nonprofit. In 1998, legislators explained and affirmed credit unions' tax-exempt status in the Credit Union Membership Access Act. The act stated that credit unions are tax exempt because they "are member-owned, democratically operated, not-for-profit organizations generally managed by volunteer boards of directors and because they have the specified mission of meeting the credit and savings needs of consumers, especially persons of modest means." (U.S. House of Representatives, Committee on Ways and Means 2005).

Credit unions are granted an advantage relative to their competitors because they are tax exempt. One measure of the size of this advantage is the total amount of taxes avoided. In a 2001 study, the Department of Treasury estimated that federal tax revenues of between \$1.3 billion and \$1.6 billion per year were lost due to credit unions' tax-exempt status (U.S. Department of the Treasury 2001a).

If credit unions paid this \$1.6 billion to their depositors in the form of greater interest on deposits, the advantage would amount to about 30 basis points (\$1.6 billion divided by \$550 billion in total credit union deposits equals .29 percent). Alternatively, if they passed it along in lower loan interest rates, the basis point advantage would be about the same (as the dollar amount of loans and deposits are about the same).

Still, it seems likely that at least part of the tax advantage move in other directions. Some of the advantage is likely to be shifted toward capital holdings at credit unions and higher salaries and expenses.

While tax exemption may provide as much as a 30 basis point advantage that can be used to attract customers to a credit union, the advantage is undercut by two other considerations. The first consideration is that many small banks are organized as Subchapter S corporations. Within certain limits, S corporations pay no federal income taxes and can, like credit unions, devote all earnings either to dividends and interest, retained capital, or some of all three. As of March 2006, about 2,400 FDIC-insured institutions (commercial banks,

Instead, credit unions increase equity only by retaining earnings. The inability to quickly add to their equity can be a disadvantage if they wish to grow rapidly. This disadvantage, compared to banks, is offset somewhat because credit union earnings are not diminished by taxes, leaving more earnings that might be retained.

savings and loans, and savings banks), or 27 percent of all FDIC-insured institutions, were organized as S corporations (Federal Deposit Insurance Corporation 2006, 4–5).

The second consideration that limits, somewhat, the advantage of credit unions over non-tax-exempt banks is the current fairly low dividend tax rate of 15 percent. As an example, assume a taxed bank earns \$100 million dollars, pays federal taxes (of \$35 million at the top federal corporate tax rate of 35 percent), and pays out as dividends all of its remaining earnings. Its shareholders then pay taxes on the dividends at the current dividend tax rate of 15 percent. Ultimately, bank shareholders receive \$55 million in earnings.

In contrast, shareholders (customers) in credit unions receive \$65 million after taxes. While they do not face double taxation as corporate shareholders do, since the credit union pays no taxes before paying them interest or dividends, the tax rate on payments to credit union shareholders is the individual tax rate, which can be as high as 35 percent. The bottom line is that the tax advantage may be smaller than one might imagine.⁸

