Credit Union Issues

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CREDIT UNIONS AND THEIR LEGAL STATUS HAVE MADE THE FINANCIAL NEWS MORE THAN USUAL THIS YEAR. IN FEBRUARY THE U.S. SUPREME COURT PARTIALLY SETTLED A LONG-RUNNING CONTROVERSY ABOUT THE CONCEPT AND EXTENT OF COMMON BOND LIMITS ON THESE INSTITUTIONS' MEMBERSHIP. THE COURT INTERPRETED THE FEDERAL CREDIT UNION ACT AS LIMITING MEMBERSHIP IN A FEDERAL CREDIT UNION TO INDIVIDUALS SHARING A SINGLE COMMON BOND.

The ensuing debate about limits of credit union membership has extended, quite naturally, to credit union tax status (see, for example, Bickley 1997; McConnell 1998; Robinson 1998). Meanwhile, the U.S. House of Representatives and Senate have overwhelmingly passed and the President has signed a bill that would substantially annul the Supreme Court decision; grandfather past common bonds, membership, and membership eligibility; and establish principles for regulation and determining safety and soundness while leaving credit unions' favorable tax status intact and limiting their business lending (Anason and McConnell 1998; Anason 1998a, b).

The controversy swirling around credit unions is often depicted as a simple fight between a group of small mutual institutions with limited membership, limited (primarily consumer) product powers, and tax exemption and a group of generally larger, generally stockholder-owned institutions that are not tax exempt (for example, see McConnell 1998; National Association of Federal Credit Unions 1997; Robinson 1998; and Schaefer 1997). However, the issues and implications of solutions for the conflict are not so simple. Changes in credit union organization and taxation are likely to affect credit unions, their customers, and their competitors in several ways. These include impacts on ease of access to credit union services by consumers; credit unions' costs, risks, and methods of corporate decision making; their competitive position relative to other financial institutions; and the extent of operations allowed for tax-subsidized entities in providing consumer financial services.[1]

This article attempts to provide a basis for thinking about current credit union issues. It begins with a brief outline of credit unions' current place among American depository financial institutions. In order to explain the development of credit unions' special legal status around the beginning of this century, it outlines the origins of these features as attempts to solve a set of problems that plagued most depository financial institutions of the time. The problems included limited information about individual borrowers who could provide no security and costly procedures for collecting unsecured debt. The article describes how classic credit union characteristics—mutuality and common bond structure—developed to attack these listed problems and how more recent developments are generating pressures to relax common bond limits. The discussion considers the spillover of common bond issues into a debate on tax exemption for credit unions.[2] In conclusion, the article turns to some of the likely impacts of changes in credit unions' legal structure.

Credit Unions' Place in the Current American Financial System

As Table 1 shows, credit unions have played an increasingly important role in consumer banking over the last thirty-five years. From 1960 to 1985 their share of the consumer credit market almost doubled, increasing to 12.4 percent. Since 1985 they have lost less than a 1 percent share, while commercial banks were losing a 5 percent share.

As they do with commercial banks and thrifts, both state and federal governments charter credit unions. A federal insurance fund, the National Credit Union Share Insurance Fund (NCUSIF), insures individuals' shares of a majority of state and all federal institutions to a $100,000 per shareholder limit. The remaining state credit unions secure share insurance from various state and private funds. There were 6,957 federal and 4,396 state credit unions at the end of 1997. State laws govern state-chartered credit unions' common bond limits and powers, which vary from state to state; however, state credit unions and their regulators have been subject to legal attacks on common bond restrictions similar to those recently waged on federal credit unions.[3]

Table 2 shows that about 30 percent of all Americans are members of credit unions. At year-end 1997, there were more credit unions—over 11,000—than any other type of depository financial institution. Although that number represents a significant decline during the past decade, the number of Americans doing business at credit unions rose during that period.

Among depository financial institutions, credit unions are generally the smallest. Their median share value (equivalent to banks' total domestic deposits) totaled $5.1 million as of the end of 1997. This amount contrasts with a median total domestic deposits figure of $57.4 million for commercial banks.

