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Community Bankers of Wisconsin

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Public Hearing of the
Senate Privacy, Electronic Commerce and Financial
Institutions Committee

SB 274 - Credit Unions

December 15, 1999

Testimony of Daryll Lund, President & CEO
Community Bankers of Wisconsin

Chairperson Erpenbach and members of the committee, my name is Daryll Lund, President & CEO of the Community Bankers of Wisconsin (CBW). CBW is a statewide trade association representing the interests of 227 community based financial institutions.

I appear before you today to testify in opposition to SB 274. SB 274 as proposed virtually eliminates the historical common bond requirements for credit unions, expands credit union powers and creates criminal sanctions against free speech.

Today, there are in fact two distinct credit union industries. The first group consists of those institutions that generally adhere to the spirit of the industry's charter – serving distinct groups. For these institutions the community banking industry has no opposition.

The second group, generally community credit unions have overstepped the original intent of the credit union charter and follow no defined common bond while offering product lines virtually identical to banks. In fact Daniel Mica, president and CEO of CUNA & Affiliates stated in a recent article that "as bank mergers continue into the 21st century, smaller banks will have much more in common with credit unions than with their enormous bank brethren." However the public policy question is whether special treatment including an exemption from paying income tax and an exemption from the Community Reinvestment Act should continue to be given to this

second group of credit unions. For these credit unions the community banking industry has strong opposition.

We oppose the following sections in SB 274:

1) Presently, "residents" within a "well-defined" neighborhood, community or rural district are eligible for membership. SB 274 eliminates the requirement that the neighborhood, community or rural district be "well-defined," and expands the field of membership to include "individuals that reside or are employed" in neighborhoods, communities, rural districts or "multicounty regions," Potentially the most significant change to the current credit union statute, the Bill would greatly expand the field of membership for credit unions. The impact of this provision is to enable community credit unions to branch statewide and even interstate.

2) SB 274 eliminates the "vicinal" requirement for employers, and expands membership to employees of industries that operate at least one facility within the neighborhood or urban, suburban or rural community; the boundary of the neighborhood or community cannot be determined by an "arbitrary physical standard."

3) SB 274 allows an "organization or association" to be a member of a credit union if a majority of its directors, owners or members are eligible for membership. Currently, the credit union statute only refers to "members." The Bill would broaden membership if a majority of the directors or owners of the business, organization or association are eligible for membership. The impact of this provision will greatly expand the credit unions ability to offer memberships to businesses that are not currently eligible for membership.

Further, it enables community credit unions to admit organizations or associations to membership in a credit union under the following two circumstances:

- if it has a business location within the geographical limits of the credit union, or
- if it provides goods and services in the ordinary course of business to credit unions, credit union organizations or persons who are eligible for membership in the credit union.

This significantly expands the field of credit union membership for businesses, associations, corporations and other organizations. Since a corporation or organization may provide goods and services over a wide geographical area, the proposed language essentially removes any membership restrictions for corporations and other organizations. This provision will also enable community credit unions to expand business accounts.

4) SB 274 will permit credit unions to purchase loans, leases and conditional sales contracts from other lenders even though these loans, leases and contracts do not involve members of the credit union.

5) SB 274 will create a penalty for any "person" who knowingly publishes false reports or makes false statements about a credit union and may be fined not less than $1,000 nor more than $5,000 or imprisoned for not less than one year nor more than 15 years or both. The proposed language in the Bill is broad and could theoretically be applied to all forms of constitutionally guaranteed rights of free speech.

6) Current law defines a "credit union" as a "cooperative, nonprofit corporation, incorporated under this chapter to encourage thrift among its members, create a source of credit at a fair and reasonable cost and provide an opportunity for credit union members to improve their economic and social conditions." This proposed change further reflect the desires of the credit union industry to move away from their original purpose and mission.

Mike Klassy will further elaborate on this subject.

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William F. Mundt
Michael R. Vaughan
Richard W. Pitzner
William J. Rameker
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COMMENTS IN OPPOSITION TO SB 274

Thank you. Senator Erpenbach and members of the committee, my name is Michael Vaughan. I am speaking today on behalf of the Wisconsin Bankers Association in opposition to 1999 Senate Bill 274. I will be submitting detailed comments on the individual provisions of SB 274, but would like to begin with some background.

A law authorizing "cooperative credit associations" was enacted in 1913. This law was succeeded by a law authorizing the establishment of credit unions which was enacted in 1923. Interestingly, both those laws provided that these entities were formed "for the purposes of promoting thrift among members" — language that formed the intellectual rationale for the income tax exemption granted to these entities. This bill proposes to eliminate that historic statement of purpose for credit unions, but does not eliminate the income tax exemption that flowed from that special purpose.

Several years ago, the Wisconsin Credit Union League began a review of the credit union statutes. After a five-year review, they introduced a bill in 1993. That bill was 73 pages long and contained 241 sections. It was described as a much needed modernization of the law, but - oddly enough - in its 73 pages and 241 sections there was not a single provision that would have increased the regulatory controls on credit unions or subjected them to the income tax requirements, enhanced regulatory burdens, capitalization levels or accounting standards that banks, savings banks and savings and loan associations live under.

The bill was described as a "modernization and simplification" of the credit union law and one that made "technical" changes to achieve this end. WBA identified approximately 40 provisions that we believed were substantive expansions of the law unaccompanied, as I said, by any commensurate increase in statutory responsibilities. We so testified at committee hearings on the bill, indicating that we did not oppose the 200 provisions of the bill that were modernizations and simplifications of the law, but did oppose the 40 expansionist provisions. Despite several meetings between us, the credit unions and we were not able to reach agreement and the bill died in the 1993 session.

In 1995, virtually the same credit union bill was introduced. We repeated our objections at public hearings to the expansionists provisions and again met with credit union

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representatives on the bill. After long discussions, we agreed on a 310-section bill that provided the modernization and technical upfixing that the credit unions sought, including several substantive grants of power they said they needed to participate in the modern world, but not including the core expansionist provisions we objected to. That bill was enacted in 1996, three short years ago.

Now you have before you a bill containing those provisions and even more expansionist material. Once again, we object to those provisions. We wonder why it is, only three years after passing their 310-section bill, that the legislature should be called upon to give credit unions those things that the legislature chose not to give them three years ago. I will be submitting a detailed analysis of SB 274, identifying our concerns with each section. Rather than lead you through that lengthy review, however, let me express our concerns more generally.

This bill expands credit union powers so as to create a new kind of "virtual bank." By that, I mean the bill creates an entity that may engage in the same kind of commercial lending that banks do, that will be empowered to locate anywhere that banks locate and that will have essentially no common bond requirements limiting its dealings with potential customers. Unlike banks, however, these "virtual banks" will not be subject to income taxation, will not have to comply with community reinvestment act requirements, will be subject to much lower reserve requirements and will benefit from less stringent regulatory standards.

These "virtual banks" will be empowered to create credit union service organizations authorized to offer goods and services to the general public. Since the Office of Credit Unions and the Credit Union Review Board maintain that they have no authority to oversee these organizations, these organizations will not be subject to state agencies' scrutiny, particularly since SECTION 1 of the bill takes credit unions out from under the consumer protection scrutiny of the Department of Agriculture, Trade and Consumer Protection.

And I must submit these comments while I still can. SECTION 40 of the bill makes it a 15-year felony to make false statements about credit unions. A credit union publication states that this provision "is necessary to discourage competitors or others from unfairly undermining confidence in a credit union." I think this gag rule is aimed at people like me, and that its point is to muzzle me and those others who speak unpleasant truths about credit unions, not false statements. This provision – and isn't there something bordering on hysteria about a 15-year prison sentence for exercising free speech rights? – couples with several secrecy requirements contained in the bill to make us all wonder what happened to those eleemosynary institutions created 85 years ago "for the purpose of promoting thrift among members."

I will be pleased to respond to any questions committee members may have.

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SB 274 – Description of Provisions

SECTION 1 — Exempts credit unions from business regulation by the Department of Agriculture, Trade and Consumer Protection.

SECTION 2 — Eliminates the basic statement that the purpose of credit unions is to "encourage thrift," create a credit source "at a fair and reasonable cost" and provide an opportunity for members "to improve their economic and social conditions."

SECTION 3 — Eliminates the present geographical limitations on so-called "vicinal" credit unions.

SECTION 4 — Eliminates the requirement that a credit union specify in its bylaws the conditions of residence or occupation which qualify persons for membership.

SECTION 5 — Eliminates two requirements that bylaws specify the conditions in which accounts may be paid in, transferred and withdrawn and the method of receipting for money paid on accounts.

SECTION 6 — Eliminates the requirement that credit union members must be residents within a well-defined neighborhood, community or rural district and substitutes a general requirement allowing membership to "individuals residing or employed within neighborhoods, communities, rural districts or multi-county regions." The general loosening is obvious; the concept of multi-county regional credit unions is new.

SECTION 7 — Replaces the existing limit on vicinal industry credit unions (see comment to Section 3) with an open-ended authorization to establish credit unions for employees of "industries that operate at least one facility within a neighborhood or urban, suburban or rural community." By deleting the existing "well-defined" limitation, the result is to set one's own imagination as the only geographic limit.

SECTION 8 — Eliminates the existing tight statutory definition of family members who are eligible for membership in a credit union and replaces it with a directive (see Section 11) to credit unions to identify eligible family members in their bylaws. The present limitation extends only to wives, husbands, parents and children, and to other relatives if they live together in the same household as the member. I suspect we may anticipate that sixth cousins by marriage who live 2,000 miles away will be eligible under the new bylaw authorization.

