The obvious defense of financial institutions to the charge of discriminatory disparate impact is that to take greater lending risks in low-income neighborhoods would be to put their profits, assets, and continued existence in jeopardy.

Such a defense should not be taken as self-evident. For one thing, it is contradicted by the experience of the South Shore Bank in Chicago, noted above. South Shore showed that loans in a poor, African American, central city neighborhood could be successful and could generate a profit for the shareholders. Its success actually induced other lenders to enter the area.

On the other hand, South Shore initially took a great risk. In attempting something that had not been done before, its management could not be assured of success. Perhaps this is part of the problem in other urban, underfinanced areas of the country. Few banks are willing to make an initial commitment to an economically depressed area because they do not see immediate, sound business opportunities there. If other banks would take the initiative, they would follow. Or, if a group of lenders would enter the area together, so that the risk to any one was reduced, they would participate. In the absence of such actions, most banks decline to make loans which, on an individual basis, they regard as too risky—and as a consequence a whole neighborhood or a whole population is underserved.[39]

Either financial institutions discriminate inappropriately on the basis of neighborhood characteristics and race or they do not; it is extremely frustrating that decades of legislation, data gathering, and studies have not resolved the question definitively. In order to establish the importance of community development credit unions, however, it is not essential to show the existence of illegal discrimination.

What is very clear from the data, and from the experience of countless people and institutions, is that poor neighborhoods and poor people, non-white neighborhoods and non-white people, have less access to loans and to other financial services than do groups that are better off. It is also clear that this is not a small issue, that access to finance is critical to economic development, to the progress of individuals and groups. Finance is not everything, but without finance many doors are closed.

Inequitable outcomes need not be the consequence of purposeful discrimination, of the malfunctioning of markets and of the firms that operate within them. The search for illegal and unethical behavior may be a chi-

[39] In the language of economics, there may be external benefits to making apparently risky loans in depressed neighborhoods. The initial inflow of capital will improve the business and residential climate for subsequent homeowners, entrepreneurs, and lenders. Since the initial lender cannot capture these benefits, but bears the whole risk of the loan, it may not be willing to make the loan. Where social benefits exceed private benefits, there will be less than the socially optimal amount of activity.

mera. Inequality is a trademark of capitalism, not an aberration. The people of eastern Europe who abandoned Communism because of its constraints on freedom discovered, in some cases to their chagrin, that the free markets they adopted favored some of them at the expense of others. Communism had guaranteed a job for everyone, for example, but capitalism produced unemployment. So it should come as no surprise if ordinary capitalist banking firms, doing business to the best of their ability, trying to maximize returns to their shareholders and seeking the most profitable lending opportunities, produce a pattern of access to credit that is seriously unequal. In addition, of course, they may be acting in illegal, discriminatory, racist, and unethical ways, but such behavior is not proven, nor is it necessary in order to produce unequal results.

Proponents of community economic development have sometimes been quick to assume that the source of the problem faced by low-income areas is overt discrimination and racism. If discrimination were the source of the problem, it could be combated through legislation, through the courts, through education, and through concerted political action. The country has had a lot of experience in successfully fighting racism. But if the source of the problem is the ordinary, non-discriminatory functioning of impersonal, capitalist markets, then the solutions are harder to come by. Legislative requirements for non-discriminatory behavior will not work, no matter how carefully enforced. Non-discriminatory application of lending criteria to all applicants and all neighborhoods may be exactly what has produced the disparate impact. What low-income communities will need is local institutions, which they own and control, that can counter the forces of the market. To the extent that the free market rather than racism is the problem, community development credit unions and other community-based financial institutions are exactly what poor neighborhoods need.

Conclusion

Conventional financial institutions do not provide adequate services in many poor communities. They do not provide the loans that are needed for housing, business development, and consumer purposes, and they sometimes act to drain funds out of poor communities.

Whether they do this because of active, intentional, and discriminatory practices, or simply because of the logic of competitive capitalist markets is an interesting but not central question. More important is the simple fact of the dearth of financial services.

Community-based financial institutions, such as CDCUs, that are dedicated to serving the needs of poor communities are therefore needed.