Most credit unions offer a simple set of deposit and loan products to consumers. There are, however, some larger, more complex credit unions. For instance, the largest twenty have a median share value of $1.4 billion; they account for 12.5 percent of total credit union share accounts. The next 100 largest have a median share value of about $480 million; they account for 17.4 percent of total share accounts. It is these credit unions that have drawn much of their competitors' fire and received the most legislative attention in recent debates on common bond and taxation (see McConnell 1998, for example).

To the extent that they accept deposits (called shares) and make loans, credit unions resemble other depository institutions such as commercial banks. However, credit unions have several distinguishing legal characteristics. Each credit union member (holder of credit union shares) has one vote in selecting its board members and making other management and organization decisions. This voting structure (one member–one vote) differs from other mutual financial institutions such as mutual savings banks. The latter allocate voting rights in proportion to the size of a member's deposit. Credit unions derive their net worth by accumulating retained earnings. They do not issue capital stock. Most credit unions rely on unpaid, volunteer boards of directors elected by, and drawn from, each institution's membership, with the board setting policies for the credit union. In smaller credit unions most of the staff is composed of member-volunteers as well. Some credit unions also receive subsidies in the form of office space or member time from their sponsors or employers (GAO 1991).

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Credit unions are not-for-profit institutions. They return earnings to their members as reduced fees, reduced interest rates on loans, or as higher "dividends on shares" (which is equivalent to interest on deposits). They may also reinvest the earnings in the credit union as "retained earnings." Important to recent debates on their status, credit unions are exempt from federal corporate income taxes.[4]

In this country credit unions have, until recently, had rather strict limitations on their membership, generally based on an affinity or "common bond" among members. For federal credit unions, this bond may be based on a common employer, association, or religious, social, or community organization.

Credit unions' competitors often assert that much of the growth in credit unions' share of consumer lending have been driven by the relaxation of membership requirements implemented in 1982 and later by federal credit unions' regulator, the National Credit Union Administration (NCUA), combined with continuing exemption from federal corporate income taxes.[5] In recent years, this concern has manifested itself primarily in litigation over the

1. *For more detailed discussions of credit unions and current policy issues related to them, see studies by the U.S. General Accounting Office (GAO) (1991) and the U.S. Department of the Treasury (1997).*
2. *Debate on the appropriate range of credit union products is also occurring. Typically, their limited ability to offer small commercial and farm loans is questioned (GAO 1991). However, few credit unions offer these loans, and they made up less than 1 percent of total assets of credit unions in the United States and its territories at the end of 1997.*
3. *For a summary of current state suits, see CUNA & Affiliates Legal Division (1998).*
4. *For a more detailed discussion of credit union characteristics, see GAO (1991) and Moysich (1990).*
5. *Specifically, NCUA reinterpreted section 109 of the Federal Credit Union Act to allow multiple common bonds in individual credit unions.*

TABLE 1 Composition of the U.S. Consumer Credit Market

	1960	1965	1970	1975	1980	1985	1990	1995
Banks and Bank Holding Companies	43.14	46.41	49.10	51.23	50.69	49.82	47.71	44.86
Thrifts	3.27	3.08	3.29	4.88	6.39	9.68	6.12	3.54
Credit Unions	6.37	7.49	9.73	12.41	12.41	12.44	11.29	11.65
Asset-Backed Securities Issuers	——	——	——	——	——	——	9.57	18.94
Finance Companies	26.31	25.36	24.03	19.94	22.19	22.26	17.04	13.48
Other[a]	20.92	17.66	13.85	11.54	8.33	5.80	8.27	7.52

Note: The market here includes the institutions reported by the source as holders of consumer debt. Figures are percentages.