SECTIONS 9 and 10 — Expands the existing statement on businesses and associations eligible for membership in a credit union. The result is that any entity that "provides goods or services to...persons eligible for membership" may become a member. This would extend the right of membership in every credit union in the state to such disparate entities as the Green Bay Packers, Firstar Bank and Miller Brewing Company.

SECTION 12 — Expands an investment authority expanded just three years ago and increases the range of allowable business investments.

SECTIONS 13 to 15 — Expands the list of activities authorized for credit union service organizations to such things as securities brokerages, travel agencies and computer sales and leases.

SECTION 17 — Changes the existing application procedure for branch offices to delete the "need and necessity" test and to permit out-of-state branches anywhere in the country.

SECTION 18 — Eliminates the present authorization for out-of-state branches in very narrow circumstances involving a company credit union. See the wide-open authorization described in the previous section that is substituted for this narrow one.

SECTION 19 — Expands a 1996 authorization to act as trustee of member funds permitted by federal law for deferred compensation deposits.

SECTION 21 — Allows deposits for funeral trusts.

SECTION 22 — Allows a wide variety of business investments.

SECTIONS 23 to 25 — Creates several secrecy requirements relating to information about credit unions, with felony penalties for violations.

SECTION 28 — By eliminating existing references to credit life insurance and credit accident and sickness insurance, appears to be an effort to authorize credit unions to engage in the sale of insurance without limitation.

SECTIONS 29 to 38 — Changes the law on interstate acquisitions and mergers of credit unions. These changes appear consistent with changes in federal law on this subject.

SECTION 39 — Grants a "free pass" to enter Wisconsin to out-of-state credit unions. Out-of-state banks, savings banks and savings and loan associations are not allowed to do this.

SECTION 40 — Creates a felony punishable by 15 years imprisonment for publishing "false reports" or making "false statements" about a credit union. This appears similar to the "false light" bills of several sessions ago. The provision gives no assistance in determining what will be "false" and subject to this gag rule.

Michael R. Vaughan

Testimony in favor of **SB 274 – The Credit Union Consumer Choice Bill**

Hello. My name is Kenneth Beine. I am the President of Shoreline Credit Union. We are located on the "East Coast of Wisconsin" along the shores of Lake Michigan. We presently serve 11,000 members.

I would like to speak on behalf of one of the service enhancement provisions of the bill.

We exist to serve our members, to provide them choices. In recent years our members have been increasingly vocal with respect to asking us to provide investment products and services. When we ask why, we hear reasons ranging from convenience .. to looking for independent advice .. to simply wanting more options.

SB 274 strengthens the role of Credit Union Service Organizations (CUSO's) within Wisconsin. It will enhance our ability to offer more service choices to the Wisconsin consumer .. such as investment services, insurance products, internet services etc. .. presently available to consumers in other states.

On behalf the residents of Wisconsin, I ask that you pass SB 274 out of committee. Give them the option to choose where to conduct their financial affairs.

Thank you.

[Senate Hearing 12-15-1999 10:00am Rm. 411 S]

[Shoreline is a state chartered community credit union serving everyone who works or lives in Manitowoc County. We operate out of two facilities located in Two Rivers, Wisconsin. $46million / 11,000 members.]
3131 Mishicot Rd, PO Box 233 Two Rivers, WI 54241 (920) 793-34541 beinek@shorelinecu.com
[C:(mo:wd)\pr\SB274Hearing]

State of Wisconsin
Tommy G. Thompson, Governor

Department of Agriculture, Trade and Consumer Protection
Ben Brancel, Secretary

DATE: December 15, 1999

TO: Senate Committee on Privacy, Electronic Commerce and Financial Institutions

FROM: William L. Oemichen, Administrator
Division of Trade and Consumer Protection Bill Oemichen

RE: **Senate Bill 274, relating to credit unions**

We appreciate this opportunity to comment on Senate Bill 274. The Department of Agriculture, Trade and Consumer Protection would like to comment in support of section 1, which adds credit unions to the list of other financial institutions that are exempt from Wisconsin Statutes Chapters 93 through 100.

Normally, the Department would strongly oppose efforts to remove any industry from the state's consumer protection laws and rules. However, all banking institutions, except for credit unions, are already exempted from our consumer protection laws. This puts the credit unions in a separate class of financial institutions.

We receive fewer than 10 credit union complaints annually, most of which are referred to the Department of Financial Institutions. Furthermore, the Department recently exempted credit unions from the new Direct Marketing rules, Chapter ATCP 127, Wis. Admin Code. This was done to recognize that credit unions should be treated like other financial institutions under our consumer protection laws. This bill will assist our Department by making it unnecessary to include rule language exempting credit unions from DATCP's consumer protection rules.

For these reasons, the Department supports Section 1 of Senate Bill 274.

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State of Wisconsin
Department of Financial Institutions

Tommy G. Thompson, **Governor** Richard L. Dean, **Secretary**

Testimony to
SENATE COMMITTEE ON PRIVACY, ELECTRONIC COMMERCE
& FINANCIAL INSTITUTIONS

Ginger Larson, Director
Office of Credit Unions
Wisconsin Department of Financial Institutions
December 15, 1999

Chairman Erpenbach, committee members, thank you for the opportunity to be heard today. I am Ginger Larson, Director of the Office of Credit Unions, Department of Financial Institutions, speaking on SB-274.

I have reviewed the bill throughout the drafting process and have no safety and soundness concerns. There are certain provisions of the bill dealing with examination issues, confidentiality, interstate acquisitions and branching that the Office of Credit Unions (OCU) has recommended and I would like to address those provisions.

Current law requires the Office of Credit Unions and the members of the review board to keep secret all facts and information obtained in the course of examinations. This bill strengthens this provision clarifying that all correspondence and information requested by OCU, other than Call Reports, will remain confidential. The bill states that examination reports are the property of OCU and must be returned upon request. It also adds penalties that can be assessed against employees of the office of credit unions and members of the review board for disclosure of confidential information.

There is a provision in current law that allows OCU to accept a CPA audit in lieu of an examination. This provision is being repealed as CPA audits and safety and soundness exams address different aspects of operations.

Current law contains provisions for Wisconsin credit unions to acquire or merge with or be acquired or merge into credit unions in certain regional states identified in the statutes. This bill removes the regional state restriction and would allow the provisions of this section of the statutes to be applied to credit unions throughout the United States. 1985 Wisconsin Act 325 defined the regional states for purposes of interstate mergers and acquisitions for all Wisconsin financial institutions. The regional definition has since been removed from the Wisconsin banking statutes because of a change in law that allowed nationwide banking. By removing it from the credit union statutes, our statutes will be more in line with other state statutes governing credit unions.

Under current law, Wisconsin credit unions are allowed to establish branch offices 25 miles outside the state and limited services offices at company facilities if the common bond of the credit union is employment by a corporation, limited liability company, partnership or association. This bill removes

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the 25-mile limitation as this limitation places a restriction on Wisconsin credit unions that is not placed on other states' state-chartered credit unions or federal credit unions.

In order for a Wisconsin credit union to exercise the limited services office provision or establish a branch office 25 miles outside the state border, other state statutes require the OCU to allow their state-chartered credit unions to exercise the same powers in Wisconsin.

Section 186.235(19), Stats., provides that all credit unions formed under this or other similar law, or authorized to transact business in this state a business similar to that authorized to be done by this chapter, shall be under the control and supervision of the Office of Credit Unions.

This bill provides specific criteria that must be met for an out-of-state credit union to establish a branch office and do business in Wisconsin—criteria that will ensure all state-chartered credit unions doing business in Wisconsin will be required to follow the same laws as Wisconsin credit unions.

All of the provisions recommended—the removal of the regional state definition and the 25-mile limitation and branching reciprocity for out-of-state credit unions address certain deficiencies in our statutes when compared to the statutes of other states. In addition, the provisions address an inherent conflict within the statutes. If a Wisconsin credit union merged with a regional credit union and the Wisconsin credit union was the survivor, the 25-mile limitation could be interpreted to limit or prevent establishing a branch office in the regional state.

If the 25-mile limitation for establishing a branch office is removed, the definition and provisions for limited service offices would no longer be needed and could be repealed.

There have been numerous federal credit unions convert to state charters throughout the country and we need to be prepared for this trend of creating out-of-state state chartered branches in Wisconsin.

While the Office of Credit Unions has recommended certain provisions of the bill, it is neutral on other provisions, and we find that none of the provisions of SB-274 impact the safety and soundness of state chartered credit unions.

BANK OF Monticello
You've banked on us for over 100 years!

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PUBLIC HEARING OF SENATE PRIVACY, ELECTRONIC COMMERCE, FINANCIAL INSTITUTIONS COMMITTEE

December 15, 1999

Testimony of Michael E. Klassy, Vice President of the Bank of Monticello, Monticello, Wisconsin, Chairman of Community Bankers of Wisconsin.

Regulation BB - Community Reinvestment Act, CRA as it is most often called, has for many years required banks to prove that the bank is meeting the credit needs of its entire community, and in particular the low and moderate income areas of its community. Recently this law has allowed for an adjustment in its testing of banks based upon the size of the financial institution, with a less detailed analysis required for banks of $250 million or less as opposed to the very detailed analysis of the larger banks over $250 million.

