CREDIT UNIONS: WHAT LIES AHEAD?

Kevin Davis

Senior Lecturer
Economics Department,
UNIVERSITY OF ADELAIDE

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The age old question of man's evolution is currently in the headlines with the challenge in the U.S. courts over the right of religious fundamentalists to have their views represented in school curricula. My task here is not to address so grand a question, but does involve evolution - that of the Australian financial system and the place of credit unions within that system. Religious issues are not, I hope, of relevance, but the issues of survival of the fittest and cooperation among members of the species clearly are relevant.

While I have no fully worked out theory of evolution in financial markets to offer you, let me outline the factors which I see as important determinants of the evolutionary process. First (although they are not in any order of priority) there is the changing needs of the customers of the financial system which, when recognized, induce financiers to adopt new methods and forms of organization. Second, there are innovations by financiers which fulfill previously unrecognized needs or better fulfill existing needs, innovations which can be marketed by advertising designed to create new needs, or those which can effectively be forced upon customers because of monopoly power. Third, there is the influence of government, both intended and unintended. The unintended influence stems from government policies which, although with other objectives, have the byproduct of inducing changes in the structure of the financial system. As an example, I would refer to the gradual decline of the banking sector, attributable in part (but only in part) to the plethora of controls developed for the purposes of stabilization. The intended influence is, I think, well illustrated by the existence of the current Australian Financial System Inquiry.

It would be foolhardy of me to attempt to 'second-guess' the forthcoming

recommendations of this Inquiry and their likely impact on credit unions. Economists have enough trouble predicting individual behaviour, let alone that of a committee. Moreover, as we have seen far too often recently, governments are hesitant about accepting the advice of the expert committees they have established for that very purpose.

I shall, therefore, concentrate on those other determinants of evolution outlined above, although I am unable to resist the temptation to engage in a bit of 'second-guessing' about the likely 'tone' of the Inquiry's recommendations and the consequences thereof. Before stepping into the unknown future, however, let me take a step backwards to examine the place of credit unions in the recent past.

1. The Battle for the Household Market

Commonsense tells us that institutions which accept interest bearing deposits can only survive if they are able to find remunerative outlets for the funds so acquired. (I hesitate to use the word profitable because of the non-profit orientation of credit unions). On both sides of this process (of taking deposits and making loans) credit unions are in competition with other financial institutions, with the process of direct financing (lending and borrowing which bypasses financial institutions), and in some cases with the government.

This competition takes many forms, the most obvious of which is that involving interest rates paid and charged. However, because credit unions are in the business of dealing with individuals, other forms of competition assume major importance. Here I would refer to such things as convenience (or ease of access), advertising, and trust (both in the safety of one's accumulated savings and in the validity of information provided by institutions).

You are all, no doubt, aware of this competition. Indeed, it seems impossible to escape from it. What I would like to do here is to assess how the battle has gone in recent years. In doing this, I must emphasise one important point. What is relevant is not how trading banks, for example, have performed overall relative to institutions such as credit unions. The trading banks also service business, and the relevant comparison is thus the one involving only the household business of trading banks. Put more generally, comparisons of the aggregate growth of financial institutions may hide the underlying developments in the various sub-markets in which they compete.

Figure 1 provides a partial picture of how alternative competitors for the household sector's accumulated savings have fared since 1967. It is (I believe) illuminating although it is incomplete because of the omission of several outlets for household savings. Three major omissions stand out, and it seems worth commenting on each before examining the picture in detail.

Households' investments with life offices and pension funds are omitted, partly because of problems with interpreting the figures,[1] and partly because these assets are of a qualitatively different nature. Given the long term, contractual nature of these investments and their insurance component, they should be seen as competing with the group considered in Figure 1 as a whole rather than with any individual institution considered here.[2]

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1 The data problem arises because of the existence of accumulated bonuses which may not be fully available if the policy holder decides to terminate the contract.

2 Moreover, their long term growth is likely to be more closely related to income growth than to that of household financial wealth which is the major proximate determinant of the growth of the assets considered here.

It is generally well known that life office and pension funds have been fighting a losing battle for the household dollar. How badly the fight has gone can be appreciated by noting that in the three years commencing June 1967 payments to these institutions constituted 15.4 per cent of the household sector's acquisition of financial assets. In the three years commencing June 1975 the corresponding figure was 7.7 per cent - exactly one half.