[a] Includes nonfinancial corporate and nonfarm, noncorporate businesses

Source: Board of Governors of the Federal Reserve System, *Flow of Funds Accounts of the United States*, table L.222

TABLE 2 Characteristics of U.S. Credit Unions, 1987 and 1997

	December 31, 1987	December 31, 1997
Number of Credit Unions	15,049	11,353
Number of Members (millions)	53.2	72.1
Number of Potential Members (millions)	181.5	244.4
Median Share Value ($ million)	1.8	5.1
Median Share Value of Top 20 Firms ($ million)	529.7	1,444.4
Median Share Value of Next 100 Firms ($ million)	217.5	482.6
Median Share Value of Remaining Firms ($ million)	1.8	4.8
Market Share of Credit Unions among Depository Institutions (percentage)	4.97	8.37

Source: Board of Governors of the Federal Reserve System, private data base definition of the common bond and in proposals for eliminating consumers' access to credit unions' government subsidies from federal income tax exemption.

Origins of American Credit Unions and Their Special Features

Credit unions developed in response to a gap in the supply of consumer banking services in the United States at the turn of the century. At this time and into the post–World War II era, commercial banks concentrated primarily on providing services to businesses and affluent individuals or making secured loans to homebuyers and farmers. In the financial environment of the time, information upon which to base decisions on the creditworthiness of potential borrowers was difficult and costly to come by.

Historically, credit unions used the common bond requirement for membership to help determine the creditworthiness of individual borrowers and to provide peer pressure on borrowers to pay their debts. Credit unions based their lending decisions largely on the reputation of loan applicants in the relevant affinity group. Because credit union members were individually liable for the loans made to other members, strict membership criteria like the common bond helped limit the lending risks borne by members and encouraged their monitoring of borrowers. Founders of early credit unions often voluntarily imposed common bond restrictions to reduce default risk and reduce the costs of monitoring loans. This country's first credit union law, passed in Massachusetts in 1909, permitted organizers to specify in their charter "conditions of residence or occupation, which qualify for membership" (Moody and Fite 1971). Other states and eventually the federal government followed suit in making the common bond a key organizing principle for credit unions.

The Federal Credit Union Act in 1934 limited membership in a federal credit union to "groups having a common bond of occupation or association, or to groups within a well-defined neighborhood, community, or rural district" (GAO 1991). The act neither elaborated on this definition at the time nor stated the reason for the requirement. Some courts have inferred that the purpose of the 1934 common bond requirement was to facilitate safe and sound operations. Until this year Congress had not addressed this issue in subsequent amendments to the Federal Credit Union Act or other law.[6]

What Is Implied by Credit Unions' Differences from Banks?

Credit unions' special features are more than cosmetic. They result in important differences between credit unions and stockholder-owned financial institutions, like commercial banks, in goals, customer base, operations, and competitiveness.

The most fundamental difference between banks and credit unions lies in two aspects of ownership—common bond and mutuality. As discussed above, common bond restrictions promote members' knowledge of the creditworthiness of other members and allow exercise of moral suasion on debtors. Lack of these limits on commercial banks and other stock institutions allows broader ownership, but, arguably, it also makes credit analysis more costly.

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Borrowers typically have more and better information about their own financial condition than anyone else does, including lenders. It is sometimes in their interest to withhold adverse information, knowing that revealing it to a lender could affect the amount and terms of lending. Lenders deal with this situation in a variety of ways. They obtain relevant information on potential borrowers from sources other than the borrowers, write contracts that provide protection against events about which they have little information, and monitor borrowers' financial condition to varying degrees. In the case of business loans, a requirement that the borrower maintain a deposit account provides a mechanism for monitoring on a continuing basis.

In the past, credit unions' common bond and mutuality organizational structure has addressed asymmetric information problems by requiring that these institutions lend only to members. The valuable information provided by records of size and pattern of balances in share accounts is often supplemented by the lending officer's personal knowledge of the borrower. In occupational credit unions, knowledge of an employer's condition can also be helpful. Prior to the general availability of on-line credit reports, the common bond and mutuality arrangement reduced costs of extending and monitoring credit to consumers whose financial statements and credit records had been difficult to acquire.

