The diversification and financial performance of US credit unions

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Abstract

For US credit unions, revenue from non-interest sources has increased significantly in recent years. We investigate the impact of revenue diversification on financial performance for the period 1993–2004. The impact of a change in strategy that alters the share of non-interest income is decomposed into a direct exposure effect, reflecting the difference between interest and non-interest bearing activities, and an indirect exposure effect which reflects the effect of the institution’s own degree of diversification. On both risk-adjusted and unadjusted returns measures, a positive direct exposure effect is outweighed by a negative indirect exposure effect for all but the largest credit unions. This may imply that similar diversification strategies are not appropriate for large and small credit unions. Small credit unions should eschew diversification and continue to operate as simple savings and loan institutions, while large credit unions should be encouraged to exploit new product opportunities around their core expertise.

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1. Introduction

In recent years, deregulation and technological innovation has permitted almost all financial institutions to capture an increasing share of their income stream from non-interest sources. US commercial banks, for example, generated 42% of operating income from non-interest sources in 2004 compared to 32% in 1990 and 20% in 1980. While part of the increase in non-interest income is due to diversification into lines of business such as investment banking, venture capital and insurance underwriting, growth in fee-paying and commission-paying services linked to traditional retail banking services has also been significant (DeYoung and Rice, 2004a,b,c). However, the shift towards non-interest income has not improved the risk-adjusted returns of US banks in recent years (Hirtle and Stiroh, 2007). Clark et al. (2007) detect a recent shift in the strategic behaviour of US banks. A return to retail has occurred because retail business offers relatively stable returns that can help offset volatility in non-retail business.

For banks, both in the US and elsewhere, several researchers have explored relationships between non-interest income and business strategies, market conditions, technological change and risk-adjusted financial performance (Gallo et al., 1996; DeYoung and Rice, 2004a,b,c; Stiroh, 2004a,b; Calmes and Liu, 2005; Landskroner et al., 2005; Acharya et al., 2006; Stiroh, 2006; Stiroh and Rumble, 2006; Carbo-Valverde and Fernandez, 2007; Laeven and Levine, 2007; Lepetit et al., 2007; Mercieca et al., 2007;
Credit unions are financial cooperatives, organised to meet the needs of their members. Surpluses or profits are returned to members in the form of reinvestment in the credit union, dividends to members, or lower interest rates on loan products (Bauer, 2007). Each credit union is governed by its members, who elect (from within the membership) unpaid volunteer officers and directors to determine the policies under which the credit union operates. Voting is one-member-one-vote, regardless of the size of the member’s savings or loans balances. At the end of 2004, there were 91,138 credit unions in the US, with a membership of 87 million and a total asset base of $668 billion. This figure represents about 8% of total FDIC-insured commercial bank assets.

Credit unions serve a membership defined theoretically by a common bond. The common bond might restrict membership to a local community, employees of a particular firm, or individuals with some other organizational affiliation (such as a church). The original purpose of the common bond was to enable members to substitute their knowledge of each other’s creditworthiness for collateral. Over time, the common bond has become less important, partly because of the formation of nationwide credit bureaus able to provide detailed information on the creditworthiness of individuals. For federally chartered credit unions, the 1998 Credit Union Membership Access Act is widely perceived to have relaxed the constraints imposed by the common bond, by permitting select employee groups (SEGs) to be added to existing fields of membership.

Credit unions were originally distinguished from other financial institutions by their emphasis on small value, unsecured, non-mortgage loans to individuals and households. Federal credit unions gained the authority to make long-term (up to 30 years) mortgage real estate loans in 1977. Previously, federal credit unions were limited to providing short-term mortgage loans such as second mortgages and mobile home loans (Walter, 2006). According to the credit union national association (CUNA, 2005), at the end of 2004 mortgages amounted to 32% of all loans.

Credit card lending has also grown in importance. Approximately 54% of credit unions offer credit cards (CUNA, 2005). Credit card lending accounts for a large percentage of all unsecured lending, although unsecured loans account for only 10% of all lending. Secured auto loans account for 37% and mortgages account for 32% of all credit union lending. Business loans increased from $8 billion in 2002 to $15 billion in 2004 to $18 billion in 2006, accounting for about 3.5% of all credit union lending. Credit unions also deal in investment products such as bankers’ acceptances, cash forward agreements and reverse purchase transactions. These offerings have increased competition between credit unions and other mainstream financial services providers.

In the empirical analysis that is reported in Sections 4 and 5 below, diversification is measured by subdividing total operating income into its interest income and non-interest income components. As far as we are aware, there is no publicly available data detailing the further decomposition of non-interest income for US credit unions. In order to obtain a clearer picture of the principal sources of non-interest income, we review the theoretical and empirical literature on corporate diversification, with particular emphasis on the financial services sector. In Section 4 we describe our data set, paying particular attention to the trend in growth of non-interest income. In this section we also describe the empirical model. In Section 5 we present and interpret the empirical results concerning the impact of diversification on credit union financial performance. Finally, we summarize and conclude in Section 6.

2. The US credit union sector

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3 Although the assets and membership of US credit unions have grown over time, the number of institutions has declined through merger and liquidation. In 1970 there were 23,687 credit unions with 22 million members and assets of $18 billion.

4 State chartered credit unions, in a number of states, had the authority to make long-term mortgage real estate loans for several years prior to 1977.

5 Recent evidence suggests that credit unions play an important role in promoting competition among retail banks in highly concentrated banking markets (Tokle and Tokle, 2000; Feinberg, 2001; Feinberg and Rahman, 2001; Hannan, 2003; Schmid, 2005).
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