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Let Credit Unions Lend More

A Modest Proposal to Increase the Availability of Capital to Small Business

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All economic choices involve the weighing of costs and benefits. And when it comes to economic stimulus spending, the costs can often prove particularly high. Spending tax money on government programs involves redistributing wealth from those who create it to government planners who believe that they can make a better use of it than can private citizens. Unless the planners make consistently better choices than those arrived at through the accumulated wisdom of the free market, such spending will undermine the economy's overall performance and efficiency.[1] Thus, politicians who peddle economic stimulus packages claiming that they bear little or no cost should be met with skepticism.

Yet there is one stimulus measure that can yield tangible benefits at practically no cost: deregulation of credit unions to make it easier for them to lend to businesses. The current shortage of business capital is the single most pressing factor facing the nation as it attempts to recover from a recession, so any measure that increases lending to any extent deserves consideration. This paper explains the structure and functions of credit unions and makes the case for expanding credit union business lending, which would unlock otherwise idle capital and thereby help create jobs, especially in areas that have difficulty receiving bank credit.

Credit Unions and Business Lending. Credit unions perform many of the same functions as banks. Although they use different terminology—a product equivalent to a bank savings account is called a "share account" at a credit union—they offer a financial services mix similar to that of a bank. Consumers can go to credit unions for checking and savings accounts, loans, credit cards, and a range of other financial services. However, credit unions differ from banks and thrifts (hereafter referred to jointly as banks) in three major ways.

- First, unlike banks, which can serve anybody they want, credit unions have a defined "field of membership." Most started out as institutions for employees of a specific company or for members of an organization, and many still operate that way. Some,

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defined as "community" credit unions, can serve anybody who lives, works, attends school, or worships in a defined area—typically a city or county.

- Second, credit unions face more regulation than banks, on balance. They deal with more and greater restrictions on to whom they can lend, the types of loans they can make, and the interest rates they can charge.
- Finally, credit unions operate as democratically governed non-profits. Although nearly all retain some earnings in order to grow, they are theoretically guided only by member interest and do not concern themselves with stockholder value.

With a few minor exceptions, credit unions do not typically seek or receive donations and, for the most part, have to make it as businesses in a competitive marketplace. Nonetheless, they enjoy non-profit status and do not pay federal income taxes. Because of their small size—they collectively control only about 6 percent of American deposits—most operate under reasonably conservative guidelines and rarely make the riskiest types of loans.[2] Consistent with this conservative tendency, many make relatively safe loans that offer a miniscule return on investment—loans which bank stockholders might consider a poor deployments of resources.

In all their activities, credit unions operate under more restrictions than banks. The restriction at the center of this paper involves business lending: Credit unions are limited to lending 12.25 percent of their assets to businesses.[3]

Credit unions lend mostly to small businesses. In fact, the typical credit union loan used for business purposes does not even count as a business loan under current government record keeping standards. Under current federal regulations, loans of less than $50,000 secured by a family's primary residence—or meeting a few other tests—get tallied as personal loans even when used for business purposes. Only 14 percent of all credit unions make any loans that are officially considered "business loans" at all.[4] Roughly 70 percent of all credit union business loans fall into the Small Business Administration's definition of "micro loans"—loans under $100,000.[5]

As things stand now, these small loans—by definition, suited only to the smallest of businesses—appear likely to continue to make up the great bulk of credit union business lending for the foreseeable future. And the total percentage is small—credit union loans currently total about half a percent of all business loans[6] and are concentrated in a few relatively limited economic sectors.[7]

Only a handful of credit unions—about 100 around the country—have the capacity to make large business loans while still maintaining a properly diversified overall lending portfolio. The average credit union has total assets of about $90 million and a roughly $11 million cap on overall business lending under the 12.25-percent cap.[8] However, since the presence of a few large credit unions drives up the average asset figure—the median credit union has less than $13 million in assets—the majority of credit unions do not have the means to make *any* large loans to *anybody.*[9] Because of their modest size, most credit unions that do any business lending must focus on small business—which is where they can do the most good.

Unlocking Capital. Restrictions on credit union business lending derive from credit unions' history as small, community-based organizations that could not wisely risk large amounts of money on a single loan. Today, such restrictions are obsolete, because credit unions use the same risk management tools as banks. Credit union members, including corporate members, should not face unnecessary impediments to getting any credit union product they want. And, in a time of economic recession, repealing the restriction—or at least raising credit unions' business lending ceiling—could provide needed new capital for American small businesses.

The amount of new capital injected into the economy would depend on market demand for loans, credit union lending standards, and the exact nature of deregulation. A proposal introduced during the 110th Congress, the Credit Union Regulatory Improvement Act, would have raised the cap from the current 12.25 percent to 20 percent.[10] In theory, this would have made available an additional $4.5 billion in business capital by increasing the cap on the average credit union's loan from about $11 million to about $18 million.