Credit unions' mutuality also has impacts on their corporate governance. The primary difference between stockholder and mutually owned institutions lies in who controls the firms and receives the earnings. A commercial bank's or stock thrift's stockholders vote for the firm's managers, distribute its profits, and are free to

6. The history of American credit unions is discussed more fully in Moody and Fite (1971).

sell their privileges. A mutual association, on the other hand, is owned by its depositors (called shareholders in the case of credit unions). In credit unions and mutual thrifts, each depositor has the right to vote for the managers of the firm.

Owners of a firm often employ managers to actively do that firm's business. These managers are their agents. What economists call agency problems refer to the difficulty that owners have in making sure that their agents—that is, managers—work in the owners' best interest. Managers, who may or may not also be stockholders, often have better information about the firm and different motivations from those of stockholders, who are often more widely dispersed geographically. This agency problem can result in improperly managed and inefficient operations with high management compensation.

A feature of credit unions' mutuality is the diversity of interests among their members/owners.

Manager/owner problems exist both in commercial banks and credit unions. Approaches to their solution are influenced by organizational structure. In mutuals like credit unions, officers and directors are often unpaid and, therefore, cannot inflate their salaries. In some credit unions other perks (such as office space) are constrained by sponsor contributions. These conditions go a long way toward mitigating the results of conflicts between owners (members) and managers. As members themselves, directors and unpaid officers have an incentive to monitor paid managers in the interest of all members. In stock firms like banks, creating incentives to resolve potential agency conflicts, including stock options for managers, can lead to higher costs. The threat of takeovers and stockholder and director revolts may also act as a check on wasteful expenditures.[7]

Some evidence indicates that credit unions' one depositor–one vote structure allows them to adapt successfully to change. A feature of credit unions' mutuality is the diversity of interests among their members/owners. Conflict amoung member groups can affect the manner in which a mutual, not-for-profit credit union is operated since the credit union cannot simultaneously maximize the dividend rate for savers and minimize loan rates for borrowers.

Some evidence on the results of member conflicts in mutual organizations comes from a study of German cooperative banks by Emmons and Mueller. Like credit unions in the United States, cooperative banks in Germany are mutual institutions that have been steadily increasing their market share relative to other types of financial institutions.[8] Emmons and Mueller focus on the diversity of interests between members of cooperative banks and highlight the dual role of members as borrowers and lenders. They develop a model showing that "a shift in the median (hence pivotal) member of the cooperative from predominantly a borrower orientation to a lender orientation causes the cooperative bank to shift its policy from underpricing credit towards the provision of competitively priced credit and deposit services" (1997, abstract). This result depends on cooperative financial institutions' one member–one vote, organization. Emmons and Mueller conclude that the democratic nature of cooperatives' ownership in fact creates opportunities for adaptation and survival. Together with a nationwide supporting infrastructure to capture scale and scope economies, the organization of German cooperative banks has allowed them to compete successfully with other, stockholder-held banking groups.

While the Emmons and Mueller model has not been directly tested on U.S. credit union data, some of the similarities between the structure and performance of U.S. credit unions and German cooperatives suggests that both gain ability to adapt from their one member–one vote characteristic.

Pressures on the Common Bond

In the past three decades, various changes in the environment in which financial institutions, particularly credit unions, operate have caused reconsideration of and changes in credit unions' common bond requirements. Developments in information technology have diluted the effect of restricting membership to a tight community. Increasing complexity and size have pushed more credit unions to seek professional managers. Extension of deposit insurance to credit union shares has lessened both member need and incentive credit monitoring. Dealing with credit union financial problems has made broader common bonds quite practical for their insurers and regulators.

Technological Change. Common bond requirements have become less important for the analysis of credit risks with the development of credit reporting services and other advances in collecting, transmitting, and analyzing credit information that have made it less costly to assess the likelihood of default on a particular loan. Both credit unions' competitors and credit unions themselves have adopted newer information technologies and greatly expanded the variety and availability of loans, both secured and unsecured.

Many credit unions—to meet customer demand and to compete with other depository institutions—also offer technology-based services such as ATMs and computer and electronic banking to take advantage of electronic account and transaction processing. The technology needed to provide such services involves substantial fixed costs. Adding more membership groups makes such investments more economical by allowing a credit union to spread its fixed costs over more members. A study of the productive efficiency of credit unions by Fried, Lovell, and Vanden Eeckaut (1993) concluded that credit unions can improve their performance by increasing their total membership as well as by increasing the number of accounts per member.