Some of the assessments utilized to determine how well a bank is meeting its entire community's needs are as follows:

- Require a bank to delineate its "local community" or "service area'. This is the area "where a preponderance of direct reportable loans" are made.
- We must maintain a map of our service area. Showing the census tracts within the service area and if there are not census tracts then the bank must use a block numbering system so that low and moderate income areas can be identified.
- A bank must maintain a public CRA file with reports for the most recent two years.

Why do I bring up the bank's CRA responsibilities? I mention CRA because the customer base that I serve is no different from credit unions if the changes in proposed Senate Bill 274 are instituted. I mention CRA because just as a name like the Bank of Monticello is insufficient to prove we serve the financial needs of Monticello, Wisconsin a charter to do business as a tax subsidized financial institution is no guaranty that all such chartered institutions will perform in a manner justifying their tax favored status.

- The change in definitions will remove the purpose for credit unions to "encourage thrift among its members, create a source of credit at a fair and reasonable cost and provide an opportunity for credit union members to improve their economic and social conditions." This old definition narrowed the customer base of credit unions and went a long way to define the purpose for which they have been awarded a tax subsidized ability to grow capital. Without this definition and the elimination of any common bond provisions the potential customer base of a credit union is exactly the same as that of all tax paying banks.
- The proposed change in the membership language will eliminate the requirement that the neighborhood, community or rural district be "well -defined". In the most recent banking reform legislation called the Gramm-Leach-Bliley Financial Services Modernization Act of 1999 the federal government sought to maintain the requirements upon all banks that a "local community" or "service area" must be delineated down to census tracts or at least a block number system. In light of the importance placed upon this by the federal government for a bank to define its service area , the State of Wisconsin cannot ignore this responsibility for tax subsidized credit unions. The bill as

proposed would create a huge advantage for credit unions and be totally unfair to the tax paying financial institutions as well as to the people in the communities they serve.

- The need for a safety net similar to CRA for banks should be required of credit unions given the proposed change in membership to include any and all organizations and corporations with only an insignificant link to the credit union field of membership.
- The request for additional powers also justifies a need for the addition of greater accountability. The request to purchase the assets of another lender clearly describes using members deposits to acquire earning assets that are not a direct benefit to other members. This out of area investment in loans, leases and other similar assets was one of the foremost reasons the Community Reinvestment Act was established. Aside from the fact that this investment will compete directly with tax paying financial institutions, the potential for a credit union to use its funds available for loans on one of these non-liquid investments will greatly increase the chance of not having funds available for members' needs.

Another question arises over the needs for such expansion of rights without a proportional increase in social responsibilities when you look at just where the tax favored credit union industry has been conducting business in Wisconsin.

A look at 1997 numbers provided by "Sheshunoff—The Branches of Wisconsin 1998" reveals that credit unions had 9.6% of all the deposits in the State of Wisconsin.

Clearly with the old definition to "create a source of credit at a fair and reasonable cost and provide an opportunity for credit union members to improve their economic and social conditions." It would be reasonable to expect that credit unions would have a proportionate share of their deposits in all counties within the state. If this were the case I would not be talking about the issue. The 10 poorest counties when looking at personal per capita income, the information provided to me by "The Wisconsin Taxpayer" January 1999 Vol. 67 No. 1, looking at 1996 data, have 104 offices of tax paying financial institutions and only 3 offices of credit unions. Those 3 credit union offices have a total of 2.25% of the deposits in these 10 counties. Seven of these counties have no credit union office in them. My point here is that while each and everyone of the 104 offices of the tax paying financial institutions must meet the requirements of CRA , serve everyone in their respective communities and do all of this within a market with Wisconsin's lowest per capita incomes, the tax subsidized institutions must have gone elsewhere in the state to generate their 9.6% of all deposits. Perhaps credit unions concentrated more expansion efforts in counties like Dane where they have more than 15% of the deposits and a per capita income that ranks Dane County 3rd in the state.

When credit unions were well defined by membership, common bonds, communities or neighborhoods served they were entitled to retain net income for capital without paying income taxes. And if there was ever any evidence that for the same tax favored status this industry was serving people who could not afford the price of financial services from tax paying institutions. Then with the proposed changes of this bill the State of Wisconsin should place upon credit unions a Community Reinvestment requirement similar to the requirements placed upon tax paying institutions within the State of Wisconsin. This bill as written represents a huge increase in rights most beyond those of taxpaying financial institutions and must be brought back to an equitable position with added responsibilities as well as some reductions in the rights requested.

Testimony of E. David Locke, President, McFarland State Bank, and Wisconsin Bankers' Association Board member, at an informational public hearing of the Senate Financial Institutions Committee regarding Senate Bill 274.
December 15, 1999

Mr. Chairman and members of the committee, I am David Locke. I am the president of the McFarland State Bank and a member of the Wisconsin Bankers Association Board of Directors. I appear before you today to express my opposition to SB 274. The main reason for my opposition is that this bill gives large credit unions even more advantages over taxpaying financial institutions – like mine.

Credit unions started out, as mutual societies owned by members who shared a common employer or neighborhood back in the 1930s. They were exempt from federal and state income taxes. The idea behind the tax break was to give a boost to working families and to permit people of "small means" to pool their savings so that they could make unsecured loans at times of need to members who share a common bond of occupation, acquaintance or trust.

It is my strong view that, for credit unions that have remained relatively small and loyal to their common bond, the tax breaks can be justified as a reasonable way to assist these affiliate groups. Indeed, the tax break offsets part of the financial disadvantage of their small size.

However, today many credit unions have expanded well beyond the 1930s notion of a "common bond." Some credit unions include more than 100,000 members and control billions of dollars in assets. The common bond, in many cases, has been stretched beyond recognition.

According to a recent survey conducted by the Credit Union National Association, credit union members have an average household income of $43,480, 37 percent higher than

nonmembers do. The survey also showed that credit union members are better educated and more likely than nonmembers to be homeowners ~~are~~ are. In short, the average credit union member today is far from being a person of "small means."

So what, you say? Indeed, what this means is that the tax subsidy credit unions enjoy and use to the disadvantage of other competitors flows primarily to well-educated, higher income individuals and it is this tax subsidy that is at the root of our concern.

Wouldn't we all like to be exempt from federal and state income taxes? Special privileges such as federal and state tax exemption should be granted only to those who would adhere to the laws under which these privileges were

granted in the first place. We think this is a fairly simple concept to grasp.

Credit union advocates, on the other hand, don't seem to understand this and, in a gratuitous way, continue to cloak themselves in the banner of nonprofit small businesses when we know today that it's just not true. The large, diversified credit unions of today are as far from the intent of Congress back in 1934 as can be imagined. They're a totally transformed industry. We believe things must change if today's large, diverse credit unions want to continue to broaden their base and provide the products and services that other taxpaying financial institutions provide. In short, large multifaceted credit unions must be regulated and taxed the same as the rest of the financial services industry today.

To put the tax issue in perspective: My $70 million asset community bank competes on a daily basis with the four largest credit unions in Madison. UW Credit Union, with $384 million in assets, is larger than 90% than all the taxpaying financial institutions in Wisconsin.

But while my bank paid $348,000 in state and federal income taxes last year, UWCU paid $0. Yet UWCU's net income for 1998 was over $2.9 million dollars. Using a combined state and federal tax rate of 40 percent, UWCU should have paid approximately $1.17 million in taxes, but paid nothing! As a result of this unfair tax subsidy favoring the credit unions, they are able to price their loans more aggressively and pay more for their deposits. We firmly believe that this type of tax subsidy of very large credit unions was and is not the intent under the law.

In addition, these credit unions offer a full range of financial products, including mortgage loans, insurance, commercial loans and savings accounts. Where is the common bond for credit unions in the commercial lending business? Neither the public nor we can be fooled. These large credit unions are just like banks!

That is the rub. Bankers all across Wisconsin are calling foul because the large credit unions use the tax break to offer higher deposit rates and lower loan rates.

We believe it is a privilege to do business in Wisconsin. We believe that this privilege comes with the responsibility and a duty and, yes, that duty is the obligation to support the needs of our government through the payment of taxes. We

believe the large credit unions are shirking their duties substantially. Typically, 40 cents out of every dollar we earn, or 40 percent of our earnings goes to the payment of our federal and state taxes. Credit unions pay nothing to support our government's operation, yet they take full advantage of all government services such as the Fed payment system, FHL Bank and SBA.. They should feel obligated and privileged to pay their fair share of taxes like everyone else does in our country; it's their duty.

By the way, don't let the large credit unions tell you they're nonprofit – that's baloney! Net profits are retained by the credit unions and are used to build plush buildings like the well-known landmark on University Avenue, pay their executives large bonuses and fatten their advertising budgets all at the expense of every taxpaying entity in the

state of Wisconsin. Credit union net earnings last year surpassed those of community banks, and community banks are the ones most affected by the credit union competition.

I have been told that at least one very large Wisconsin credit union annually calculates the amount of taxes it would pay if required to do so. This credit union then allocates that amount, roughly $2.29 million, and uses it for its technology budget. Think about that for a moment. We are constantly told that credit unions pass their tax-exemption on to their customers. Well, apparently not this credit union. Now think about the advantage this credit union has over local community banks in its market. It's a huge advantage and poor public policy overall.

There is a very positive side to all this hoopla, however. Fully three-fourths of the 12,000 U.S. credit unions that exist today adhere to the original common bond mandate and are not trying to "beat the system." To this group of small credit unions that continue to serve the traditional credit union role and fulfill the original mandates prescribed by law, we say; We neither want nor expect you to change how you operate. You should retain your tax-exempt status.

