Competitive Enterprise Institute
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Advancing Liberty – From the Economy to Ecology

November 2, 2007 **No. 124**

Let Credit Unions Grow

The Case for Expanding Field of Membership

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Introduction. When Americans deposit their paychecks, get loans, and make certain types of investments, they can visit either banks or credit unions. Banks are typically owned by stockholders. Credit unions always belong to their members. Although terminology differs somewhat—credit unions have "shares" rather than "deposits"—the two institutions offer a similar product lineup.

Credit unions, like banks, mediate financial transactions between savers and borrowers, although credit unions have maintained a relatively small market share. As Table 1 illustrates, credit unions' share of the consumer credit market peaked during the 1980s at about 12 percent, and since then has shrunk to just under 10 percent.

TABLE 1: Composition of the U.S. Consumer Credit Market

	1960	1965	1970	1975	1980	1985	1990	1995	2000	2005
Commercial Banking	43.14	46.41	49.1	51.23	50.69	49.82	46.34	43.00	31.65	30.56
Savings Institutions	3.27	3.08	3.29	4.88	6.39	9.68	6.02	3.43	3.72	4.72
Credit Unions	6.37	7.49	9.73	12.41	12.41	12.44	11.11	11.29	10.59	9.88
Asset-Backed Securities Issuers	--	--	--	--	--	--	9.30	18.24	30.35	26.13
Finance Companies	26.31	25.36	24.03	19.94	22.19	22.26	16.75	13.02	13.46	22.32
Other (a)	20.92	17.66	13.85	11.54	8.33	5.8	10.47	11.01	10.23	6.39

Note: Figures are percentages.
(a) Includes non-financial corporate business, federal government, and government-sponsored enterprises.
Source: Board of Governors of the Federal Reserve System, Flow of Funds Accounts of the United States, table L.222

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The two types of institutions compete (although Credit unions have a very modest market share) and, for years, they have competed in the political realm. The American Bankers Association, the nation's largest banking industry trade association, portrays credit unions as unfair competitors that act like profit-making companies, while they face far less regulation than banks., As the ABA argues on its website:[1]

> The once-familiar model of a group of people—typically brought together by their jobs—pooling their resources to promote savings and to make small consumer loans is threatened…[Credt] unions are full service, diversified, financial institutions serving hundreds of unrelated groups, as well as entire states. Even though many credit unions have strayed beyond their original mission, they are still afforded special treatment: federal tax exemption and exclusion from many of the regulatory responsibilities that apply to banks, such as the Community Reinvestment Act.

None of this is false on its face: Credit unions do enjoy these exemptions, and many operate in a very businesslike fashion. But, in fact, credit unions *are* different and, in important ways, *more* regulated than banks. They all operate on a non-profit basis—although nearly all retain earnings—and, at least in theory, return excess revenues to members—that is, their depositors—rather than distribute them to stockholders. While stockholder-owned banks respond only to their shareholders—which they are legally obliged to do—credit unions theoretically exist only for the benefit of their members. Credit unions, furthermore, face limitations on the interest rates they can charge, how they may spend their revenues, and, most importantly for this paper, whom they can serve.

Banks can serve anybody who walks in the door. Credit unions, on the other hand, can only serve members of particular groups. State laws define these in each state and two major types of groups exist under the Federal Credit Union Act:

1. Single common bond, based on occupation or association, such as, for example, all the employees working for General Motors;
2. Multiple common bond: These serve multiple groups (each with its own common bond) and confined within a reasonably small geographic area. For example, it a credit union could serve all employees of Microsoft in Washington, D.C. *and* all students at Washington, D.C.'s Georgetown University also located in Washington, D.C.
3. Community, based on a well-defined, geographic area.[2] Although a few credit unions operate statewide, most limit themselves to a city or county. Generally, someone must live, go to school, work, or worship in the community a credit union serves in order to join that credit union.