Credit-analysis advances provided by new technologies have not, however, eased another risk feature of the tight common bond. The more that a credit union's membership shares a common bond of employment or otherwise has similar exposure to plant closings or other economic risks, the less diversified is its exposure to credit risk. Diversifying the membership base makes the credit union more resilient in the face of problems experienced by any one local employer. This diversification can be accomplished by multiple common bonds.

Managerial Factors. Managerial factors may also create incentives for credit unions to grow by adding new membership groups. A credit union board of directors seeking to attract high-quality, professional managers may find it easier to do so if the credit union is large or has growth opportunities. Moreover, as nonprofit cooperatives, credit unions do not generally compensate their managers on the basis of profit or stock performance. Instead, management compensation often reflects a credit union's size and product offerings. Managers may therefore have an incentive to increase the credit union's size. Adding new membership groups is an obvious method of doing so (GAO 1991).

Share Insurance. Discipline to control risk taking by mutual depository institutions can be provided by creditors, depositors, owners, and managers. In the case of credit unions, if bankruptcy occurs creditors other than depositors are generally fully protected. Creditors have this protection because their position in the liquidation of a failed credit union is senior to that of depositors, whose shares are judged to represent equity, not debt. An important feature of the traditional common bond between members of a credit union was the willingness of some members to put their personal savings at risk by letting the credit union lend these funds to other members. This relationship between borrowers and savers originated to engender a higher sense of obligation than borrowers might otherwise feel toward ordinary creditors (GAO 1991).

The monitoring relationship between savers and borrowers has no doubt diminished since the introduction of share insurance in 1970. Credit union members still own their institutions. Since 1970, however, to the extent that their share accounts fall under $100,000, they are insured owners. This insurance dilutes the impact of the common bond in inducing shareholders to monitor borrowers and management.

Further dilution of the risk-management impact of the common bond may also have come from the increase in credit union size with the expansion of the common bond in the 1980s. Credit union membership has increased. The average credit union had more than 6,000 members as of year-end 1997.

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Financial Difficulties. In the early 1980s, the technical and organizational pressures on the common bond, discussed above, combined with a practical need to reduce economic distortions associated with credit union financial troubles. These factors induced significant easing of common bond restrictions. In 1982, faced with major difficulties in the industry, the NCUA reinterpreted the National Credit Union Act to substantially ease its common bond policy. Through this change, credit unions were allowed to have more than one common bond group in the same organization. The NCUA adopted and later expanded this policy to allow merging of credit unions that had financial problems, to provide a diversity of membership that would help credit unions weather economic downturns, and to make credit unions' services more widely available (Burger and Dacin 1991; Murphy 1996).

This relaxation has also enabled credit unions to grow larger (Good 1996; Murphy 1996; Smale 1997). As of June 1996 more than half of the 7,244 federal credit unions had multiple group fields of membership. These credit unions had a total membership of 32.6 million and accounted for approximately 80 percent of total federal credit union shares (Smale 1997).[9]

Other Factors. Several other factors have encouraged credit unions to add new membership groups: Downsizing or closings at manufacturing firms, military bases, and other large employers have shrunk the membership base of many occupational credit unions. Worker mobility has made the membership base less stable than in the past, when many members had a long-standing relationship with their employers. In addition, restricting

7. See Jensen and Meckling (1976) and Fama and Jensen (1983) for a more complete discussion of agency problems.

8. Unlike U.S. credit unions, cooperative banks in Germany do not enjoy tax advantages.

9. Comparable information on state-chartered credit unions is not available.

credit unions to a single common bond has made credit union services unavailable to many segments of the population. Finally, since the minimum viable size of a credit union has been generally understood to be around 500, employees of small companies have faced barriers to forming successful credit unions (Evans and Shull 1998).