To the large bank-like credit union and our elected officials we say - the Legislature should have serious concerns about allowing large credit unions, which have stretched the common bond beyond recognition, to expand unchecked while retaining their tax and regulatory exemptions.

We believe this debate is not about credit unions or the credit union movement itself. It is about privileges and responsibilities within our system of government. We believe that traditional credit unions have a rightful and important role in the nation's financial services system, providing consumers with another avenue of credit that inherently adds to the strength and diversity of that system. We cannot emphasize strongly enough the fact that we support that role.

However, it is important to challenge those credit unions that seek to capture the benefits of laws favorable to credit unions without regard for the conditions under which those special privileges were established. Stated simply: Large expansion-minded credit unions "can't have it both ways."

Credit union lobbyists have stated that this issue is about choice and the public's right to choose a credit union. We agree. However, competition, not a tax break, ought to decide where Americans want to bank and Congress should act accordingly.

RUTHANN NELSON –

MILWAUKEE JOURNAL-SENTINEL
November 20, 1999

OCEAN SPRAY OPTS TO REMAIN A COOPERATIVE

. . . . "As a farmer-grower-owner, the idea of remaining a cooperative has some appeal to me," said Greg Fanning, who's also president of the Wisconsin State Cranberry Growers Association. "At the same time, I'm a realist, and I know that the world market has changed as to the production and sale of food."

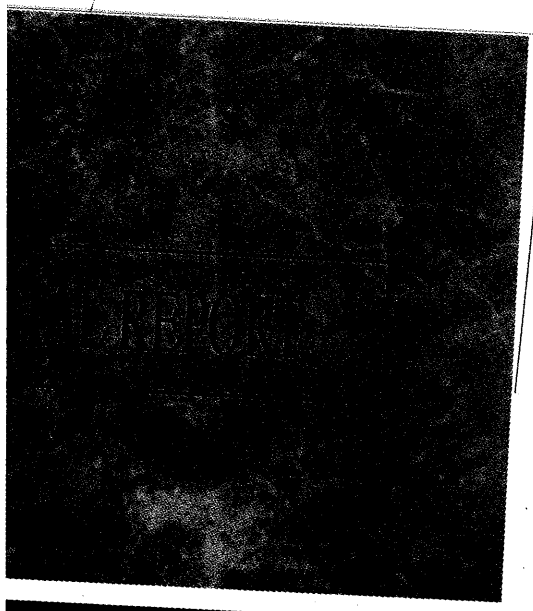
Whatever Ocean Spray does, John Sager hopes it's fruitful.

Sager, owner of J&J Cranberries, Inc., with a 75-acre marsh in Adams County, grows for Northland Cranberries, Inc., in Wisconsin Rapids.

But he figures that all growers will benefit from a stronger Ocean Spray.

"Anything they can do to improve themselves is positive," Sager. . . . "The industry needs a very strong Ocean Spray. The industry needs a very strong Northland."

. . . .



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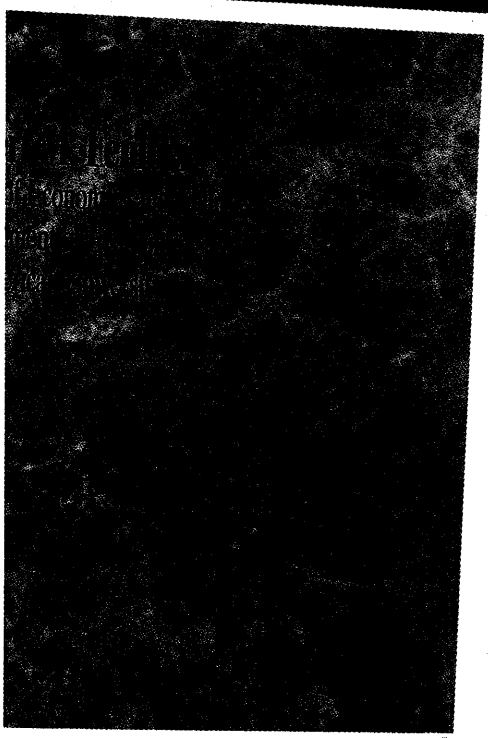

SPECIAL REPORT

The Effect of Credit Unions on Market Rates for Unsecured Consumer Loans

Robert M. Feinberg
Professor of Economics and Chair
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About the Author

Robert M. Feinberg

Robert Feinberg is Professor of Economics and Chair of the Department of Economics at American University in Washington, DC. He received his B.A. in Mathematics and Economics at the University of Pennsylvania and his Ph.D. in Economics at the University of Virginia. Dr. Feinberg spent ten years on the economics faculty of Penn State University, during which he spent time as a visiting scholar at the Federal Trade Commission and the Antitrust Division of the Justice Department, and at the International Institute of Management in Berlin.

Following 4 years as a Senior Research Economist at the U.S. International Trade Commission, Dr. Feinberg returned to academia at American University where he has taught courses in Industrial Organization and Microeconomic Theory at both the undergraduate and graduate levels for the past ten years. He received a Fulbright Fellowship to teach and research in Ireland, and has been named a Fellow of the *International Journal of Industrial Organization* for his many contributions to that publication. Dr. Feinberg has published more than 60 articles in economic journals including the *American Economic Review,* the *Review of Economics and Statistics,* the *Antitrust Bulletin,* the *Journal of Business,* the *Journal of Industrial Economics,* and the *International Journal of Industrial Organization.*

Dr. Feinberg has consulted in litigation involving antitrust, trade law, and patent infringement issues, and has particular research interests in the area of financial services, with past studies in determinants of mortgage default and the economics of title insurance, in addition to continuing interest in economic issues involving credit unions. In addition, he has often researched issues at the intersection of industrial economics and international economics.

Contents

Executive Summary

This technical report examines two economic issues with major public policy implications:

1. The influence of small financial institutions on personal loan rates in local markets.
2. The effect of dominant banks/thrifts in a local market on personal loan rates.

These are timely issues, given the recent rush of bank mergers. Economists know that sufficient numbers of small firms with a significant share of the market can restrain the market power of dominant firms and promote competition. Consolidation in banking raises serious concerns about the ability of banks to alter interest rates to the disadvantage of consumers.

This study examines the pricing of personal, non-credit card loan rates in up to 90 small U.S. markets. Credit unions in each of these markets are small competitors, with total credit union share of market ranging from 0% to 31% of deposits, with an average share of 9%. Our research focused on the pricing impacts of 1) market shares of dominant banks/thrifts and 2) the market share and potential for expansion of credit unions.

We found that the combined market share of the two largest banks/thrifts in a local market and the presence of credit unions affect personal loan rates at banks. Our four general findings relating to bank markups on personal loans are:

1. Rates increase as the combined share of the local market held by the two top banks/thrifts increases.
2. Rates decrease as the combined share of the market held by all credit unions increases.
3. Rates decline as the possibility of future expansion of credit union market share increases.
4. The rate-restraining influence of credit unions becomes stronger as the combined market share of the largest two banks/thrifts in a local market increases.

Our findings support the notion that consumers would benefit from the following public policy actions relating to the financial services industry:

1. Reduction of barriers to entry and the encouragement of expansion of small lenders, including credit unions.
2. Anti-trust remedies for bank and thrift mergers if there is an absence of a strong presence of small financial institutions such as credit unions.

I. Introduction

As banks continue the rush to consolidation which has eliminated large numbers of competitors from the marketplace, concerns have arisen about the competitive effect this may have. In particular, with greater market shares in local markets, will banks be able to raise loan rates to the disadvantage of consumers without the opportunity for home equity financing? Economists know that sufficient numbers of small firms can provide a threat to dominant providers and promote more competitive performance. However, the effect of credit union presence on bank loan rates has never been tested. The issue is relevant to how state and federal banking and antitrust authorities evaluate mergers in the industry.

First, let's discuss the appropriate geographic scope of markets for financial services. Access to credit cards is nationwide, and solicitations of home equity-backed lending across the country are increasingly offered by national firms as well. However, local firms retain a prominent position in mortgage lending. New car lending is dominated by national automobile company credit operations, but there is still a role for local lending. And the market for unsecured loans and loans secured by used vehicles is primarily local. National firms compete in these markets, but target primarily high-risk individuals and do not attempt to compete on price.

Simons and Stavins (1998) present evidence that banking markets are still predominately local. They point to the Federal Reserve Board's 1992 *Survey of Consumer Finances,* which shows that 94.1 percent of households using a financial institution identify a local institution as their primary provider of financial services. Both deposit accounts and sources of credit are primarily local,[1] even though some financial products are more local than others. Therefore, the following analysis and discussion focuses on one product, unsecured non-credit card loans, which seem most likely to be provided in a local market.

First we'll establish an analytical framework to consider the impact credit unions may have on bank loan rates. The specific issues are:

- Does the share of a lending market held by credit unions imply downward pressure on consumer loan rates?
- Does this effect depend on the existence of concentrated commercial lending structures? The results have implications for antitrust treatment of bank and S&L mergers, and for encouraging the expansion of credit unions. These implications are explored in a concluding section.