Today, field of membership is an historical anachronism—in the hands of regulators and bank lobbyists, it has become an effective way to shut out competition.

Why are credit unions limited in field of membership? Credit unions first developed in Germany in the mid 19th century as part of the larger socialist and religiously inspired movements toward labor organization and cooperatives.[3] They were seen as a way to help the poor gain access to credit at less-than-usurious interest rates.

Early credit unions had a variety of membership fields. The German liberal politician and reformer Hermann Schulze-Delitzsch founded the first credit unions, and did so without any formal limits on field of membership. However, these early credit unions faced natural restrictions of geography and transportation costs, in addition to a small membership fee and the cost of a share. Credit union entrepreneur Friedrich Raiffeisen largely copied this model, but preferred to restrict membership to the local parish. Canadian journalist Alphonse Desjardins set up the first credit union in North America in 1901 at Levis near Quebec. As he stated, "The main security is the fact that the association is working within a small area and that everybody knows each other." However, he pushed to include everyone in the surrounding area, both urban and rural.[4]

These early credit unions succeeded because membership and share ownership were economic innovations which provided a solution to the old banking problem of asymmetric information between borrowers and savers. Membership tightened the link between borrowers and savers, and share ownership made them residual claimants, giving them an incentive to monitor and improve each others' credit worthiness. This was facilitated by detailed information on members' saving patterns. Today, credit reporting agencies perform essentially the same task, which has made obsolete the need for a common bond or field of membership.

However government regulation still maintains limits on field of membership. The first credit union law in the U.S., enacted by the Massachusetts legislature in 1909, allowed, without limiting,[5] organizers to specify in their charter "conditions of residence or occupation, which qualify for membership." In 1934, the Federal Credit Union Act limited[6] membership in a federal credit union to "groups having a common bond of occupation or association, or to groups within a well-defined neighborhood, community, or rural district."

The economic downturn of the 1970s and early 1980s led the National Credit Union Association (NCUA) to loosen regulations on field of membership. In 1982, the NCUA started to allow multiple common-bond groups in the same organization, and began allowing credit unions to merge. This quickly transformed the industry; by 1996 more than half of credit unions had multiple-bond fields of membership.[7]

In 1998, after years of controversy between credit unions and banking interests over growing fields of membership, the Supreme Court interpreted the Federal Credit Union Act as limiting membership in a federal credit union to individuals sharing a single common bond. Later that year, Congress passed the Credit Union Membership Access Act (CUMAA), which allowed multiple common-bond charters but restricted community charters to a "well defined, local community, neighborhood or rural district." This has

allowed banking interests to successfully block membership expansion of both community and single common-bond chartered credit unions.[8]

Further, the ABA made a strong case that the language amending the 1998 Credit Union Act limited the addition of low-income groups to only those federally chartered credit unions with multiple common bonds.[9] Therefore, on 22, 2006, the NCUA relented, revising its field of membership regulations to allow only credit unions with multiple common-bond charters to expand into "financially underserved areas"—essentially those areas without a credit union.

What are the current proposals to relax limits on field of membership and how do they stack up? The inability to sufficiently define what it means to be local has effectively given the NCUA freedom to decide on a case-by-case basis, and to periodically adjust its definition in the Credit Union Chartering Manual.[10] A bill recently introduced in Congress, the Credit Union Regulatory Improvements Act of 2007 (CURIA, H.R. 1537), provides a more straightforward way to relax field of membership limits. It should help to reduce the uncertainty that has resulted from ambiguous language in CUMAA. It allows all credit unions, not just those chartered with multiple common bonds, the flexibility to expand membership.

In particular, the law would allow all Federal Credit Unions to add low income areas to their fields of membership, resolve certain logistical conflicts to make Credit union mergers easier, and make it somewhat easier for credit unions converting from common bond to community charters to keep groups that would be outside of their boundaries.