They are not the only possible solution. The point of the Community Reinvestment Act is to pressure banks and thrifts into serving low-income communities more fully. In addition, larger, mainstream credit unions can expand into low-income communities and provide financial services. Most people in the community development credit union movement welcome other institutions that are genuinely responsive to their neighbors' needs. But they remain skeptical. Almost two decades of the CRA have not led banks to change their behavior markedly, and it is not clear whether large credit unions, whose membership base lies in middle-class communities, behave any differently from banks in poor areas.

Community development credit unions in low-income areas may be able to do what banks and other conventional institutions cannot, because of their cooperative, non-profit structure and because of their base in the community. A corporation's first responsibility has to be to its owners, its stockholders, and their interest is in profits. If banking in poor communities does not generate high profits, then the poor communities are not served by banks. Credit unions also serve their owners, but their owners are their members, their depositors, the people of the local community. Their owners' interest is not in profits but in service at reasonable rates. Therefore CDCUs may occupy a niche that other institutions reject.

CDCU organizers must be careful not to assume, however, that they can be successful just because they have a different organizational structure or just because the banks have rejected good business opportunities because of their inherent racism. Credit unions may not have to maximize profits, but they do have to stay solvent. As Chapter 5 shows, because they operate in poor neighborhoods, they face business problems that are more challenging than those confronting financial institutions serving the middle class.

Lillian Bent (standing), Manager of the Union Settlement Federal Credit Union in New York.

Photo: NFCDCU

Opening day (May 1988) at D. E. Wells Youth Credit Union in Springfield, Massachusetts, the first youth credit union in the country.

Photo: NFCDCU

Medicine man blessing the Casa Grande, Arizona branch of First American Credit Union, a CDCU serving Native Americans.

Central Brooklyn Partnership: pledge drive.