II. Previous Related Research

Economic theory shows that the number of firms, their relative sizes, and the nature of competition from substitutes or potential entry all play a role in price determination. From the oldest model of oligopoly behavior, the Cournot model in 1838, to more recent models of price leadership behavior by a dominant firm or group of firms, the number of competitors in a market or those threatening to enter a market and the size of a competitive fringe group of smaller firms predicts downward pressure on price. These models predict the effect most striking when markets are highly concentrated. The expansion of the number of firms from 99 to 100 has negligible impact, while expanding from two to three may have a large effect. This suggests that the role of credit unions, viewed as a new entry or a possible expansion of fringe supply, is more crucial in determining competitive performance of lending markets where there are a relatively small number of commercial banks and S&Ls.[2]

While there is considerable empirical literature on the role of market structure in banking markets (most recently, Rhoades 1997, Humphrey and Pulley 1997, and Simons and Stavins 1998; also Berger and Hannan 1989, Rhoades 1987, and Hannan 1991), the research has focused almost exclusively on commercial banks, and to a lesser extent on savings and loans. The competitive effect of credit unions on consumer credit rates has not been examined, however.

[1] The Federal Reserve Board's 1993 Survey of Small Business Finances shows a similar picture.

[2] For a clear overview of oligopoly models and their predications, see Sherer and Ross (1990), ch. 6.

In 1987, Rhoades examined how nonbank thrift institutions including credit unions might impact the profitability of commercial banks. The data, averaged over the period 1978-82, overlapped the period of regulation of deposit rates and entry of non-bank institutions, and may have been too early to capture such impacts. In addition, the nonbank share of market was not considered explicitly as a variable. Furthermore, no separate credit union impacts were examined, and the sample of 335 local markets did not distinguish between more and less competitive markets, or between large and small ones. The study's conclusions were quite weak.

Heaton and Dunham (1985) discussed antitrust implications of their finding that credit unions sometimes have large shares of the consumer deposit market in New England. Competitive effects were asserted, however, rather than derived from evidence. More recently, Kaushik and Lopez (1996) found that credit unions on average are as profitable as both commercial banks and savings banks, and that their loan portfolios have grown more rapidly. The implication of these findings is that credit unions may be a substantial threat to commercial banks and S&Ls. Evidence presented in Feinberg and Shaanan (1997), disaggregating entry effects on manufacturing pricing, suggests that unexpected entry has the largest competitive impact.[3] In terms of local financial market competition, credit union growth would more likely fall into this category than would smaller banks and S&Ls. All of this suggests that a study of the competitive impact of credit unions is overdue.

III. Analytical Framework

Virtually all models of imperfect competition, covering the spectrum between perfect competition and pure monopoly, imply that increasing entry and supply from fringe suppliers lowers prices. The ability of sellers to markup price above cost is inversely related to the number of competing firms. This suggests that an increasing credit union presence disciplines prices in local financial services markets. Consider how this credit union pressure might be expressed in an economic model.

The foundation for the analytical model is known as the dominant firm-price leadership model. This approach assumes that there is one dominant firm setting price in the market—or a group of such firms acting together—and a number of small, fringe producers who take this price as given, acting as competitive suppliers. But while credit unions are generally regarded as the "price-taking fringe",[4] not all banks and S&Ls constitute a dominant group. Nevertheless, *collectively,* banks and S&Ls are relatively dominant, with the degree of coordination among them increasing as bank and S&L deposits are more concentrated in the leading two institutions.

The number of major firms is usually small in the markets examined in this study, and there is concern that in the absence of pressure from a competitive fringe these firms may act in a collusive manner. Appendix A presents the formal mathematics. The resulting expression shows that personal loan rates at bank/thrifts:

1) Increase as the combined market share of the top two banks/thrifts increases,
2) Decrease as the combined market share of credit unions increases,
3) Decline as the ease of future expansion of the credit union share increases, and
4) Both of the effects 2) and 3) are larger when the share of the top two bank/thrift institutions is larger.

While this model is somewhat *ad hoc,* it is well-suited to study the small local lending markets described below. The implication of the model is that the top two-bank share, the credit union share,

[3] In addition to entry of firms previously outside the market, we would include here growth in supply from fringe suppliers already in the market.

[4] While it is reasonable to expect that in most local markets credit unions are in the fringe, it is less clear that they are the *only* institutions in the fringe group. On the one hand, small banks and S&Ls are unlikely to be well-characterized as within a dominant group, and certainly provide some competitive discipline in a market. On the other hand, there are other sources of competition for the type of loan considered here: consumer finance companies, and perhaps pawnshops. But credit unions are unique: they provide loans at rates better than consumer finance companies and pawnshops, and generally have management which is arguably more likely to challenge pricing decisions of larger banks and S&Ls than would management of smaller banks; this is especially likely in smaller communities where there is a small close-knit group of local bankers.

and the supply elasticity of credit unions, which may be proxied by the regulatory climate and other measures of the ease of expanding customer base, matter in determining the exercise of market power in these markets.

In some markets, particular credit unions are a major force. For example, in 20 of the 101 small markets studied, a single credit union is one of the top two financial depository institutions during at least one of the years 1992-96. In these markets, describing credit unions as fringe players seems inappropriate. Therefore, these markets were excluded from the statistical analysis.[5]

IV. Preliminary Findings

We initially identified 101 small local markets consisting of 19 metropolitan areas under 100,000 population; 33 metropolitan areas with populations between 100,000 and 125,000; and 49 non-metropolitan counties with populations under 125,000. Excluding the 20 markets in which a single credit union is one of the two leading depository institutions left 81 markets, which are listed in Appendix F.[6]

These markets average a little less than 80,000 in 1990 population, ranging from 7,000 to 124,000. The average combined credit union share for these markets is 9.2%. However market share varied from zero in Tensas Parish, Louisiana, and between 1 and 2% in Victoria Texas, to a credit union market share as high as 30.5% in Lihue, Hawaii and over 20% in Dubuque, Iowa; Escanaba, Michigan; and Gadsden, Alabama. The combined market share of the top two non-credit union institutions averages 50%, but also varies widely from 28% in Decatur Illinois to 100% in Tensas Parish, Louisiana.[7]

The purpose of this study is to investigate bank and thrift market loan rates. However, historical data on bank and thrift rates could not be obtained for small markets. Therefore, a preliminary statistical analysis focused on explaining average *credit union* loan rates for unsecured loans, with data reflecting self-reported average transaction rates obtained from the National Credit Union Administration (NCUA). The data is based on semiannual reports from all federally-insured credit unions from June 1992 to December 1996. A high correlation between credit union and bank/thrift rates is consistent with the assumptions of our model and would constitute a test of credit union impact on market lending rates.[8] However, the use of credit union rate data is a limitation of the study, which we will remedy in succeeding sections of the paper.

Based on deposit data from banks, thrifts and credit unions, the share of total market deposits held by credit unions and by the top two depository institutions were obtained from Sheshunoff Information Services for each market and time period. In addition, state-level credit union shares of all depository institution assets for 1996 and national average credit union costs of borrowing and savings were obtained from the Credit Union National Association and included in the database, the latter as a proxy for the cost of funds.

Statistical results are reported in detail in Appendix C. They explain credit union unsecured loan rates by 1) the deposit share of the top two non-credit-union institutions—lagged 6 to 12 months, 2) the total share of deposits held by credit unions, 3) a binary variable equal to one for markets in states with a credit union share of depository assets greater than 10% and a mean state-level share of 7%, 4) the national average credit union cost of funds—lagged 6 months, and 5) market population.[9] The latter variable, market population, is included to control

[5] It would be an interesting project for the future to investigate whether the impact of these "dominant" credit unions on market prices is any different from that of similarly sized banks and thrifts.

[6] The competitive influence of credit unions would be more likely to show up in smaller markets. The sample analyzed here, therefore, is not intended to be a random sample of local markets intended to test for a credit union effect generally, but rather a selected sample of small markets used to search for whether the price effects proposed can be found.

[7] The combined share of the top two non-credit union institutions is 100% when the market contains exactly two banks and no credit unions. This was the case for Tensas Parish, Louisiana.

[8] In fact, there is a statistically significant positive correlation (+0.24) between credit union and bank/thrift unsecured loan rates, in the small sample for which both are available.

[9] Clearly, one omitted variable here is the nature of other loan terms, e.g., fees, maximum size of the loan. To the extent these other terms are uncorrelated with the variables of interest, statistical bias in our findings should not result. It was determined that there was no significant correlation across markets between average size of the loan and average interest rates charged.

for omitted market-level differences.[10]

The results show that larger markets have lower loan rates, and in all cases the cost of funds has strong positive impact. More relevant for our focus, there is a significant impact of market structure.[11] Credit unions exert a strong pro-competitive influence: an increase of five percentage points in credit union market share lowers loan rates by two tenths of a percentage point. In states with a significant credit union presence, rates are reduced by almost a full percentage point. This variable proxies credit union elasticity of supply, or the ease with which credit unions could expand in the market.

However, there is a puzzling *pro-competitive* impact of increases in the percentage of the market held by the two largest non-credit union institutions. This could be because the market share held by the two largest firms is high when one or both of these firms is large. If larger firms are more efficient, this could lower both costs and prices.[12]

V. Explaining Bank Loan Rates

We found data on bank/thrift loan rates for 39 of the original 101 markets from RateWatch, a financial reporting firm, for the last week of March 1998. Data were also available on an additional 13 markets of comparable characteristics to make a sample of 52 rural counties and small Metropolitan Statistical Areas (MSAs). Of these 52 markets, eight in which a single credit union was one of the top two financial institutions in the market were dropped in order to focus on the "credit-union-as-fringe-supplier" hypothesis. Of those markets remaining, only 34 had information on unsecured loan rates. A study based on this small cross-section, with loan rates as of end of March 1998 and market structures as of the end of June 1996 is reported below, and the markets are listed in Appendix F.