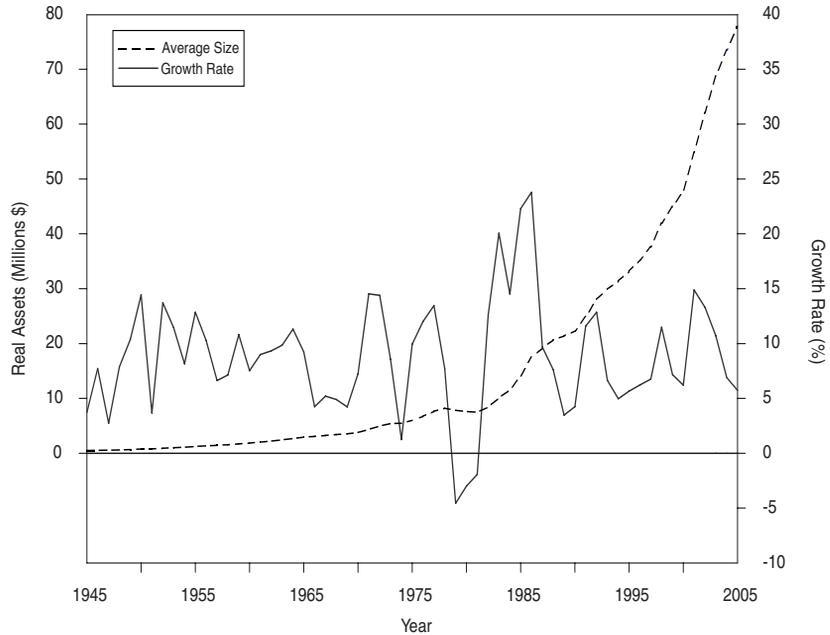
4. SIZE RELATIVE TO BANKS

As of December 2005, there were about 9,000 credit unions, 3,600 of which were state-chartered and 5,400 of which were federal credit unions (Credit Union National Association 2006). In sum, these 9,000 credit unions held \$700 billion in assets. In comparison, there were 8,800 banks, savings and loans, and savings banks, together holding \$10.9 trillion in assets. Several banks, individually, have assets that exceed the total assets of the sum of all credit unions. Nevertheless, with 87 million members as of 2005, credit unions are important competitors in the market for consumer loans and deposits (Credit Union National Association 2006).

Like banks, credit unions come in a wide range of sizes. Still, compared to banks, a much higher proportion of credit unions are very small. Approximately 46 percent of all credit unions are smaller than \$10 million in assets (Credit Union National Association 2006). Only 79 banks, or 1 percent of all banks, have assets below this threshold. In part, this size difference reflects the long-standing focus of credit unions on retail deposits and loans compared to banks' focus on lending to firms and holding their deposits. Commercial loans account for only 2.5 percent of all credit union assets, though this amount has grown fairly rapidly in recent years. This contrasts with banks where

⁸ Because these calculations of amounts received by bank and credit union shareholders are made assuming the highest tax rates (corporate and individual rates), they cannot be considered accurate for all shareholders. For example, credit union shareholders in lower tax brackets (presumably a majority of shareholders) will receive higher after-tax earnings.

Figure 1 Average Credit Union Size and Percentage Growth in Size

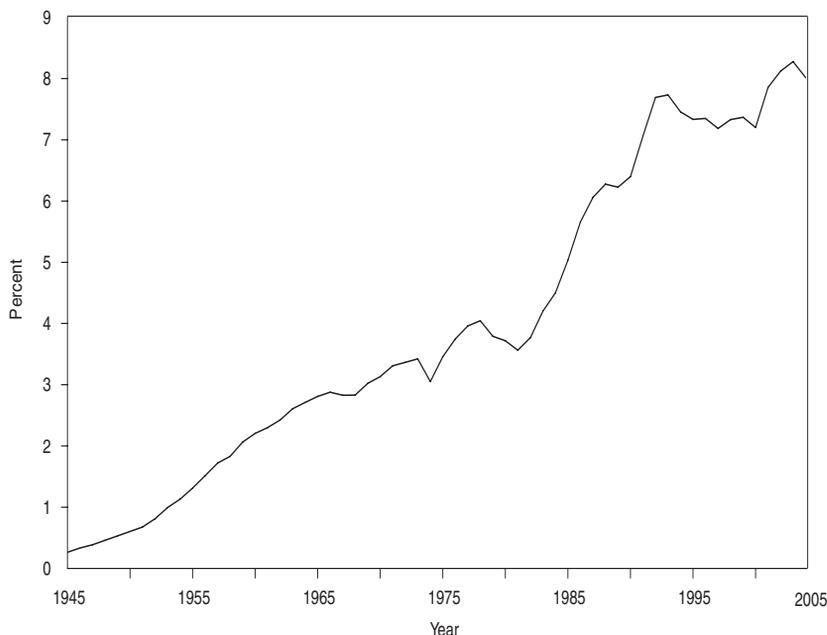


Notes: Commercial bank data are from FDIC. Credit union data are from Credit Union National Association.

commercial loans amount to about 22 percent of total assets (Credit Union National Association 2006).