By expanding credit union field of membership, credit unions would get a critical freedom, enjoyed by virtually all other businesses to serve who they want. For credit unions same basic economic reasoning applies. First, there are evolving economies of scale caused by such factors as the fixed costs of setting up ATMs and electronic banking, or of attracting top managerial talent. It takes many members—that is, customers—to make such investments cost effective. The optimal number of members is best determined by credit unions themselves, since they have the best handle on cost conditions and the incentives to minimize those costs. Artificially limiting field of membership puts credit unions at a competitive disadvantage, since it prevents them from making large, fixed-cost investments.

Second, limits on field of membership prevent credit unions from diversifying risks, e.g. the risk of one employer or one local economy going belly up. It makes little sense to allow Bank of America, Citi, and the other mega-banks to pursue such diversification without allowing their competitors to do so.

CURIA also would increase credit unions' commercial lending authority and reduce their statutory capital levels, to which the ABA objects apparently for altruistic reasons:[11]

> This legislation will allow credit unions to divert financial resources from consumers they were chartered to serve by increasing their commercial lending authority and will make them more risky by reducing their statutory capital levels.

It is more likely that the ABA opposes CURIA because it means that banks have will have to compete more openly with credit unions. This is the sort of competition that reduces costs and improves quality for the consumer. The best way to make credit unions less "risky" and more stable is to allow them to diversify their risk by expanding membership and to supplement their revenue with commercial lending. Some credit unions may, of course, continue to have limited fields of membership—in fact, it is likely that most will, but it should be a competitively determined matter.

Banks have a right to compete with credit unions on a level playing field. However, in some respects, the playing field is not level now. Banks should strive to reduce their own regulatory costs rather than increase those of their competitors. In particular, banks should push to reduce the corporate income tax and eliminate costly regulations such as the Community Reinvestment Act. Banks and credit unions perform too vital an economic function for either to be burdened with unnecessary regulation.

Notes

[1] http://www.aba.com/Industry+Issues/Issues_CU_Menu.htm

[2] This comes from the National Credit Union Administration's *Chartering and Field of Membership Manual*, dated March 2003, chapter 1, page 1, and chapter 2.

[3] J. Carroll Moody and Gilbert C. Fite, *The Credit Union Movement; Origins and Development, 1850-1970* (University of Nebraska Press: Lincoln, 1971), chapter 1.

[4] *Ibid*., chapter 1.

[5] *Ibid*., chapter 2, especially page 39. Also, see Frank King and Aruna Srinivasan, Credit Union Issues. *Economic Review*, Federal Reserve Bank of Atlanta, July 1, 1998.

[6] See Section 9 of the 1934 Federal Credit Union Act.

[7] Frank King and Aruna Srinivasan, Credit Union Issues. *Economic Review*, Federal Reserve Bank of Atlanta, July 1, 1998.

[8] See the ABA's website for a list of past and pending lawsuits: http://www.aba.com/Industry+Issues/Credit+Union+Information.htm

[9] This is in a comment letter to the NCUA dated July 5, 2007, which can be found on the ABA's website at: http://www.aba.com/NR/rdonlyres/89635B44-3A9A-407C-A921-1731DDAF595C/48776/FinalNCUAOperations20070705.pdf

[10] Currently, the Manual treats a single political jurisdiction, such as a city, as a presumptive local community regardless of the size of the population or land area served. The NCUA is proposing to modify the Chartering Manual to treat statistical and rural areas as local, well-defined communities. Despite a lengthy definition of "statistical area," this proposed change does little to clarify what it means to be "local and well-defined," a goal which remains elusive nearly ten years after the passage of CUMAA. Perhaps CUMAA, and particularly the whole feasibility of placing geographic limits on field of membership, should be reconsidered.

[11] http://www.aba.com/NR/rdonlyres/89635B44-3A9A-407C-A921-1731DDAF595C/48006/HouseMemoreCURIA031507.pdf