Two dependent variables were of primary interest: average bank/thrift rates for unsecured loans—(a) for a $1000 loan, and (b) for a $5000 loan.[13] In addition to the market structure variables described above, to capture the scale economy effects, or the potential cost-reducing advantage of large size, the sum of branch deposits of the largest institution in the market was included in the regression equations. By using a single time period, it seemed reasonable to assume that the cost of funds was equal across markets in this analysis. Descriptive statistics on the sample are given in Appendix D.

In many ways this small sample is representative of the larger group of markets considered earlier, with an average population of 78,000 compared to 80,000 for the larger sample of 81 markets, a combined credit union share of 9.9 percent compared to 9.2 percent in the larger sample, and a top two-bank share of 49.8 percent compared to 50.0 percent in the larger sample. For this small sample the mean credit union rate for unsecured loans was 13.30%, below the mean bank/thrift rate both for $1000 loans (13.99%) and for $5000 loans (13.45%).

The full statistical results are presented as Appendix D. However, the general findings are as follows:

The bank/thrift concentration ratio and the market share of credit unions *both* seem to affect unsecured loan rates in the predicted direction, although these effects hold only for certain ranges of credit union market shares as described further below. In addition, the potential entry/expansion of credit unions, as proxied by the state-level credit union share, again shows a pro-competitive impact. However, there is no evidence supporting a role for scale economies.

In the quadratic specification—first for a $1,000 loan—the marginal impact of the credit union

[10] Contrary to the theoretical prediction, there was no indication of a larger pro-competitive impact of credit unions where the leading banks and thrifts had larger shares of the market. An alternative statistical procedure using all variables in logarithms produced similar results.

[11] "Market structure" refers to the number and size of different types of competing institutions in a market.

[12] Another possible explanation for finding bank concentration correlated with lower loan rates is more subtle. In this analysis, we worked with a model that assumed a uniform rate in the market, measured empirically by the credit union rate. The model assumes that the rates are uniform between banks and credit unions, but predicts that this uniform rate would be lower with either less bank concentration or with a stronger credit union presence. However, if prices were not uniform between banks and credit unions, then we might expect that as bank concentration increased, loan rates at banks would exceed those at credit unions by greater amounts. In this case, using credit union rates as estimates of both credit union and bank rates would understate bank rates. This understatement would be larger as bank concentration ratios in the market became greater.

[13] The average outstanding unsecured credit union loans for the 81 markets initially examined was a little under $2200 in 1997.

market share on loan rates suggests that a four percentage point increase in credit union market share implies about a one-half point reduction in the unsecured loan rate. In this model, a higher market share for the two largest institutions raises the loan rate, as expected.

For a $5,000 unsecured loan, the impact of market share of credit unions and of the top two institutions are similar to those for the $1,000 unsecured loan. A three percentage point increase in credit union market share implies about a one-quarter point reduction in the unsecured loan rate. As the market share of the top two firms increases, the loan rate increases for most values of this top-two share.

A few examples may make these results clearer: Victoria, Texas, with a combined credit union market share in 1996 of under 2%, had a market rate of 16.1% for a $1000 unsecured loan, while Missoula, Montana, with a combined credit union share of 13.4%, had a rate of 11.8% for the same type loan. Hazard, Kentucky, with no credit union presence, had a bank rate of 16.5% for a $5,000 unsecured loan, while Albany, Georgia, with a combined credit union share above 21%, had a rate of 11.3% for the same loan.

While the results of this study support the model of credit union influence presented at the outset, the sample size is problematic. We worked with data on one of the variables—the bank loan rate—for only 39 markets and only in a single time period. To remedy this problem, we estimated bank rates for the other markets and time periods, using the empirical relationship between bank rates and credit union rates in those markets and time periods for which both bank and credit union rates were available.[14]

We used these estimated values for markets in which actual bank rates were not available, to expand the sample size. After excluding markets with a dominant credit union and those with neither a reported credit union nor bank/thrift loan rate, the sample consisted of 89 markets for the $1000 bank loan rate, and 90 markets for the $5000 bank loan rate.

[14] Appendix E provides a detailed report of the results.

Statistics on this sample are in Appendix E. The mean bank rates, combining actual and estimated values, for this larger sample are close to those for the smaller sample which includes only actual bank rates. Also, in the sample, average credit union loan rates are below comparable figures for bank loan rates on both $1,000 and $5,000 unsecured loans.

The full statistical results are presented in Appendix E. The general findings again show a clear impact of market structure on loan rates, especially for the $5000 unsecured loan. Credit union share, bank/thrift concentration, and the dummy variable for state-level encouragement of credit union expansion show statistically significant impacts, while the scale economy variable has the predicted sign but is not significant at conventional levels. The results for the $1,000 unsecured loan are similar but are not statistically significant.

The results of the quadratic specification for the $5,000 loan indicate that a four percentage points increase in the credit union market share implies about a one-quarter point reduction in the unsecured loan rate. As the market becomes more concentrated, the price-decreasing impact of a larger credit union market share gets stronger, as predicted.[15] For markets where the credit union market share is below 8.33%, an increase in market concentration raises the loan rate.[16] This is consistent with the notion that a larger credit union role in a market limits the ability of leading banks and thrifts to raise prices.

VI. Conclusion

With any empirical study, data limitations and measurement issues raise concerns about the strength of the findings reported. Nevertheless, the results suggest that unsecured loan rates in small consumer financial markets are affected in a significant manner by both local market concentration, which implies a role for smaller financial institutions generally, and by the share credit unions hold in those markets. In addition, the

[15] See Item 3 in Section IV.

[16] The quadratic specification results reported in this paragraph will not be constant as is the case with a linear specification. Therefore, the results reported above are for typical levels of the variables in the regression equation. See Appendix E for more detail.

potential for growth in credit union influence may exert a disciplining role on loan rates.

Future research should continue to explore the impact of credit unions on competitive performance in local lending markets. If these results are confirmed in future studies, they may affect antitrust treatment of bank and S&L mergers and policy on easing the entry and expansion of small lenders of all types, including credit unions. Legislators and regulators may regard a strong fringe group of lending institutions as important to the interests of consumers.

Appendix A: Mathematical Derivation of Analytical Framework

The analytical approach is based on a modified version of the dominant firm-price leadership model. The modification involves the notion that while credit unions may be regarded as the price-taking fringe, not all banks and S&Ls would realistically constitute a dominant group. Nevertheless, as a group banks and S&Ls may be dominant, with the degree to which a monopoly position over their residual demand (i.e., netting out credit unions) is exploited depending on how concentrated bank and S&L deposits are in the leading two institutions.

The number of major firms is usually quite small in the type of markets examined in this study, and there is a concern that in the absence of pressure from a "competitive fringe" these leading firms may be able to act in a collusive manner. In the spirit of Saving (1970), a homogeneous product is assumed, with market demand for loans, $Q = D(P)$. Credit unions are treated as a price-taking fringe, with their supply $S^{CU}(P)$ and the demand faced by banks and S&Ls, $D^{B}(P)$, a residual:

(1) $D^{B}(P) = D(P) - S^{CU}(P)$

Taking first derivatives with respect to price yields

(2) $D^{B\prime}(P) = D'(P) - S^{CU\prime}(P)$

Multiplying all terms in (2) by (P/Q), and multiplying the left-hand-side expression by $(D^{B}(P)/D^{B}(P))$ and the last term by $(S^{CU}(P)/S^{CU}(P))$ produces the following

(3) $$\frac{P\, D^{B\prime}(P)\, D^{B}(P)}{D^{B}(P)\, D(P)} = \frac{D'(P)\, P}{D(P)} - \frac{S^{CU\prime}(P)\, P\; S^{CU}(P)}{S^{CU}(P)\, D(P)}$$

or, simplifying, and defining CU to be equal to $S^{CU}(P)/D(P)$—the credit union market share—an expression in terms of price elasticities of demand and supply is obtained,

(4) $|\eta_B|\,(1\text{-}CU) = |\eta| + \varepsilon_{CU}\, CU$

and

(5) $|\eta_B| = |\eta| / (1\text{-}CU) + \varepsilon_{CU}\,(CU/(1\text{-}CU))$.

If it was assumed that all non-credit union institutions acted to jointly maximize profits, this would imply that the Lerner Index, LI, $\equiv (P\text{-}MC)/P = 1/|\eta_B|$. More realistically, the extent to which the Lerner Index approaches this value is parameterized as a function of dominance *within the bank and S&L group* of the 2 leading firms (to simplify, a linear function) so that

(6) $LI = \theta/|\eta_B|$, where $\theta = k\, CR2/(1\text{-}CU)$, CR2 = the share of the two largest financial institutions in total market deposits (including credit unions), k is a constant, and $0<\theta<1$.

Substituting (5) into (6), the bank/thrift Lerner Index is found to be

(7) $$LI = \frac{k\, CR2}{|\eta| + \varepsilon_{CU}\, CU}$$

Without any further mathematical analysis, the following implications clearly emerge:

(i) as CR2 increases the LI increases as well,

(ii) as CU increases the LI declines;

(iii) as ε_{CU} increases the LI declines;

and, not quite as obvious (but easy to derive), the declines in (ii) and (iii) are larger in absolute value as CR2 is larger. While the mathematics is a bit more complicated, all of the qualitative results above follow when LI is replaced with the market price, which is the variable explained in the empirical part of this study.

Appendix B: Definition of Variables

The variables used in the regression equations are shown below with their definitions.