A second omission from the figure is the holding of shares and debentures of business companies by households. Again, this reflects data problems but we may note that over the period being considered households have generally been net sellers of such securities.

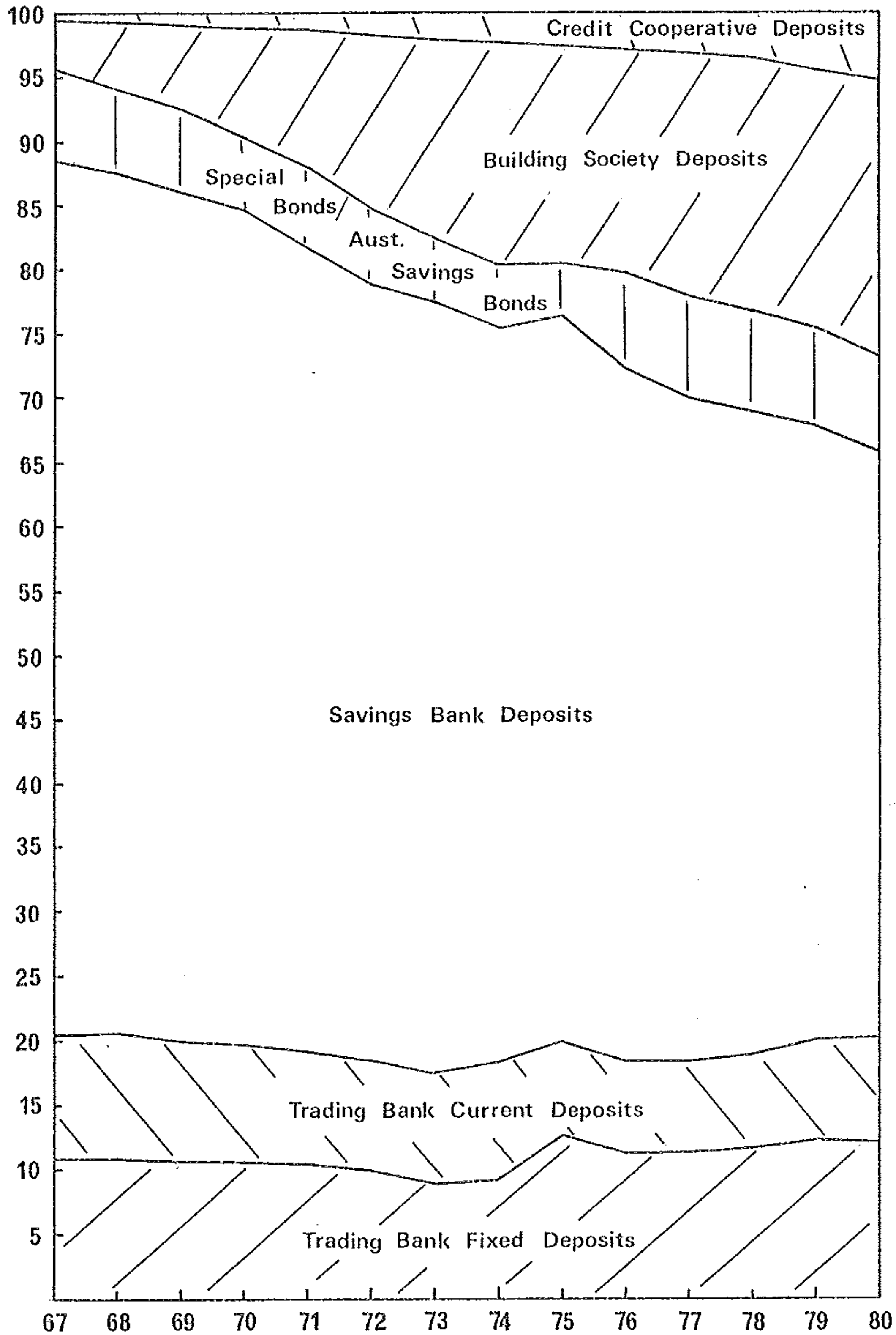
The third, and most serious, omission is that of household investments with finance companies. The data is simply not available, but some rough calculations (based on a number of heroic assumptions) suggest to me that while finance companies have done better than the banks, they have not done as well as the cooperative institutions. Consequently, I do not think the overall picture given in Figure 1 would be much changed if we were able to include the finance companies.