Nevertheless, there are some large credit unions, even by bank standards. For example, 104 credit unions had assets greater than \$1 billion as of June 2005 (Callahan and Associates 2006, 44–46).

While compared to banks, most credit unions are small, as Figure 1 shows. Yet, the size of the average credit union has grown significantly over the years. Figure 2 demonstrates that, relative to banks, credit union assets have grown fairly consistently. They increased from less than 1 percent of bank assets in 1944 to about 3.5 percent in 1981. Growth was especially rapid relative to banks during the 1980s and early 1990s, as membership restrictions were first being eased and banks were experiencing a widespread decrease in profits. More recently, growth has been less robust in relation to bank assets (see Figure 2).

Figure 2 Credit Union Assets as a Percent of Bank Assets

Notes: Commercial bank data are from FDIC. Credit union data are from Credit Union National Association.

5. REGULATORY FRAMEWORK

Historical Development

The first credit union in the United States operated under a special charter granted specifically to that credit union by the New Hampshire legislature in 1909.⁹ As noted earlier, over a period of years following the 1909 chartering of the first credit union, other states passed laws giving credit-union-chartering authority to state banking agencies. Credit unions were required to seek state charters, otherwise they would have run afoul of state laws stipulating that deposits may be accepted only by entities holding government-issued charters.

⁹A 1922 study of cooperative lending associations notes that there were several credit union-like financial institutions operating even before 1909. For example, a cooperative association was created for employees of the Boston Globe in 1892. It gathered deposits from employees and made small-value loans to them. The Boston Globe Cooperative Association, and several other similar associations, operated without legal authority, leading the Massachusetts banking commissioner, Pierre Jay, to call for a law authorizing these activities (Whitney 1922, 17).

These early charter laws typically specified rules such as how credit unions might be founded, from whom they might gather deposits (credit union members), to whom they might make loans (typically only to members), who might become members (those sharing a community or occupational bond), and how an individual might become a member (by purchasing at least one share in the credit union) (Whitney 1922, 21–29). State banking agencies not only chartered credit unions, but also oversaw their operations, including sending examiners to review their activities (Whitney 1922, 48).

A federal charter for credit unions was created in 1934. At that time, 39 states had laws authorizing credit unions and there were 2,028 state credit unions (Giles 1951, 106; U.S. Bureau of the Census 1975, 1,049). The Federal Credit Union Act, enacted on June 26, 1934, created a federal agency to grant charters so that credit unions could be formed in any state regardless of whether that state offered charters to credit unions. The federal agency was placed in the Farm Credit Administration (Moody and Fite 1984, 120).

Over the years the agency responsible for federal credit unions was housed in government entities. It was moved to the FDIC in April 1942 and then in July 1948 to the Federal Security Agency—later renamed the Department of Health, Education, and Welfare (Croteau 1956, 121).

Current Regulatory Environment

In March 1970, legislation was enacted to create an independent agency, the National Credit Union Administration (NCUA) (Moody and Fite 1984, 304). The NCUA charters and supervises all federal credit unions. State credit unions continue to be chartered and examined by state agencies.

Also in 1970, credit unions gained federal deposit insurance when the Federal Credit Union Act was amended in October of that year to create the National Credit Union Share Insurance Fund (NCUSIF). The Fund is overseen by the NCUA. All federal credit unions must join the fund and state-chartered credit unions may choose to join.

The amendment that created the NCUSIF passed in spite of the objections of the credit union industry, which argued that insurance premiums would be high and losses from credit union failures had been quite low historically (Moody and Fite 1984, 304). While opposed in the beginning, insurance is now almost universal; only 191 state-chartered credit unions, out of the total of 3,600 such credit unions, operate without NCUSIF coverage (Callahan and Associates 2006, 19).