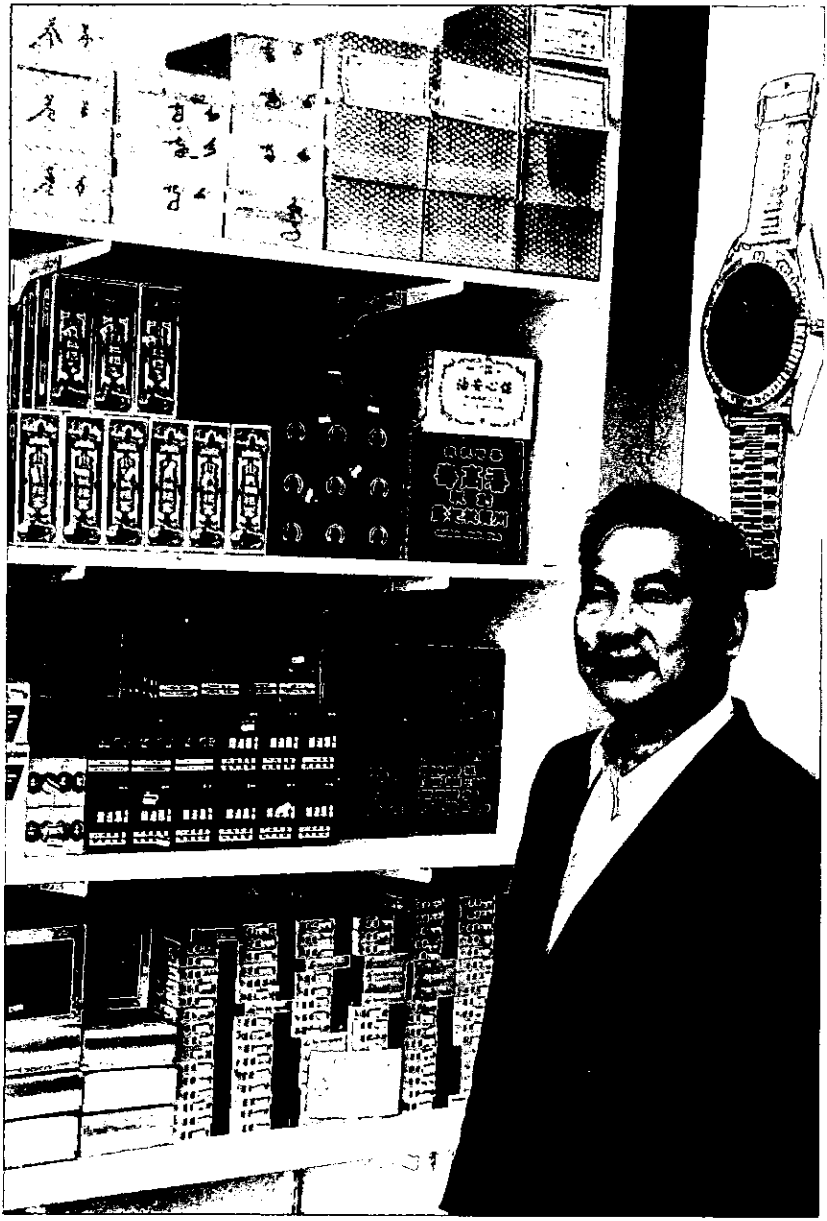
Photo: NFCDCU

Frontier Housing, Inc., in Morehead, Kentucky. It is a low-income housing builder and a branch of Central Appalachian People's FCU.

Photo: Tom Del Salvio

Joyce Rogers, assistant manager at Central Appalachian People's FCU since 1986. She began in 1981 as a credit union volunteer, the branch contact person at Redbird Mountain Medical Center.

Photo: Gienia Mikee



A Chinese herb and medicine store in the Tenderloin district of San Francisco. A start-up loan was made by Northeast Community Federal Credit Union to the son in order to enable the father, an herbalist in Vietnam, to begin life anew in San Francisco.

Photo: Northeast Community FCU

Santa Cruz Community Credit Union: Jeff Wells, Vice President; Mardi Wormhoudt, President; John Isbister, Board Member.

Photo: Trey Dunbar

Clifford Rosenthal, Executive Director of the National Federation of CDCUs, speaking at a meeting of the Lower East Side People's Federal Credit Union in New York.

Photo: NFCDCU

CHAPTER 5

THE OPERATIONS OF CDCUs

An emphasis on small deposits, small loans, technical assistance and member counseling can be very expensive.

—Linda Hoke[1]

Lending to low-income people can, indeed, be a risky business. But...that risk can be managed. And when it is managed successfully, the social rewards are great: economic opportunity, personal dignity, and community empowerment.

—Clifford N. Rosenthal[2]

Like all financial institutions, community development credit unions attract funds and they allocate funds. They accept deposits from their members (and in some cases from non-members), and in turn they lend and invest most of those deposits. They assume the risk inherent in lending. From their loans and investments they earn interest. They use the interest earnings to pay for their expenses, to compensate the members for their deposits, and to save in their reserve accounts.

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1 Hoke.

2 Rosenthal and Schoder.

This chapter explores these basic operations of CDCUs, using information from their financial statements on December 31, 1991.[3]

Credit Unions' Financial Statements

The chapter begins with an overview of the sort of information that is included in credit unions' financial statements.

Every business entity has at least two types of financial statements, a balance sheet and an income statement. The balance sheet shows the condition of the institution—its assets, liabilities, and net worth—at a moment in time. The income statement shows the income, expenses, and profit of the business over a period of time. To use the language of economists, the balance sheet shows stocks, while the income statement shows flows. Or, to use a more familiar image, the balance sheet shows the level of water in the bathtub at a particular moment; the income statement shows the flow of water in, and the drain of water out, over a period of time, that produced the level of water in the tub. This chapter uses balance sheets as of December 31, 1991, and income statements covering the period January 1 to December 31, 1991.

Table 5.1 is an accurate, although simplified, balance sheet for the Santa Cruz Community Credit Union on December 31, 1991.