The outstanding feature of Figure 1 is the way in which building societies and credit unions have eaten away at the savings banks' share of the market. Most observors of the financial system attribute this to government regulation of the savings banks which prevents them from competing effectively. I suspect that this is partly the case, but I would point out that the interest rate margins of the banks are also consistent with their privileged position leading to organization slack and/or making excess profits. It is hardly surprising in such circumstances that their share of the market has declined.

FIGURE 1

THE BATTLE FOR HOUSEHOLD SAVINGS

Percentage Distribution of Household Assets Between Selected Groups.



<u>Source</u>: *Reserve Bank*, Statistical Bulletin
Statistical Bulletin - Flow of Funds Supplement

Budget Papers, Government Securities on Issue.

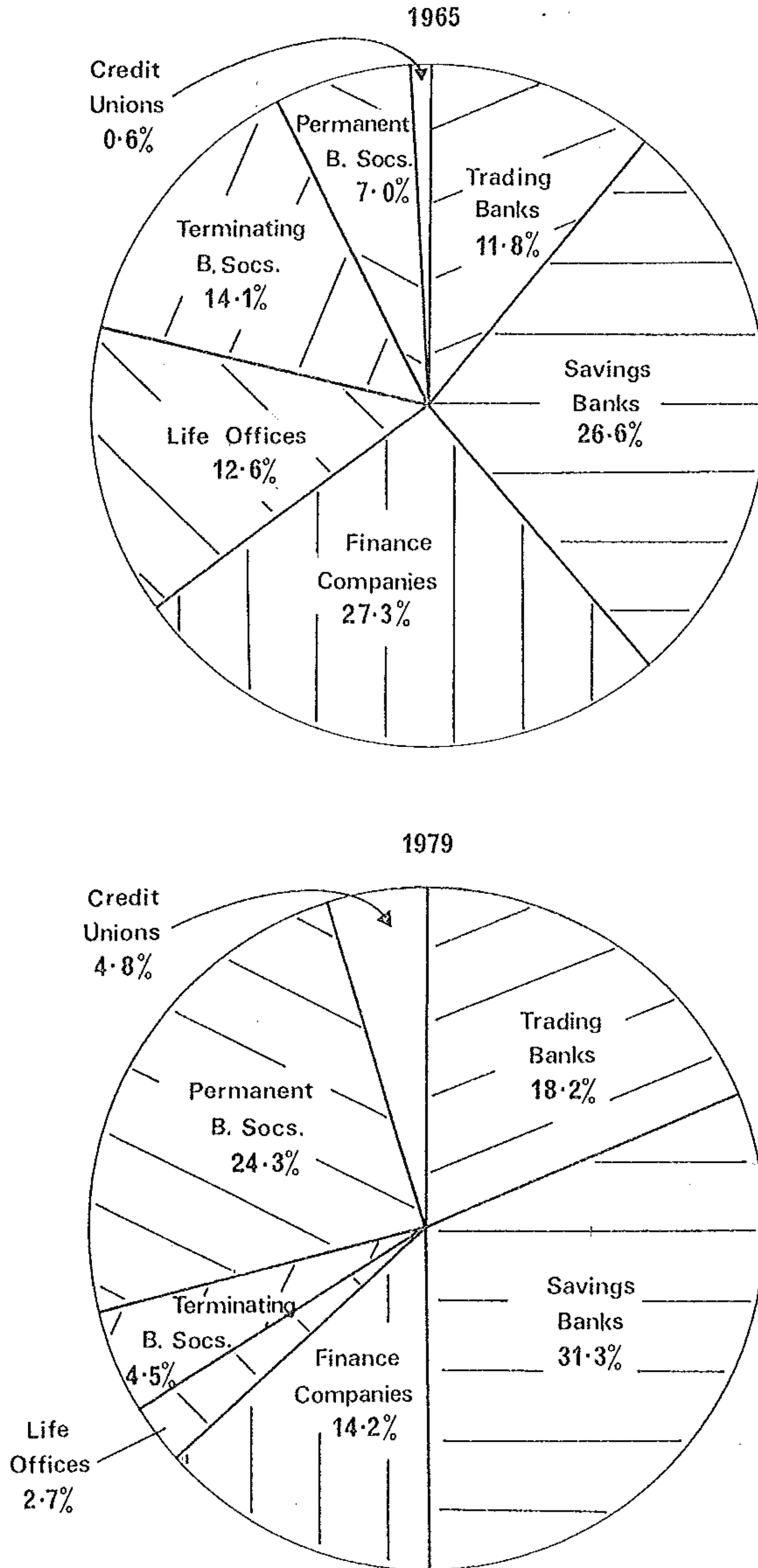
Another feature of Figure 1 is the sharp changes in the relative shares of trading bank fixed deposits and government debt in the mid 1970s. As you will see from Figure 3, these changes coincided with sharp changes in relative interest rates and, while it does not prove the point, the coincidence is consistent with the view that households *are* responsive to interest rate changes. The fact that interest rates vary markedly between institutions *does not* indicate a lack of responsiveness, but simply that the other factors mentioned earlier (such as convenience) are important.