6. ADVANTAGES OF COMMON BOND LENDING DIMINISH

In the second half of the 20th century, a number of factors combined to slowly undercut the advantages of common bond lending relative to other forms of

lending. First, nationwide credit-reporting agencies emerged and expanded in the 1970s, lowering the cost of lending to consumers with whom the lender had no direct contact. Credit-reporting agencies are companies that gather and sell information about individual consumers, information that can be used to predict the likelihood that a consumer will repay a debt. Second, in the 1980s and 1990s the home equity line of credit was developed and became widely available, allowing consumers to easily tap their home equity for small purchases. Third, credit card lending developed as a convenient, and reasonably low-cost means of making small, unsecured loans. And fourth, the advent of deposit insurance eliminated some of the social pressure that might be brought to bear on members who failed to repay loans.

Growing Availability of Creditworthiness Information

Until the 1970s, credit information was gathered largely only on a local basis, and on just a limited number of consumer variables. For example, Trans Union, one of several nationwide credit-reporting agencies, entered the credit-reporting business in 1969 by purchasing a local credit-reporting agency, and then expanding nationwide, and developing the computer technology to store and retrieve broad, detailed records on millions of consumers over the next several years (Trans Union 2006b). Before computers were employed, information was necessarily limited to a few items on each consumer, and was difficult to retrieve quickly.

Today, three credit-reporting agencies—Equifax Credit Information Services, Trans Union, and Experian Information Solutions—gather and maintain information that lenders consider predictive of debt repayment on the majority of United States consumers. Such information can include the consumer's debt and bill repayment history, bankruptcies, liens, number of loans and lines of credit, amount owed on each, home address, and employer name (Trans Union 2006a). For a fee, a reporting agency will supply this information about a consumer to a lender considering making a loan to that consumer, as well as a score that grades the consumer's creditworthiness based on the information. A lender might gather scores and the underlying information from two or three of the agencies before deciding to make a loan. Because many borrowers know that a default will mean a lowered credit score and higher interest rates on future loans, the presence of these credit agencies provides an incentive to repay. Because of the low cost and ease with which lenders can gather consumer creditworthiness information, and the repayment incentive their presence provides, the relative advantages of creditworthiness knowledge gained by maintaining direct contact with the borrower through a common bond and the motivation to repay produced by common bond relationships are reduced.

Home Equity Lines of Credit

The spread of home equity lines of credit (HELOCs) also tended to undercut the advantage of common bond lending. Prior to the mid-1980s spread of home equity loans, it was difficult for a consumer to make use of the equity built up in his or her house as collateral for a loan (Canner, Durkin, and Lockett 1998, 242). Second mortgages were often taken on homes to make a large, one-time purchase. But closing and other transaction costs made such loans expensive to use for making smaller and more frequent consumer purchases.

The development of HELOCs greatly expanded the ability of consumer borrowers to tap the equity in their homes and, thereby, collateralize borrowings for occasional consumer expenditures.¹⁰ With a HELOC, the consumer bears the closing costs only once, but then can borrow as frequently as desired by simply writing a check against the HELOC. Further, such loans are far less risky than uncollateralized loans, and, therefore, allow lenders to offer consumers a lower rate of interest. The growing availability of HELOCs greatly diminished the need to employ the collateral substitution ability provided by common bond lending, at least for consumers with home equity.

Credit Card Lending Use Expands

Credit card lending makes use of a cost savings similar to that provided by HELOC lending. Once the credit card lending arrangement is established, costs of drawing down the credit card line are minimal for the lender and for the consumer. The credit card company makes an initial credit decision, based largely upon information from credit-reporting agencies, on whether to grant a loan to a consumer, at what rate, and how large a line. The consumer is then free to draw on the line in whatever increments he or she chooses, and to pay it down over a period largely determined by the consumer.