The largest asset of the credit union is its loans outstanding. These can be thought of as IOUs, held by the credit union, indicating the sums owed by the members to the cooperative. The "allowance for loan loss" is a fund held by the credit union as a negative asset, in anticipation of loans that may not be repaid and will have to be charged off. Net loans is the difference between loans outstanding to the members and the allowance for loan loss; it is an estimate of the true value of loans that will be recovered by the credit union. The next largest asset is the investments; these are funds placed in other financial institutions or financial instruments of some sort that earn interest for the credit union. Cash is held in the office to conduct transactions with the members. The fixed assets consist of the building that the credit union owns plus its furnishings and equipment, principally its computer.

On the Liabilities and Capital side of the balance sheet, the liabilities consist of notes payable and other obligations that the credit union owes. The deposits are included on the right hand side of the balance sheet because they are funds that the credit union owes to the people who have placed

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[3] The tables in this chapter may be compared with statistics developed by the NCUA on credit unions identified by that agency as serving a low-income membership. As explained later in the text, the NCUA low-income list is somewhat different, and smaller, than the list of CDCUs used in this chapter. The NCUA has undertaken to produce an annual report on the performance of these credit unions.

them in the institution. It is here that the principal ambiguity lies in credit union accounting. If the credit union were a privately owned bank, then the deposits would be a liability; they would represent funds owed by the bank to its customers. A credit union is not a privately held corporation, however; it is a cooperative whose member-savers are its owners. It seems not quite proper to think of the members' deposits as a liability of the credit union, since they are funds "owed" by the credit union to its own owners. So member shares are usually counted as capital rather than liabilities. On the other hand, the rationale for counting shares as capital is less compelling than it was before 1970, when deposit insurance was introduced, since the shares are not at risk. If the credit union has deposits from non-members, they are unambiguous liabilities.

Table 5.1
($ in Thousands)

Balance Sheet
Santa Cruz Community Credit Union, December 31, 1991

Assets		Liabilities and Capital	
Cash	790	Liabilities	435
Investments	5,370	Deposits	17,288
		Shares	17,288
		Non-member deposits	0
Loans	11,586		
– Loan loss allowance	-296	Net capital	642
= Net Loans	11,290		
Fixed assets	647		
Other assets	268		
Assets	**18,365**	**Liabilities and Capital**	**18,365**

By definition, a balance sheet balances. The assets are always equal to the liabilities plus the capital. This occurs because the last item on the liabilities plus capital side is a residual. Different types of institutions give it different names; in credit unions the name of choice is reserves or net capital. There are actually different capital accounts in a credit union, including regular reserves, special reserves, and undivided earnings. For some purposes, the allowance for loan loss is taken away from the asset side and included as a positive reserve account. Together, however, these capital accounts total whatever sum is needed to make the two sides balance. The logic behind this is straightforward. The left hand side of the balance sheet shows what the credit union has. All but the last item on the right hand side show what the credit union owes, either to outsiders or to its own members. Whatever is

left over, whatever the credit union has but does not owe, is the net capital, owned collectively by the members. The net capital can be, and in some cases unfortunately is, negative.

Table 5.2 is the income statement for the same credit union, for the calendar year 1991.

Table 5.2
($ in Thousands)

Income Statement
Santa Cruz Community Credit Union
January 1 to December 31, 1991

Income		Expenses and Surplus	
Loan interest	1,317	Operating expenses	1,299
Investment interest	375	Provision for loan loss	91
Other operating income	441	Dividends	595
		Net surplus	148
Total	**2,133**	**Total**	**2,133**

A credit union's income results mainly from the interest it earns on its assets. In Santa Cruz, as in most credit unions, the major part of this is in the form of interest earned on the loans that are made to the members. A smaller portion comes from the interest earned on the investments. In addition, some income results from fees and penalties that are assessed as people do business with the credit union.

On the right hand side of the income statement are the operating expenses, including salaries, insurance, and many other items. The provision for loan loss is the source of the funds that become the allowance for loan loss on the balance sheet. Once these two sets of payments are subtracted from income, the remaining revenues of the credit union constitute its surplus. The surplus is divided into two parts. Some is returned to the members individually in the form of a dividend on their savings (credit unions are also permitted to return surplus earnings to members in the form of an interest rebate on their loans). Some, called here the Net Surplus, is retained by the members collectively, and is transferred to one of the reserve accounts. The income statement balances because the surplus is calculated as a residual, the difference between income and expenses.