Figure 2 shows the change in the distribution of household debt outstanding to selected institutions between 1965 and 1979 and some marked changes are apparent. First, the demise of the terminating building societies is apparent. They appear to be a group unable or unwilling to adapt to evolution. Second, the life offices have decreased substantially in significance as lenders to the household sector. In part, this reflects their relatively slower growth rate over the period being considered, but is primarily due to their decreased involvement in lending in housing. Third, savings banks have captured a larger share of the market, a fact which may appear surprising in the light of their relatively slow growth. However, successive reductions in their L.G.S. requirement have enabled them to allocate a larger share of their assets to lending to households.

Other features of Figure 2 which seem worthy of note include the increased importance of the trading banks and the diminished role of finance companies. The former can be traced to the growth of personal loans and bankcard lending, but the latter is less easy to explain. In part, I suspect, it may reflect decisions by the bank holding companies to concentrate lending to individuals in their banking rather than finance company subsidiaries. The other feature of note is, of course, the

FIGURE 2

THE DISTRIBUTION OF HOUSEHOLD BORROWINGS: DEBT OUTSTANDING TO SELECTED INSTITUTIONS



Source: Australian Financial System Inquiry, Interim Report, Table 2.2.

increased share of permanent building societies.

Among this welter of changing market shares, what has happened to the place of credit unions? Clearly they have captured a much larger market share both in terms of borrowing from and lending to the household sector. Indeed, their growth rate, in terms of total assets has been consistently in excess of 30 per cent per year throughout the 1970s - an impressive record. Currently they appear to undertake about 5 per cent of borrowing from and lending to the household sector. Yet, some 8 per cent of the population are members of credit unions (and the percentage would presumably be much higher if we considered only adults), raising the question of why the share of financing is not higher. One explanation might be that credit unions cater primarily to the less wealthy sector of the community but, while this might please the founding fathers of the credit union movement, I do not think it is necessarily the case. Rather, the discrepancy reflects the fact that households, including credit union members, do not generally place all their eggs in one basket. Credit unions must not only attract members if they are to grow, but must also compete with other institutions for a larger share of their members' savings and borrowings.

Since the credit unions' market share is currently much the same as that held by permanent building societies in the late sixties, it is tempting to ask whether we might expect a similar pattern of growth to occur. Although this preempts my later discussion, let me indicate some of my doubts about such a scenario. First, permanent building societies have achieved such growth largely by the expansion of existing societies rather than by the growth of new societies. This path to growth seems barred to the credit union movement as long as the common bond of membership criterion (which limits membership of any individual union) is maintained. Moreover, if the cooperative spirit is to be maintained this path should not be trodden since,