CU	Combined market share of credit unions
CR2	Market share of largest two institutions
POP	Population of local market
COST,6mo	Credit union cost of funds, lagged six months
CU-RATE	Average rate in a local market for unsecured (non-credit card) loans at credit unions
HIGHSTATE	Binary variable, equal to 1 if the market share of credit unions in the state is > 10%, otherwise, 0.
Top Branch Deposits	Total deposits in all branches of the largest institution in a market

Appendix C: Regression Results for Credit Union Loan Rates

Regression Coefficients
(t-statistics in parentheses)
See Appendix B for definition of variables.
All variables in levels

Dependent variable: Credit Union Loan Rate (unsecured non-credit-card loan)

CONSTANT	15.46	(29.77)
COST	0.27	(3.55)
POP (000s)	-0.01	(5.98)
CR2	-0.039	(5.69)
CU (credit union market share)	-0.038	(3.94)
HIGHSTATE (state CU share>10%)	-0.86	(5.44)
CU*CR2<40	0.005	(0.43)
CU*CR2>60	0.007	(0.25)

n = 769
R^2 = 0.152

Sample Statistics
(number of observations in parentheses)

		Mean	St. Dev.	Minimum	Maximum
CU	(810)	9.19%	7.22	0	30.49
CR2	(810)	50.00%	12.47	28.21	100
POP	(810)	79,849	35,005	7,108	123,786
COST, 6 mo. lag	(810)	3.99%	0.73	3.18	5.76
CU-RATE	(769)	13.33%	1.66	7.00	18.00

Appendix D: Regression Results for Actual Bank Rates

Quadratic specification

The regression results are shown below. However, note that in the quadratic specification, to explain the impact of coefficients—first for a $1,000 loan—the marginal impact of the CU on loan rates is 1.54 - .020 (CR2) - .044 (CU). This is negative (as predicted) for CU > 35.0 - .455 (CR2); for example, for a CU of 15% and CR2 of 50%, the marginal impact is -0.12 (suggesting that in this range, a 4 percentage point increase in the credit union market share would imply about a one-half point reduction in the unsecured loan rate). The marginal impact of CR2 is .981 - .020 (CU) - .0138 (CR2). This is positive (as predicted) for CR2 < 71.1 - 1.45 (CU) = 58.0 at the mean credit union market share of 9%.

For a $5,000 unsecured loan, the impacts of CU and CR2 are quite similar to those above. The marginal effect of CU on loan rates is 0.93 - .0124 (CR2) - .027 (CU). This is negative for CU > 34.4 - .46(CR2); for CU = 15% and CR2 = 50%, the marginal impact is -0.08 (so, in this range, a 3 percentage point increase in the CU market share would imply about a one-quarter point reduction in the unsecured loan rate). Here the marginal impact of CR2 is .367 - .0124 (CU) - .0044 (CR2), which is positive for CR2 < 83.4 - 2.82 (CU) = 58 at the mean credit union market share of 9%.

Regression Coefficients
(t-statistics in parentheses)
See Appendix B for definition of variables.

Dependent variable = actual bank loan rates, excluding markets with "dominant" CU

	Unsecured loans $1000	**Unsecured loans $5000**
Constant	-19.23 (1.74)	-0.18 (0.02)
CU market share	1.54 (2.78)	0.93 (2.10)
(CU market share)^2	-.022 (2.17)	-.014 (1.56)
CU share X CR2	-.020 (2.53)	-.012 (2.02)
CR2	0.98 (2.95)	0.37 (1.40)
(CR2)^2	-.0069 (2.77)	-.0022 (1.07)
HIGHSTATE	-1.85 (1.89)	-1.38 (1.78)
Top Branch Deposits ($billions)	.0002 (0.16)	.0006 (0.56)
R^2	.408	.267
sample size	29	34

Sample Statistics

Cross-section sample with actual data on unsecured bank loan rates—excluding markets with a "dominant" credit union (one among top 2 depository institutions)

	N	Minimum	Maximum	Mean	Standard Deviation
C	34	0	22.8	9.9	7.1
CR2	34	29.1	87.4	49.8	13.9
Top Branch Deposits in market ($millions)	34	58.6	2,222.7	296.2	361.3
State Credit Union Share	34	1.5	17.3	6.9	3.2
CU Members, As % of Population	34	0	70.8	26.8	19.7
Population	34	12,000	123,786	78,377	37,597
$1,000 bank loan rate	29	10.5	20.33	14.0	2.1
$5,000 bank loan rate	34	10.67	18.0	13.4	1.8
CU loan rate	32	11.17	16.76	13.3	1.4

Appendix E: Regression Results With "Imputed" Bank Rates

Background

The results of the cross-section study shown in Appendix D support the model of credit union influence presented at the outset of the paper. However, the small sample size is problematic. A solution which was attempted next was to estimate for that small sample the empirical relationship between each of the two bank loan rate measures (for March 1998) and the credit union rates (averaging December 1997 and June 1998 measures), and using that result to predict bank loan rates for closer to the full sample for which market structure data were available. The following regression equations were estimated (a log specification produced the best fits, with estimated coefficients statistically significant at conventional levels):

ln BANKRATE ($1000 loan) = 1.315 + 0.514 ln CURATE $\quad R^2 = 0.13$, n = 28

ln BANKRATE ($5000 loan) = 1.509 + 0.419 ln CURATE $\quad R^2 = 0.12$, n = 32

The results of these regressions provided imputed loan rates for banks where actual data was not available.

The regression results are shown below. As before, to explain the impact of coefficients in the quadratic specification—here just for a $5,000 loan—the marginal impact of the CU on loan rates is

0.260 - .0042 (CR2) - .0058 (CU).

This is negative (as predicted) for CU > 45 - .724 (CR2); for example, at values about 20% above their means, CU = 12 and CR2 = 60, the marginal impact is -0.06 (suggesting that in this range, a 4 percentage point increase in the credit union market share would imply about a one-quarter point reduction in the unsecured loan rate). As the market becomes more concentrated (CR2 increases), the price-decreasing impact of CU gets stronger, as predicted. The marginal impact of CR2 is .035 - .0042 (CU). This is positive (as predicted) only for CU shares below 8.33 percent, consistent with the notion that a larger credit union role in a market limits the ability of leading banks and thrifts to raise prices.

Selected Regression Coefficients
(t-statistics in parentheses)
See Appendix B for definition of variables.

Dependent variable = "Imputed" bank loan rates, deleting markets with "dominant" CU

	Unsecured loans $1000	Unsecured loans $5000
Constant	12.95 (10.61)	11.69 (11.58)
CU market share	0.202 (1.43)	0.260 (2.20)
(CU market share)2	-.0029 (0.99)	-.0029 (1.18)
CU share X CR2	-.0030 (1.45)	-.0042 (2.40)
CR2	0.025 (1.17)	0.035 (2.05)
State CU Share over 10%	-0.60 (1.43)	-0.61 (1.77)
Top Branch Deposits ($millions)	-0.0006 (0.92)	-.0007 (1.19)
R^2	.060	.111
Sample size	89	90

Sample Statistics

Cross-section sample using "imputed" bank loan rates (and excluding "dominant" CUs)

	N	Minimum	Maximum	Mean	Standard Deviation
State CU Share	90	0.66%	28.20%	6.95%	4.41%
Population	90	12,000	123,786	75,769	35,896
CU	90	.00	29.21	9.82	7.64
CR2	90	29.05	99.56	49.82	12.53
Top Branch Deposits ($millions)	90	58.6	2,222.7	273.0	243.2
CU loan rate	88	10.19	18.00	13.37	1.62
Bank loan rate ($1000)	89	10.50	20.33	14.09	1.43
Bank loan rate ($5000)	90	10.67	18.00	13.41	1.23
State CU Share (=1 for share>10%)	90	.00	1.00	0.1778	0.3845

Appendix F: Sample Markets

1. List of 81 Markets for credit union loan rate time-series study.

A. SMSAs under 100,000 population (1990):

1. Bismark, ND
2. Casper, WY
3. Dubuque, IA
4. Elmira, NY
5. Enid, OK
6. Gadsden, AL
7. Great Falls, MT
8. Iowa City, IA
9. Jackson, TN
10. Kokomo, IN
11. Lawrence, KS
12. Owensboro, KY
13. Pine Bluff, AR
14. Rapid City, SD
15. St. Joseph, MO
16. San Angelo, TX
17. Sherman-Denison, TX
18. Victoria, TX

B. SMSAs between 100,000 and 125,000 in population

1. Abilene, TX
2. Albany, GA
3. Anniston, AL
4. Billings, MT
5. Bryan-College Station, TX
6. Columbia, MO
7. Cumberland, MD/WV
8. Danville, VA
9. Decatur, IL
10. Dover, DE
11. Florence, SC
12. Glens Falls, NY
13. Goldsboro, NC
14. Grand Forks, ND/MN
15. Greenville, NC
16. La Crosse, WI/MN
17. Lawton, OK
18. Lewistown-Auburn, ME
19. Muncie, IN
20. Pueblo, CO
21. Punta Gorda, FL
22. Santa Fe, NM
23. Sharon, PA
24. Sheboygan, WI
25. Sioux City, IA/NE
26. State College, PA
27. Texarkana, TX/AR
28. Wausau, WI
29. Williamsport, PA
30. Yuma, AZ