In some ways the dividend is analogous to the interest payment made by a bank to its depositors, but in other ways it is different. The interest payment made by a bank is an expense, a contractual obligation of the bank just as is the wage payment it makes to its employees. Once a bank has accepted a deposit from a customer, it is required to make interest payments on that

deposit, at whatever level it has announced, until such time as it publicly changes its announced rate. In a cooperative credit union, on the other hand, because the depositors are the owners, they cannot guarantee a payment to themselves. The member-owner-savers can receive a dividend payment only to the extent that the credit union generates a surplus. Consequently, dividend payments are not guaranteed in advance but are declared by the board of directors of a credit union at the end of an accounting period. A member may be told in advance what dividend rate to expect, but that rate can never be guaranteed until the credit union generates the surplus funds.

In most institutions, the last item would be called "profit," and some credit unions do use this term. "Surplus" is a better word, however, because credit unions are non-profit institutions. Their net earnings do not belong to a small group of shareholders, as in a corporation, but to all of their members collectively. It is not a goal of a credit union to maximize its surplus, but simply to generate enough of it to keep a reasonable level of reserves (or net capital) to protect against losses.

The entries in the financial statements of the country's CDCUs can be used to develop a picture of how those institutions operate.

A Note on the Data

The data used in this chapter are derived from the "Call Reports" or "Reports of Condition" that federally insured credit unions file with the National Credit Union Administration semi-annually. From this set of over 13,000 credit unions, the author selected a small number of institutions for study as CDCUs. Since CDCU is not an official designation, a certain arbitrary judgment was required in making the selection. First, all 91 members of the National Federation of CDCUs in the spring of 1992 were included, on the grounds that if credit unions wished to participate in the CDCU movement at the national level they should be counted. Second, most of the credit unions designated by the NCUA as "low-income" were included. The two lists overlap considerably but not completely, and the NCUA list is longer. Not all NCUA low-income credit unions were included, however. The university student credit unions on the low-income list were excluded, as were all of the employee-based credit unions except those whose employer was an institution specifically serving low-income people. In the former case, while students may lack money, this is typically a temporary condition, and they do not need a social change agent to transform their community. In the latter case, most credit unions dealing with employees of a single company do not have a mission of outreach to low-income people or a purpose of social change. In addition, a small number of credit unions with

assets numbering just a couple of thousand dollars, or even in the hundreds, were excluded, since they barely exist as institutions. One quite large church credit union was excluded because its reported data in some categories seemed to be wildly anomalous and therefore suspect, and would have skewed the averages seriously in some cases.[4]

The selection yields a set of 180 CDCUs for the reporting date of December 31, 1991. The balance sheet items in the reports refer to that date, and the income statement items to the calendar year 1991. For the purpose of deriving the tables in the spread analysis, some of the balance sheet items from December 31, 1990 were included. Some of the tables that follow are based on fewer than 180 CDCUs because of data limitations.

These data make possible quite complete analyses of the financial condition of the CDCUs. They also permit comparison between the CDCUs and all American credit unions. Data summaries for all credit unions are published semi-annually by CUNA.[5] Because of the form in which CUNA presents its data, however, the comparisons are tricky, and this requires some explanation.

Much of the data that are shown in the tables that follow are in the form of averages of ratios across all CDCUs or across CDCUs in a certain category. The method is to calculate the ratio in each credit union and then to average the ratios. This procedure gives each credit union, the small as well as the large, equal weight in the average. The average can be interpreted as a "typical" value for a CDCU. CUNA uses a different method in presenting its data for all American credit unions. It sums the numerator and denominator of each ratio separately, across all the credit unions in the category under consideration, and then takes the ratio of the two sums. This method weights the credit unions according to their size in the compilation of the final figure. Put differently, it treats all credit unions as if they were lumped together into a single institution.