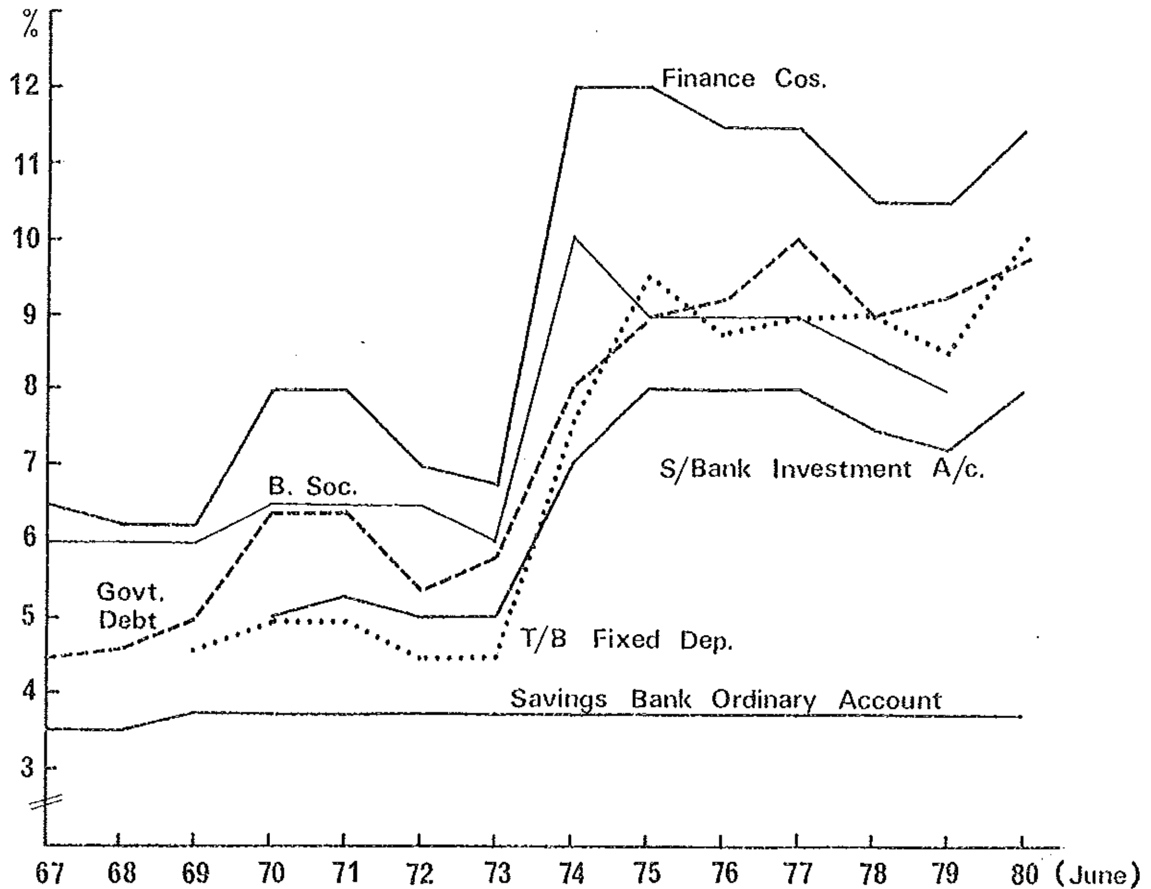
in my view at least, the permanents have achieved growth at the expense of becoming cooperative in name only.

My second reason for doubt stems from the changed financial environment existing as we enter this decade. It is far easier to achieve an increased market share in an expanding market and in an environment where competitors are prevented by regulation from (or unwilling to) freely adjusting interest rates. Both these aspects of the Australian financial system are, I feel, somewhat changed. Figure 3 presents interest rates for some of the competititors for household savings and it is noticeable that until the mid 1970s there was little change in the structure of relative interest rates. Since then there has been greater variability, and recent government measures have led to even greater scope for interest rate competition. These doubts do, however, need to be interpreted, in the context of ignorance about the likely recommendations of (and government response to) the Campbell Inquiry.

Of course market shares are not everything. An important (and related) issue is the yield differential between borrowing and lending rates of financial institutions. Since this differential reflects the efficiency of financial institutions, their degree of monopoly power, and elements of taxation, it would seem a safe generalization to argue that the lower is this differential, the better it is from society's viewpoint. Given their overall objectives, credit unions can be expected to aim to minimize this differential for the benefit of their members. Unfortunately, sufficiently detailed figures are simply not available to enable the relevant comparisons to be made, particularly when it is remembered that the yield differential is likely to vary when different amounts of maturity transformation are undertaken by different intermediaries.

FIGURE 3

INTEREST RATES FOR HOUSEHOLD SAVINGS



NOTES

T/B FIXED DEP. - maximum rate on 12 month fixed deposit at major trading banks.

S/B ORDINARY A/C - predominant rate on accounts < $4,000.

FINANCE COS. - maximum rate on 2 year debentures with trading bank affiliated finance companies.