Of course, lending would expand by less than the total capacity allowed. Most credit unions do not make any business loans at all, and not all credit unions which expand lending will expand it by the full amount allowed. Therefore, to further increase the amount of capital available to small businesses, Congress should move to allow credit unions to serve larger membership groups, including more businesses. Doing this would likely increase credit unions' total stock of capital, yielding them more money to lend and to bolster their own stability.

Yet whatever Congress does, businesses are certain to have more credit available to them if the government were to allow credit unions to provide it.

Creating New Jobs—and New Entrepreneurs. Expanding credit union business lending would also allow new entrepreneurs to venture into new—often undercapitalized—sectors. Currently, the businesses most likely to borrow from credit unions are those which traditionally have had the most difficulty getting credit from banks or other financial institutions. Nearly half of credit union business lending goes for things that do not interest most banks. These include things like loans for taxicab medallions and small organic farms—thinly traded assets that are difficult to appraise, and thus use as security, without the sort of industry insider knowledge which credit union officials are more likely to possess.

Credit union business lending likely will continue to thrive in these niches and others when and if restrictions on lending get lifted, but credit unions' greater ability to lend will enable them to capitalize other, more traditional sectors, as well.

With more investment capital, businesses that receive credit union loans will create jobs. The results could prove significant. As so many banks face severe, even existential, threats, they are likely to cut back on the types of loans which require the most specialized, focused, and difficult lending criteria—exactly the type of loans that credit unions disproportionately finance today, and for which they could fill the gap in the future.

No Cost to Taxpayers. Best of all, expanded credit union business lending will have not cost taxpayers. It requires no government subsidy, no bailout, and no interference—only a regulatory change to let credit unions do what their members want them to. And it is certain to help expand credit. While the billions of dollars spent on various bailouts have not served to stabilize the banking system or bring about a full-scale resumption in business lending, a repeal or easing of caps on credit union business lending would serve to unlock some new investment capital.

The two frequently mentioned potential downsides of expanded credit union business—increased inflation and decreased credit union solvency—appear of minor importance.

- First, more credit union lending will expand the money supply and, absent gains in productivity, could push up inflation. But given that the nation currently faces a bigger threat from deflation, this concern appears trivial in the current context.[11]
- Second, more business lending will tend to diversify credit union risks and therefore make them *less* risky on balance, thus boosting their solvency, making them safer places to keep deposits. Their low default ratios relative to banks show that, on balance, credit unions are conservative in their lending practices.[12] Loan risk diversification will help make them even more stable.

Conclusion. Expanding credit union business lending would yield economic stimulus at no cost to taxpayers. By freeing up capital for small businesses, it would send more money flowing through the economy and create jobs. The higher Congress raises the cap on credit union lending, the more capital it can unleash. Of course, credit union deregulation is but a small step to getting the American economy growing again. But given the current need for capital for businesses of all sizes, deregulation of credit union business lending can only prove beneficial.

Notes

[1] For more on this, see Wayne Crews. "Still Stimulating Like It's 1999: Time To Rethink Bipartisan Collusion on Economic Stimulus Packages," *Issue Analysis* 2208 No. 1, Competitive Enterprise Institute, February, 2008, http://cei.org/cei_files/fm/active/0/6425.pdf.

[2] American Bankers Association, "Operations Credit Unions: Oppose Credit Unions' Continued Growth," http://www.aba.com/Industry+Issues/OperationCreditUnions.htm.

[3] Credit Union National Association, "Member Business Lending," http://www.cuna.org/gov_affairs/legislative/issues/2008/curia_tp_mbl.html

[4] Department of the Treasury, "Credit Union Member Business Lending," January 2001, P. 10.

[5] Ibid, p. 26. Although personal residences are used as collateral, these loans are officially tallied as business loans and the borrowers tell the credit unions that they intend to use them for business purposes.

[6] Small Business Administration, Office of Advocacy, "Small and Micro Business Lending: 2004-2005," December 2006, and U.S. Department of the Treasury, pp. 3 and 37.

[7] For more on this, see Eli Lehrer, "Taxicab Medallions and Heirloom Tomatoes to the Rescue: How Expanding Credit Union Lending Can Help Small Businesses Survive the Credit Crunch," *OnPoint* No. 121, Competitive Enterprise Institute, September 18, 2007, http://cei.org/pdf/6139.pdf.

[8] Credit Union National Association, "Frequently Requested Bank/Credit Union Comparisons," http://advice.cuna.org/download/freq_compar.pdf. It is worth noting, of course, that no prudent lending officer capable of making $10 million in loans would offer a $10 million loan (or, in all probability, a $1 million loan) to anybody.

[9] Credit Union National Association, "Size Doesn't Matter in a Credit Union Being a Credit Union," http://cuna.org/download/ra_cu_size_analysis.pdf

[10] H.R. 1537 (2007). Sec 201.

[11] Tom Petruno, "Investors brace for risk of deflation," *Los Angeles Times,* November 1, 2008.

[12] Credit Union National Association,"CU360: Default Ratios and Spreads," Fourth Quarter, 2008, http://cu360.cuna.org/static/op_ratios_spreads.html