Each method is "correct," but each takes a different perspective. Since much of the focus of this study is on the description and analysis of quite small institutions, the author decided it was important to retain a perspective that gives equal weight to all CDCUs. But when comparisons between CDCUs and the wider credit union industry are needed, the "summation" method has to be used. These latter cases are always clearly labeled. The aver-

[4] I am grateful to Bill Hampel, Chief Economist, and Marc Shafroth, Director of Data and Statistics, at CUNA, who culled the CDCU data from the larger sets of data for all credit unions in the country, and who supplied me with easily accessible disks. I would be happy to give copies of the disks and the associated documentation to other researchers. The disks are formatted for dBase III and IV on DOS.

[5] Credit Union National Association, *Credit Union Operating Ratios and Spreads*. Unless otherwise noted, all of the industry-wide credit union data in this chapter are taken from this source.

ages for all American credit unions (in contrast to just the CDCUs) are constructed in such a way as to represent credit unions of the same size as the CDCUs. Consequently, whatever differences exist between the two averages—the CDCU figure and the figure for all credit unions—reflect true differences in the character of the institutions, and not just differences in size.[6]

The Questions

The remainder of this chapter proceeds systematically through the operations of the country's CDCUs, asking the following questions:

- Where do CDCUs' resources come from? This section looks at the right hand side of the balance sheet, the liabilities and capital.
- What do CDCUs do with their resources? This section turns to the left hand side of the balance sheet, the assets.
- How do CDCUs earn their income? Next the focus turns to the income portion of the income statement.
- How do CDCUs allocate their income? This section looks at the use of income, for operating expenses, for dividend payments to the members, and for reserves.
- How do CDCUs create a spread between income and outgo? Next the chapter treats the gap between income and expenses, or the "spread."
- How are CDCUs rated by their examiners? Finally, the financial data are used to illuminate the ways in which federal and state

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6 The following method is used when comparing CDCUs with all credit unions. CUNA presents averages, using the summation method, for all credit unions and for ten asset size categories: (in millions of dollars) less than 0.5, 0.5-1, 1-2, 2-5, 5-10, 10-20, 20-50, 50-100, 100-200, 200 and over. For the most part, in this study two asset-size categories are used, less than 0.5, and over 0.5, since this division cuts the number of CDCUs roughly in half.

The smaller CDCU category is compared directly with the smallest CUNA category. The figures for CDCUs over a half million dollars, and for all CDCUs, are compared with CUNA figures for all credit unions, with the latter figures weighted according to the proportion of CDCU assets in each size category (not according to the proportion of assets in each category for all credit unions). In other words, the figures for all American credit unions are artificial composites, based on the assumption that those credit unions are distributed by size in the same manner that CDCUs are. Relatively small credit unions are thus given much more weight than they world have when compared to all other American credit unions. The proportional distribution of assets in CDCUs, by size, in December 1991, from smallest to largest category, was: .054, .085, .122, .211, .108, .233, .187, 0, 0, 0, summing to 1.0. These weights were multiplied by the CUNA figures in each size category, and results summed, to arrive at a comparative figure for all credit unions. When the comparison was for credit unions over a half million dollars in assets, the first proportion was eliminated, and the remaining ones adjusted to sum to 1.0. Note that this method completely excludes American Credit unions in the top three size categories, above $50 million, because no CDCUs are of this size. Using this method, the resulting comparison between CDCUs and all American credit unions are based on institutions of the same size.

examiners assess CDCUs, according to the "CAMEL" system.

Where Do CDCUs' Resources Come From?

Table 5.3 analyzes the liabilities and capital of 180 CDCUs, as of December 31, 1991. Each item is shown as a percentage of total assets (or, since the amount is the same, as a percentage of total liabilities plus capital). The table shows where the credit unions' resources come from.

Total liabilities plus capital consist of savings deposits, plus borrowings and other liabilities, plus reserves. The savings deposits are divided into two parts: member deposits or shares, and non-member deposits. So in Table 5.3, column 1 equals columns 2 + 3, and Total Liabilities plus Capital equals columns 1 + 4 + 5 + 6. Column 7 is a more expansive version of reserves than column 6, adding in the allowances for loan and investment losses which are normally carried as negative assets on the balance sheet.