B. SOC. - deposit yield - N.S.W. building societies.

GOVT. DEBT - yield on Special/Australian Savings Bonds.

Source: *Reserve Bank:* Statistical Bulletin
Australian Financial System Inquiry, Interim Report.

2. Some Inherent Conflicts

Before proceeding to consider what lies ahead, it seems appropriate to address some basic philosophical issues which confront the credit union movement in its quest for survival in the modern financial system. The self help orientation and communal ownership nature of the credit union movement are, in my view, admirable, but may conflict with the operating practices needed for the viability of credit unions. These conflicts arise because of the interdependencies within the financial system and, as the system evolves, new conflicts are bound to arise. Moreover, unless institutions adapt to the new environment they are doomed to extinction. Witness the demise of terminating building societies illustrated in the diagrams of the preceding section.

(a) *Self Help and Government Involvement*

The rationale for self help credit institutions lies in the existence of percieved deficiencies in the services provided by institutions dominated by the profit motive. That, however, is not sufficient since such deficiencies may be rectified by government action.

The very concept of self help raises connotations of independence from government involvement. In practice such independence is impossible, if only because government intervention in other parts of the financial system impinges on credit unions. The figures presented in the previous section indicate how credit unions are competing with other financial institutions, and competing well because of their inherent advantages in some areas. It would, however, be 'ostrich-like' to believe that these advantages will necessarily survive or that they are sufficient to offset disadvantages in other areas.

In particular, I would single out the issues of depositor and borrower protection. On the latter score, credit unions would seem to have an inherent advantage in presenting an image of 'truth in lending'. It is difficult and costly for individuals to obtain the information required to make rational decisions about borrowing costs. One can, hopefully, feel confident that one's own institution won't engage in 'rip-offs', thus saving a lot of time which would otherwise be spent in obtaining information. Governments can legislate against undesirable practices, such as hidden charges and concealment of the 'true cost' of borrowing, but, as the recent fiasco on taxation indicates, it is hard to close all the loopholes. Far better be it that institutions who adhere to socially desirable practices be allowed (and encouraged) to grow so that their competition keeps the others honest.

The conflict I see existing arises from government programmes which ensure depositor protection at other financial institutions. This advantage of a government 'stamp of approval' is undoubtedly a significant influence on competitive ability and raises a dilemma for institutions with a self help orientation. The temptation exists to petition governments for equivalent treatment but, in doing so, independence is threatened because of the government's quite justifiable demand for some *quid pro quo*.

The alternatives are to ignore the problem, or to devise some industry based scheme for depositor protection. The former approach would, I believe, stultify the growth of credit unions although it may be argued that the record indicates no need for extra schemes for depositor protection. Unfortunately, it is not the truth but rather the public's perception of the truth which is important, and the phrase 'government guaranteed' does have a certain appeal to the household saver. Perhaps a feeling of membership may encourage

confidence in the safety of cooperative institutions and offset this advantage, but I have my doubts. More importantly, confidence is a fickle phenomenon and doubts following the failure of one institution can be highly contagious.

Following this argument through, I am led to the conclusion that the only viable response fully consistent with the self-help/independence orientation is that of an industry based voluntary deposit insurance scheme. Whether this is the best response is another question - insurance schemes raise some tricky problems, not least of which is a desire of the insurer to have some control over the actions of those insured. In the context of a scheme run by credit unions themselves, each contributing credit union has an incentive to vote for rules which limit the independence of other contributors, in order to safeguard the viability of the scheme.

Which path should be taken is not for me to say. I merely stress that continued independence and continued growth may raise inconsistencies between philosophy and practicality which require some difficult decisions.

(b) *Growth versus Identity*

It is only natural for credit union managers and committee members to see growth of their own union and of the movement as a whole as an important objective. While growth could be consistent with other objectives of the movement, I suspect that it, in practice, it is likely to involve changes in the nature of credit union operations.

The reason for this stems from my earlier remarks about credit union members also being customers of other financial institutions. Consequently, credit unions must offer and charge interest rates on terms as good or

better than those of other institutions in order to acquire the business of members. At the same time, they must adjust borrowing and lending rates to members in such a way as to ensure sufficient outlets for the funds deposited with them. However, such adjustments impinge on the size of business of the credit union and the problem is particularly severe for those unions whose members have a strong propensity to save. Faced with few demands for loans from members and a large supply of funds, the appropriate response is to lower interest rates - thereby encouraging more members to borrow, but at the same time causing members to transfer some of their deposits elsewhere.