Credit card availability grew rapidly following a 1978 Supreme Court decision, which allowed credit card lenders to avoid state usury ceilings (Athreya 2001, 11–15). Because credit cards offer low-transaction-cost lending, based on detailed creditworthiness information from the files of credit reporting agencies, credit card lending offered an additional strong alternative to common bond lending.

Credit Unions Receive Federal Deposit Insurance

The 1970 application of federal deposit insurance to credit unions also tended to undercut an advantage of common bond lending. Before federal deposit

¹⁰ Weinberg (2005) provides a thorough analysis of the growth in recent decades of consumer debt, the causes of this growth, and its consequences.

insurance was extended to credit unions, credit union members had reason to monitor one another's loan repayment. Any defaults increased the probability of the failure of the credit union and losses to its depositors. Sharing a common bond also meant that borrowers were likely to have frequent contact with one another and, therefore, the opportunity to bring pressure on delinquent borrowers. Additionally, frequent contact implies that a borrower might face significant embarrassment if he or she defaults.¹¹

But once credit unions gained federal deposit insurance, the incentive to monitor repayment was reduced. With insurance in place, members are protected against loss of principal and interest if a default or several defaults cause the failure of the credit union. If the default is too small to cause the failure of the credit union but leads to a reduction in interest payments, a competitive market for deposits means that members can simply shift their deposits to another depository, paying an unreduced interest rate.

7. CREDIT UNIONS EVOLVE

As the benefits of common bond lending declined for reasons discussed previously, the credit union industry moved in directions that tended to de-emphasize this form of lending. As long as common bonds were important to consumer lending, one would expect credit unions to operate with fairly small memberships in order to take advantage of the tighter bonds present in smaller groups. Once the advantage of the common bond is undercut, credit unions should tend to move toward the size of other depositories that are not focused on common bond lending. Further, one would expect credit unions to begin to place greater emphasis on other forms of lending. This movement is evident (1) in the growing average size of credit unions, encouraged to a degree by liberalizations that broadened the potential membership base of any given credit union, and (2) the move of credit unions into real estate, credit card, and business lending.

Common Bond Requirement Loosened

The strict common bond requirement for credit unions ended in 1982. In that year, the NCUA began to allow single credit unions to draw members from multiple groups. At the time, the failure rate of credit unions was at a historically high level. Failures were likely driven, in part, by the inability of credit unions to achieve diversification due to tight common bond membership limitations (Wilcox 2005, 1, 3). For example, a credit union with a membership

¹¹ Athreya (2004) finds evidence that fear of embarrassment or stigma remains today as an important incentive to repay. His finding contrasts with an often-cited view that the stigma has diminished.

comprised completely of employees of one firm is likely to face heavy losses if the employer goes out of business.

While in 1998 the Supreme Court determined that the NCUA had overstepped its statutory limits when it approved multiple groups for one credit union, this decision was nullified almost immediately by legislation. In 1998, shortly after the Supreme Court decision, Congress passed, and President Clinton signed, the Credit Union Membership Access Act, which authorized individual credit unions to serve multiple groups, within some restrictions. The credit union industry had lobbied aggressively for passage of this liberalization (Gill 1998).

The move to allow multiple groups along with mergers of credit unions, which were frequent in the 1980s, offered credit unions the opportunity to enlarge their membership base and size. As seen in the growth rates plotted in Figure 1, year-after-year growth in the average size of credit unions increased, in constant dollars, at historically high rates between 1982 and 1987, following the liberalization of membership requirements. Overall, average size increased from \$7.5 million in 1981 to \$77.7 million in 2005; though the annual growth rate after 1987 is about the same as it was before 1982.

In 1920, the average number of members per credit union was 200. By this measure, credit unions remained fairly small, even in 1960, with an average of 598 members per credit union. By 2005, the average credit union membership had risen to 10,000. Regarding lending decisions, there is probably little opportunity to use special knowledge gained from direct contact between members.¹² Further, it seems likely that embarrassment and social pressure will play a less important role in institutions with thousands of members than in small institutions in which members are known to one another.