Table 5.3 shows that the majority of the resources come from savings deposits, 86 percent for the average CDCU. The ratio of deposits to assets rises with the size of the credit union.

CDCUs receive on average almost seven percent of their resources from non-member deposits. NCUA forbids non-member deposits in most American credit unions, but allows them up to a level of 20 percent of assets in the credit unions it designates as serving low-income people. The 20 percent limit is sometimes relaxed upon petition by an individual credit union. CDCUs can sometimes obtain the support of outside organizations such as churches, foundations, corporations, and philanthropic groups, through their use of non-member deposits. The deposits are made either directly or, as explained in Chapter 3, through the intermediary of the National Federation of CDCUs. They are insured up to $100,000 just as are member deposits, and they receive a rate of interest that is negotiated at the time of deposit.

Table 5.3 shows the differences in the reliance of the various categories of CDCUs upon non-member deposits. The urban-rural distinction does not make much difference. Large CDCUs make proportionately more use of non-member deposits than do small CDCUs. Non-church credit unions rely much more heavily upon them than do church-affiliated credit unions and, not unexpectedly, members of the National Federation make a great deal more use of them than do non-members.

From the figures in Table 5.3, it would not seem that the NCUA's 20 percent limit represents a hardship, since even among NFCDCU members the average use of non-member deposits is only about half the limit. The table masks, however, the fact that most CDCUs do not use any non-member deposits, while those that do use them tend to depend quite heavily on them. Of the 180 credit unions in this set, only 58 (or 32 percent) had any

non-member deposits at all at the end of 1991; for these 58, the average ratio of non-member deposits to assets was 20.8 percent.

Table 5.3
(As Percentages of Total Assets)

Distribution of Liabilities Plus Capital in 180 CDCUs, December 31, 1991

Credit Union Category	1 Total Deposits	2 Shares	3 Non-Member Deposits	4 Borrowing	5 Other Liabilities	6 Net Capital	7 Total Reserves
Assets up to $500K	82.7	77.2	5.5	0.2	2.4	14.7	17.2
Assets > $500K	89.3	81.4	7.9	1.1	1.3	8.2	10.2
Church	85.2	82.4	2.9	0.7	1.9	12.1	14.9
Non-Church	86.4	78.1	8.3	0.7	1.8	11.1	13.2
Urban	87.5	81.0	6.4	0.7	1.8	10.1	12.4
Rural	83.6	76.4	7.2	0.7	2.0	13.7	16.0
NFCDCU	88.9	77.8	11.1	1.3	1.3	8.4	10.6
Non-NFCDCU	83.1	80.9	2.2	0.0	2.4	14.5	16.9
All CDCUs	**86.0**	**79.3**	**6.7**	**0.7**	**1.9**	**11.4**	**13.7**
Summation Method							
CDCUs up to $500K	84.4			0.3	2.3	13.0	15.4
All CUs up to $500K	84.5			0.1	1.6	13.8	15.6
CDCUs $.51-50 Mil	91.2			0.7	0.9	7.1	8.7
All CUs $.51-50 Mil	90.0			0.1	0.9	9.0	9.8
CDCUs	90.9			0.7	1.0	7.5	9.1
All CUs	89.7			0.1	1.0	9.2	10.1

This is not to say that all 58 credit unions use non-member deposits right up to the 20 percent limit. Twenty-seven had less than 15 percent non-member deposits, 14 had between 15 and 25 percent, and 17 had over 25 percent. Most if not all of the latter group received special permission from the NCUA to exceed the limit. A significant number of CDCUs have succeeded, therefore, in attracting outside, socially responsible investments into their communities through the use of non-member deposits.

Column 6 of Table 5.3 is Net Capital as a percentage of assets; this represents the assets of the credit union that are not offset by the amounts that the credit union owes to either members or outsiders. It is one of the most important indicators of the financial strength of a credit union. A healthy level

of capital indicates that a credit union has a cushion to withstand a period of negative earnings or some other kind of significant loss. Capital is somewhat stronger in the rural credit unions than in the urban, and in the church credit unions than in the non-church; it is considerably stronger in the small CDCUs than in the large ones and in the credit unions that are not affiliated with the National Federation.