I doubt that such a response, which reduces the size of the credit union, is the one most preferred by managers or members. The alternatives are twofold. Either, new members desirous of borrowing must be found (and this alternative is limited by the requirement of a common bond), or new outlets (other than loans to members) must be found for members' funds.

The latter response of finding new outlets for funds is, I feel, the only one consistent with maintenance of the common bond element and sustained growth of credit unions (and, I would note, was recommended by the 1971 U.S.A. Report of the Presidents' Commission on Financial Structure and Regulation). Perhaps this can be achieved within the movement by transfers of funds between credit unions. Alternatively, credit unions will need a greater range of allowable investments and, while this can benefit members, it involves a blurring of the distinction between them and other financial institutions.

Again, I offer no solutions, but simply emphasize that a choice between growth and identity may be necessary.

(c) *Cooperatives and the Transfer of Wealth*

For cooperative financial institutions to survive, it is necessary that they accumulate reserves to meet possible losses and insolvency. In effect, these reserves act much like the shareholders' funds and reserves of a profit making concern, but are different in one crucial respect. Shareholders wishing to sever their connection with a corporate body will receive compensation for their past sacrifices of dividends in order to build up reserves, since the value of these reserves will be reflected in share prices. For members of cooperatives, however, there is no such mechanism whereby their share of the accumulated wealth of the cooperative can be transferred.

Perhaps this is a relatively minor issue, but it does have one implication which concerns me. Because of this non-transferability of wealth, members of cooperatives may vote for their institution to operate with lower reserves than would shareholders of a comparable corporate institution. While both groups will wish to avoid the risk of the institution becoming insolvent, the cost of avoidance is less in the corporate case. Consequently we might expect cooperatives to operate with lower reserves and be more 'risky' ventures than comparable corporate institutions.

In practice, other factors may offset this potential for higher risk. The common bond of association may reduce the level of default risk, professional managers will undoubtedly have a different perspective from members on the level of adequate reserves, while in cases such as that of building societies and mutual life offices the wishes of members seem to have little (or no) influence on managerial decisions.

3. The Decade Ahead

Attempts to forecast future events are fraught with danger. In fact, the only forecasts in which I feel much confidence are that things will be different and that those of us surviving will be older (if not necessarily wiser). Nevertheless, past events can provide some guide to the likely course of evolution of the financial system, and it is to some (hopefully) educated guesses about future prospects that I now turn.

(a) *Technological Advance and the Financial System*

Recent and expected advances in communication and information systems raise the possibility of quite marked changes to the financial systems as we now know it. Of particular interest is the emergence of electronic funds transfer systems (E.F.T.S.) which threaten to revolutionize the payments system by rendering cheques largely obsolete.

The emergence of such systems raise quite difficult issues for public policy, for while they can create great benefits for society (just as did the earlier emergence of bank cheques as a means of payment) the problems of ownership and access are enormous.

There is, I think, little doubt that the emergence of one unified system is in society's best interests (if not inevitable) since, while the operating costs are minimal, the set up costs are very large. The problem which arises is that those financial institutions with direct access to such a system (and possibly control of it) will gain a distinct advantage over those with no access. It is not a new problem, for banks currently possess an advantage over other institutions via their provision of the payments mechanism, but is a problem of much greater magnitude.

Other institutions have, in the past, been able to compete with banks for two reasons. The first is the government regulations which have inhibited banks from undertaking particular activities and so preventing them from utilizing this advantage to its fullest extent. The second, is that other institutions have been able to offset their disadvantage in this sphere because of other advantages such as convenience and ease of access for their customers. A full scale E.F.T.S. system may render such advantages almost worthless, since remote access via telephone makes physical location largely irrelevant.

The issues involved require far greater consideration than I have yet been able to give them, but my reactions at this stage are the following. First, E.F.T.S. is a matter for public policy and should not be left to emerge as a result of décisions by the private sector (e.g., the banks). I adopt this view, in part because the payments system is at the heart of our economy (and society), but mainly because the innovations required involve cooperation between the institutions involved, and, as Adam Smith writing in 1776 remarked,

> "People of the same trade seldom meet together, even for merriment and diversion, but the conversation ends in a conspiracy against the public, or in some contrivance to raise prices".