The Tax Exemption Issue

As credit unions have grown larger and developed more diverse membership, their long-standing exemption from federal income taxes has drawn more fire from competitors. One should not be surprised that tax exemption has become an issue that is attached to common bond extension.

Credit unions' special legal and tax status is often related to their role in providing an alternative source of financial services for less affluent individuals with few alternatives.

Credit unions' exemption from federal income tax dates back to the Revenue Act of 1916, which provided tax-exempt status to mutual thrift institutions and cooperatives. Because they were found to be "organized and operated for mutual purposes and without profit," the U.S. Attorney General ruled in 1917 that credit unions, which were all state-chartered then, were entitled to the exemption. According to Moody and Fite (1971) this ruling was relatively noncontroversial at the time. The first federal credit unions were chartered in 1934 and granted tax-exempt status in 1935 under a ruling by the Internal Revenue Service.

Since 1937 Congress has reconsidered the tax-exempt status of mutual financial institutions on several occasions. In 1951 it repealed the tax exemption for all mutual institutions except credit unions. This decision was based on the view that credit unions (unlike other mutual financial institutions) had remained true to their original purpose of providing cooperative financial services to members. Mutual savings banks, on the other hand, were deemed in a 1951 report by the Senate Finance Committee to be "in active competition with commercial banks . . . for the public savings, and . . . with many types of taxable institutions in the security and real estate markets" (cited in Burger and Lypny 1991, 16).

Competitor financial institutions as well as legislators attempting to balance the federal budget have challenged the tax-exempt status of credit unions since at least 1970. Commercial banks and thrifts have claimed that the easing of common bond limits and the expanded products and services that credit unions have been allowed to provide their members have eroded the distinction between banks and credit unions. This argument closely parallels arguments made a half-century ago, when Congress removed tax exemption from mutual savings and loan associations and savings banks (Moody and Fite 1971).

The credit union industry has evolved over the last sixty years in an environment that treats credit unions as nonprofit cooperatives. Without tax exemption the industry would probably have evolved differently. It is likely that credit unions would not have grown as fast, and some credit unions might not have formed. Moreover, credit union customers would have received some combination of lower deposit rates and higher borrowing rates.

Credit Unions' Public Purposes

Credit unions' special legal and tax status is often related to their role in providing an alternative source of financial services for less affluent individuals with few alternatives. Evidence on the current economic status of credit union membership and on available alternative sources of loans and deposit services may dilute the strength of these public purpose arguments.

The purpose of the Federal Credit Union Act as set forth in 1934 was "to make more credit available to people of small means" (GAO 1991). None of the common bond criteria in that law, however, address the economic status of members or potential members. While there are no statistically reliable data on the economic status of credit union members earlier in the century, it was accepted that members were generally not affluent (Moody and Fite 1971).

Expansions of the common bond requirement in the 1980s may have contributed to changes in membership characteristics. The little publicly available data on membership characteristics suggest that members are not all "of small means" but may still not be as well off as commercial banks' individual customers. Two recent published surveys give information. A Gallup Organization poll reported in the *American Banker* found that the average annual family income of credit union members was lower than the income of bank customers (Seiberg 1997). The average income for credit union members was also slightly below the 1996 level for the entire population. An earlier survey by the Secura Group for the American Bankers Association suggests that the typical credit union member is in his or her "early 40s, employed, with above-average income, better educated than a non-member and with access to financial services from a variety of sources" (reported in GAO 1991). This evidence is consistent with the results of an earlier survey in 1987 by CUNA & Affiliates, a credit union trade group (reported in GAO 1991).

Another major public purpose argument in the development of credit union laws hinged on the existence of few borrowing alternatives for consumers

(Moody and Fite 1971). While a paucity of alternatives may have characterized the beginning of this century and even the early postwar period, consumers now have a rather broad set of alternatives for credit for most purposes. Several types of suppliers exist for each type of consumer credit, and they make their services available in many markets.