C. Selected non-metropolitan areas with county populations under 125,000

1. Fairbanks, AK
2. Lewiston, ID (Nez Perce County)
3. Newport, VT (Orleans County)
4. Sheridan, WY (Sheridan County)
5. Butte, MT (Silver Bow County)
6. Many, LA (Sabine Parish)
7. Escanaba, MI (Delta County)
8. Lihue, HI (Kaluai County)
9. Arkadelphia, AR (Clark County)
10. Live Oak, FL (Suwanee County)
11. Douglas, GA (Coffee County)
12. Fort Dodge, IA (Webster County)
13. Mankato, MN (Blue Earth County)
14. Grand Island, NE (Hall County)
15. Juneau, AK
16. Pierre, SD (Hughes County)
17. Lancaster, NH (Coos County)
18. Glenwood Springs, CO (Garfield County)
19. Great Bend, KS (Barton County)
20. Hazard, KY (Perry County)
21. Tensas Parish, LA
22. Fairmont, WV (Marion County)
23. Laramie, WY (Albany County)
24. Blytheville, AR (Mississippi County)
25. Seaford, DE (Sussex County)
26. Rome, GA (Floyd County)
27. Wailuku, HI (Maui County)
28. Augusta, ME (Kennebec County)
29. Brainerd, MN (Crow Wing County)
30. Austin, MN (Mower County)
31. Laurel, MS (Jones County)
32. Jefferson City, MO (Cole County)
33. Keene, NH (Cheshire County)

2. **List of 34 markets for cross-section bank rate study (with "actual" bank rates, excluding markets with "dominant" credit unions.)**

1. Casper, WY
2. Great Falls, MT
3. Jackson, TN
4. Kokomo, IN
5. Victoria, TX
6. Albany, GA
7. Billings, MT
8. Columbia, MO
9. Cumberland, MD
10. Danville, VA
11. Decatur, IL
12. Florence, SC
13. Glens Falls, NY
14. Grand Forks, ND/MN
15. LaCrosse, WI
16. Muncie, IN
17. Santa Fe, NM
18. Sheboygan, WI
19. State College, PA
20. Williamsport, PA
21. Lewiston, ID
22. Hazard, KY
23. Laramie, WY
24. Brainerd, MN
25. Jefferson City, MO
26. Grand Junction, CO
27. Dodge City, KS
28. Lebanon, KY
29. Middlesboro, KY
30. Somerset, KY
31. Bozeman, MT
32. Missoula, MT
33. Devil's Lake, ND
34. Camden, TN

3. **List of 90 markets for bank loan rate study using "imputed" bank loan rates (excluding markets with dominant credit unions)**

Bismarck, ND
Casper, WY
Cheyenne, WY
Dubuque, IA
Elmira, NY
Gadsden, AL
Great Falls, MT
Iowa City, IA
Jackson, TN
Kokomo, IN
Lawrence, KS
Owensboro, KY
Pine Bluff, AR
Rapid City SD
St. Joseph, MO
San Angelo, TX
Sherman-Denison, TX
Victoria, TX
Abilene, TX
Albany, GA
Anniston, AL
Billings, MT
Bryan-College Station, TX
Columbia, MO
Cumberland, MD
Danville, VA
Decatur, IL
Dover, DE
Florence, SC
Glens Falls, NY
Goldsboro, NC
Grand Forks, ND
Greenville, NC
LaCrosse, WI
Lawton, OK
Lewiston-Auburn, ME
Muncie, IN
Pueblo, CO
Santa Fe, NM
Sharon, PA
Sheboygan, WI
Sioux City, IA
St. College, PA
Texarkana, TX
Wausau, WI
Williamsport, PA
Yuma, AZ
Fairbanks, AK
Lewiston, ID
Newport, VT
Sheridan, WY
Butte, MT
Many, LA
Escanaba, MI
Lihue, HI
Arkadelphia, AR
Live Oak, FL
Douglas, GA
Fort Dodge, IA
Mankato, MN
Grand Island, NE
Juneau, AK
Pierre, SD
Lancaster, NH
Glenwood Springs, CO
Great Bend, KS
Hazard, KY
Fairmont, WV
Laramie, WY
Blytheville, AR
Seaford, DE
Rome, GA
Waikulu, HI
Augusta, ME
Brainerd, MN
Austin, MN
Laurel, MS
Jefferson City, MO
Keene, NH
Grand Junction, CO
Vincennes, IN
Dodge City, KS
Lebanon, KY
Middlesboro, KY
Somerset, KY
Owatonna, MN
Bozeman, MT
Missoula, MT
Devil's Lake, ND
Camden, TN

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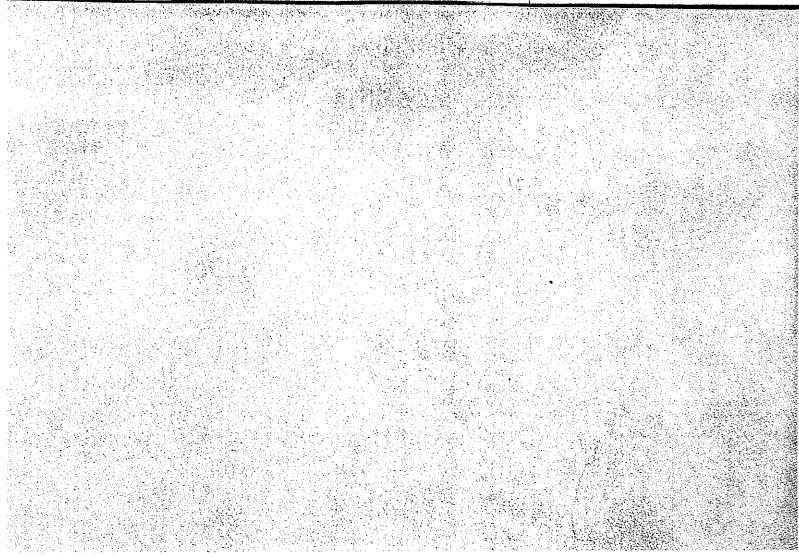

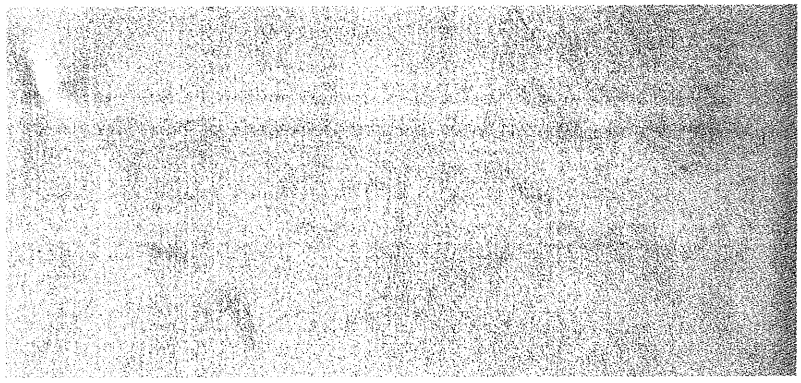

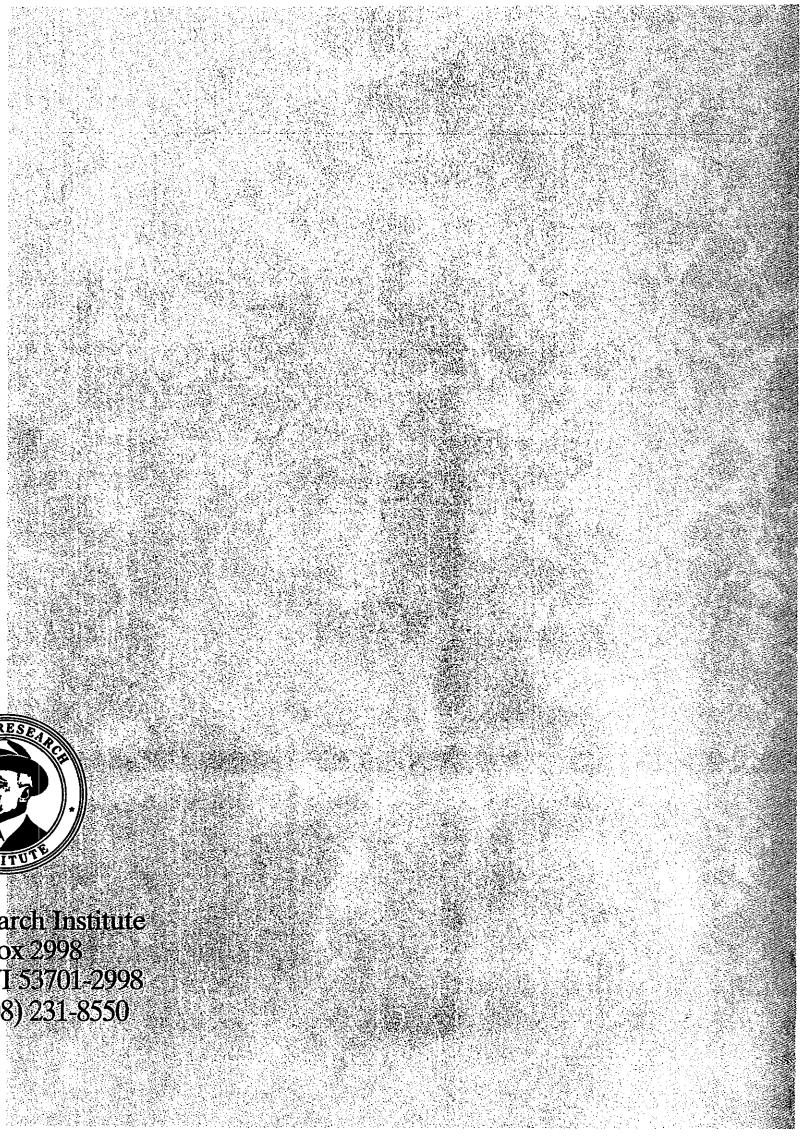

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