Second, the chòice for public policy would seem to be between allowing fairly liberal participation of financial institutions in the E.F.T.S. system, or restricting the other activities of those few permitted to participate.

These, I would stress, are my initial reactions to the issue, but it seems apparent to me that the future evolution of the financial system, and the role of credit unions in that system, depends heavily on this issue. It is to be hoped that the call by A.F.C.U.L. for a national

approach to the issue (in its submissions to the Campbell Inquiry) are heeded.

One other aspect of the technological advances in information and communication warrants mention. Over time we have seen a growth in intermediation vis a vis direct financing; a phenomenon normally attributed to the ability of financial intermediaries to pool risk, to their ability to undertake maturity transformation, and to their superior ability to gather information. Is it possible that the advent of the home computer will enable households to become as well informed as to outlets for their savings as the institutions who currently receive these savings? The advances in information and communication systems may enable borrowers and lenders to more easily come together directly, thereby reducing the advantages possessed by intermediaries. Should this occur, we may see some retarding of the growth rates of all financial intermediaries.

(b) *Sources of Growth*

The preceding discussion leads into the question of the likely growth of the financial system overall and for credit unions specifically. While growth of the system *in toto* is linked to the borrowing and lending decisions of the various actors on the economic stage, the growth of any individual sector is not so constrained. For example, I would be surprised indeed if the growth rates recorded by the permanent building societies and credit unions in the 1970s only reflected new savings by members. Undoubtedly much of the growth is attributable to decisions to transfer accumulated past savings from other repositories to these institutions.

With the greater liberalization of interest rates resulting from

recent government decisions, I am thus doubtful that the 1970s growth experience of the 'permanents' will be replicated in the 1980s by the credit unions. Growth from new savings will maintain the market share, and an increase in the share by wooing customers away from other institutions is feasible. However, the competition (particularly from the banks) will be far hotter than in the past decade.

While the course of household savings thus will be one determinant of growth of credit unions, it is also necessary that credit unions are able to attract these savings by offering competitive rates. As I have argued ealier, to do this they must be able to find remunerative outlets for these funds among the household sector. In recent years, households have been willing borrowers rèlative to business, partly because of depressed business conditions, partly because of regulations which have distorted the structure of interest rates, and partly because interest rates have not truly reflected inflation rates. The last two factors seem to be changing, and the resources development programmes will lead to business making large demands on the capital market. While many of these demands may be met from overseas sources, I would not be surprised to see those financial institutions which learn how to efficiently transfer household savings into business lending experiencing rapid growth rates. Conversely, those institutions specializing in household lending may find themselves being outbid for funds and thus experiencing slower growth rates.

(c) *Regulation and Future Prospects*

Much of what I have had to say about future prospects clearly depends on the regulatory environment within which credit unions have to operate. How this environment will change in the coming years is anyone's guess, but if recent experience is any guide we are in for a bout of deregulation.

Deregulation can be benefical, since the ad hoc evolution of regulations on the financial sector which has occurred in Australia has undoubtedly created inefficiencies and inequities. The danger, as I see it, is that some regulations are necessary if the system is to function smoothly, but that those very regulations can create inequities. Haphazard deregulation may be worse than no deregulation at all.

I have confidence that the Campbell Inquiry will present a consistent package of regulatory change which recognizes this problem and includes the necessary checks and balances. My worry is that governments, because of ill-defined philosophies or bowing to pressure from interest groups, will pick the eyes out of the package and lead us to a worse state of affairs.

If credit unions are to be a viable part of the financial system in 1990, they have little choice but to exert pressure on government to ensure that a consistent regulatory framework emerges. In doing so they will hopefully heed the maxim that 'What is best for credit unions is *not* necessarily best for Australia'. In other words, they should not seek special treatment, but simply fight for a 'fair go'.

Provided that a 'fair go' is achieved, I would be surprised if credit unions did not constitute a larger part of our financial system in 1990 than they do currently. How much larger is another question, but I would hypothesise that any significant increase in market share will require substantial changes in the nature of credit unions as we now know them. Traditionalists may find this disconcerting but that, I guess, is the price of survival in the evolution of a (hopefully) better order.