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ScienceDirect
Journal of Banking & Finance 32 (2008) 1836–1849
Journal of BANKING & FINANCE
www.elsevier.com/locate/jbf

The diversification and financial performance of US credit unions ☆

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Received 28 June 2007; accepted 10 December 2007
Available online 1 January 2008

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.

JEL classification: G21

Keywords: Credit unions; Diversification; Risk; Performance

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;

☆ This paper was reviewed and accepted by the Editorial Board while Professor Giorgio Szego was the Managing Editor of The Journal of Banking and Finance.

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0378-4266/$ - see front matter
doi:10.1016/j.jbankfin.2007.12.015

Hirtle and Stiroh, 2007). Similar attention has not, however, been given to the US credit union sector. In part this is because as financial cooperatives, organised to meet the needs of their members, credit unions have not had the same diversification opportunities as banks. Only since the passage of the Credit Union Membership Access Act 1998 have US credit unions been permitted to offer their members business loans, for commercial, corporate, business investment or property purposes, up to a maximum of 12.25% of assets. At the end of 2004, non-interest income contributed 18% of total operating income. This figure is similar in magnitude to that for US commercial banks in the early 1980s.

Nevertheless, since 2000 there has been a steady increase in the share of non-interest income in operating income for the US credit union sector as a whole. For the larger credit unions, the pace of growth has been exceptional. In our sample (see Section 4), the share of non-interest income in operating income for credit unions with assets greater than $50 million increased by around 1% on average in each six-month period between 2001 and 2004. This period of rapid growth provides the background for the present study of the impact of revenue diversification on the financial performance of US credit unions.

The remainder of the paper is structured as follows. In Section 2 we describe recent developments in the US credit union sector, including the trend towards product diversification, especially among the larger institutions. In Section 3 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

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 9138 credit unions in the US, with a membership of 87 million and a total asset base of $668 billion.[3] 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).[4] 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.[5]

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-

[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).