Challenges in Court

Relaxing previously limited common bond restrictions has brought credit unions into more direct competition with other depository institutions such as banks. These institutions, banks in particular, have argued that credit unions' less restrictive common bond makes credit unions very similar to taxed financial institutions. They conclude that tax exemption amounts to a federal subsidy to credit unions and their members and gives credit unions unfair competitive advantages (Fettig 1996; Marshall 1996).

Banks have gone to court to limit the scope of credit unions whose charters define particularly large fields of membership on the grounds that potential members do not share the requisite common bond. Their suits have been filed in both federal and state courts. Until a recent U.S. Supreme Court decision, the federal suits had met with mixed results.[10] In the 1980s two courts found that the common bond contributed to the sound management of a credit union and thus to the safety and soundness of the industry as a whole. Yet neither court found much legislative guidance on limitations of the common bond. One of the courts inferred from a state statute that the common bond requirement had been imposed to promote the institution's financial stability. In a later case, a federal court dismissed the banking industry's challenge to a proposed charter for a multiple-bond credit union on the grounds that Congress had "purposefully sacrificed the competitive interest of banks" in favor of making credit more readily available to people of small means through the chartering of credit unions (GAO 1991).

Earlier this year, the U.S. Supreme Court ruled on a pivotal case involving the AT&T Family Credit Union (Supreme Court 1998). The institution had expanded from its original core group of employees of Western Electric Company in three North Carolina cities to 112,000 members in fifty states and more than 150 separate employer groups. The lower courts disagreed on the interpretation of the common bond language in the original statute. The district court ruled that the statutory language was ambiguous and deferred to the NCUA's interpretation of the law. However, the appeals court found the actual language of the statute to be clear in defining credit unions to include a single group with a common bond. Any subsequent groups wanting to join the credit union would have to share a common bond with the original group. According to the appeals court, Congress had used the common bond mechanism to "ensure both that those making the lending decisions would know more about applicants and that borrowers would be more reluctant to default. . . . [and, thereby to unite] credit union members in a cooperative venture" (U.S. Court of Appeals 1996).

The Supreme Court ruled that the NCUA's interpretation of the common bond language of section 109 of the Federal Credit Union Act was illegal. The case returned to lower court for a decision on whether common bond requirements should revert to their status as defined in 1982 or continue at their current status and, if so, whether credit unions with multiple common bonds should be allowed membership expansion in their existing groups. These questions became moot when President Clinton signed the legislation recently passed by the House and Senate.

Relaxing previously limited common bond restrictions has brought credit unions into more direct competition with other depository institutions such as banks.

This law maintains the concept of common bond but allows combining of groups with different common bonds in a single credit union. It does not change credit unions' tax exemption, but it limits credit unions' commercial loans of more than $50,000. The NCUA must still issue regulations based on the new law.

Conclusion

Recent and future actions on credit unions' common bond limits and federal tax status may well have implications for the efficiency, risk, and competitiveness of these institutions—and their competitor financial institutions. Clearly, credit union customers would be affected.

Allowing past multiple common bonds to stand and leaving open the way for others has positive implications for credit unions and their customers but negative implications for their competitors, their competitors' customers, and taxpayers. Individual credit unions and the industry will be better able to expand and to offer customers more products, taking advantage of scale economies, diversification, and tax exemption. Their growth

10. Currently thirteen states have suits on common bond in process (see CUNA & Affiliates Legal Division 1998).

and market share expansion will probably be greater. Countering these positive effects might be some small overall diminution in credit unions' ability to gather credit information and collect debts. This loss will be particularly true for small credit unions. Credit unions' gains will come at the expense of competitor financial institutions. Their individual customers would have the choice of moving to credit unions, and some likely would. Taxpayers, considered as a separate group in the abstract, would pay more subsidy for provision of consumer financial services.

If easing common bond restrictions allows larger credit unions and the industry grows, and if some credit unions approach their business loan limits, one might expect the movement to remove credit unions' tax- exempt status to become more active and credible. Credit unions would appear more like other financial institutions, such as mutual thrifts, that are taxed. Issues of whether they still primarily serve people of small means and whether they are one of a limited set of consumer financial alternatives are likely to receive a great deal of attention.

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