Credit Unions Gain Mortgage Lending Powers

Federal credit unions gained the authority to make long-term (up to 30 years) mortgage real estate loans in 1977 with amendments made to the Federal Credit Union Act by Public Law 95-22. Before these amendments passed, federal credit unions were limited to providing short-term mortgage loans such as second mortgages and mobile home loans (Credit Union National Association 1978, 12).

State-chartered institutions in a number of states had this authority prior to 1977. Consequently, at the beginning of 1978, credit unions held \$2.55 billion in first mortgages, which accounted for 6.2 percent of all credit union

¹² Karlan (2005) finds that for members of a group-lending organization in Peru, loans are more frequently repaid by members of groups who live close to one another and who are more culturally similar. This result occurs because such individuals are better able to monitor one another.

loans. Since 1977, first mortgage real estate lending has grown in importance as a percentage of credit union lending. As of 2005, mortgages amounted to 32 percent of all loans (Credit Union National Association 2006). As common bond lending became less necessary, credit unions moved more extensively into real estate lending.

Growth of Credit Card Lending

Similarly, credit card lending has grown in importance for credit unions, so that today such lending accounts for a large percentage of all unsecured lending by credit unions. Approximately 54 percent of credit unions offer credit cards, and the percentage rises from very low at the smallest credit unions to 98 percent at the largest (Credit Union National Association 2005). Since this type of lending is most important for the largest credit unions, (those with the largest membership) it seems unlikely that common bond lending can play much of a role in this new category of credit union assets.

Expanded Business Lending

During the last several years, credit unions expanded their business lending significantly, doubling the amount of such loans over the three years before 2005 (Credit Union National Association 2006). Specifically, business loans increased from \$8.3 billion, in 2002, to \$16.9 billion, or 2.5 percent of credit union assets, in 2005. In comparison, in 2005, business loans accounted for 22 percent of total assets at commercial banks (FDIC 2005). Since these loans are typically collateralized and made for business purposes, they are beyond the historical credit union emphasis on uncollateralized consumer lending.

Still, the extent of business lending by credit unions is limited. The 1998 Credit Union Membership Access Act set limits on credit union lending to businesses. Specifically, the sum of all business loans of a federal credit union may not exceed 1.75 percent of its net worth or 12.25 percent of its total assets, whichever is the lesser (National Credit Union Administration 2004, Section 723.16).

8. CONCLUSION

Credit unions once focused almost entirely on small-value, unsecured consumer lending. Other depositories, specifically commercial banks, savings banks, and savings and loans, emphasized lending to businesses or making large-dollar-value consumer loans based on real estate collateral. For unsecured consumer lending, the credit union model of taking deposits from and lending to a tightly knit group of members of a community or organization

was an ideal business model in the early part of the 20th century, filling a niche in the marketplace at that time.

But the financial marketplace changed greatly in the second half of the 20th century. Computer databases and networks allowed the inexpensive collection and dissemination of consumer creditworthiness information. Home ownership spread and products developed that allowed consumers to borrow against their home equity for repeated small-value loans. Further, the availability and use of credit cards as a vehicle for unsecured consumer loans expanded immensely. The combination of these factors required credit unions to change as well.

Credit unions shifted away from their heavy emphasis on unsecured consumer loans into mortgage lending, other forms of collateralized consumer lending (such as auto loans), credit card lending, and business lending. Today, unsecured consumer loans account for only about 10 percent of all credit union loans. Auto loans are responsible for 37 percent, and mortgages comprise most of the remainder (Credit Union National Association 2005).

Additionally, while the very small credit union was well-suited to common bond lending, small size became less advantageous as common bond lending lost its advantage over the last several decades. Concurrently, the average number of members and size of credit unions increased significantly. Nevertheless, a large portion of credit unions remain quite small in comparison to commercial banks. By evolving with changes in the marketplace, the credit union industry remained healthy and grew, both in terms of dollar amounts and relative to other depositories.

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