The bottom panel of Table 5.3 compares the CDCUs to all American credit unions, using the summation method outlined above. Use of the summation method can make a considerable difference. Note, for example, that the net capital ratio in column 6 is 11.4 percent for all CDCUs when the ratio of each credit union is given equal weight, and just 7.5 percent when the weights are proportional to the assets in the summation method. This follows from the fact that the larger credit unions—which are weighted more heavily in the summation method—have lower capital ratios, as shown in the first two rows.

CDCUs derive roughly the same portion of their resources from deposits as do other credit unions. They use more borrowed funds, although the proportion is small in both cases. The net capital ratio of the CDCUs shown in column 6 is, however, somewhat lower, particularly for credit unions over a half million dollars in assets.

To get a full picture of capital adequacy, however, one should add the allowance for loan loss together with the reserve accounts, as is done in column 7. The allowance for loan loss is an account that is available to be drawn down should a loan default.

When all of the capital accounts are summed, the financial strength of CDCUs is seen to be almost comparable with that of all credit unions of the same sizes. The overall reserve ratios are almost exactly the same for the small credit unions, and just one percentage point different for the larger ones. Contrary to the opinion of some observers, poor people's credit unions do not tend to be financially weaker than other credit unions, at least in terms of their reserve accounts.

The reason CDCUs have almost comparable reserve ratios, however, is that their allowances for loan loss tend to be higher than in other credit unions. As will be shown, this is a prudent step on the part of CDCUs since their delinquency and default rates on loans to their members tend to be higher.

What Do CDCUs Do with Their Resources?

Table 5.4 shows the distribution of the various types of assets of CDCUs as percentages of total assets. The table begins to answer the question of

what CDCUs do with their resources.

On the asset side of the balance sheet, the allowance for loan losses is carried as a negative item; total assets are equal to columns 1 - 2 + 3 + 4 + 5 in Table 5.4.

Table 5.4
(As Percentages of Total Assets)

Distribution of Assets in 180 CDCUs
December 31, 1991

Credit Union Category	1 Loans	2 Allowances for Loan and Investment Losses	3 Cash	4 Investments	5 Fixed and Other Assets
Assets up to $500K	42.6	2.5	11.3	47.7	0.8
Assets > $500K	59.2	2.1	5.7	34.9	2.1
Church	44.8	2.8	10.0	47.1	0.8
Non-Church	53.7	2.1	7.8	38.7	1.8
Urban	48.3	2.3	9.4	43.0	1.5
Rural	55.7	2.4	6.9	38.2	1.5
NFCDCU	53.2	2.2	8.2	39.0	1.8
Non-NFCDCU	48.8	2.4	8.8	43.5	1.2
All CDCUs	**51.0**	**2.3**	**8.5**	**41.2**	**1.5**
Summation Method					
CDCUs up to $500K	47.8	2.5	9.0	44.5	1.1
All CUs up to $500K	60.2	1.7	7.2	33.6	0.7
CDCUs $.51-50 Mil.	62.4	1.6	3.6	32.3	3.0
All CUs $.51-50 Mil.	59.9	0.9	3.1	36.0	1.9
CDCUs	61.6	1.6	3.9	32.9	2.9
All CUs	59.9	0.9	3.3	35.9	1.8

The largest single asset is loans to members. The loan-to-asset ratio is strongly and positively related to the size of the CDCU. Non-church CDCUs, rural CDCUs, and NFCDCU members have significantly higher loan-to-asset ratios, on average, than do their counterparts.

Most of the assets that are not loaned to members are invested or are held in cash. Consequently, the cash and investment ratios move roughly inversely to the loan ratio: when the latter is higher, the former are usually lower. The loan-to-asset ratio is therefore the clue to the overall structure of the assets.

It would be useful to establish whether the variation in loan-to-asset

ratio by church, urban, and National Federation categories are independent phenomena or whether those categories are just proxies for size. After all, in each case the group with the lower loan-to-asset ratio is also the group with the smaller credit unions, and smaller CDCUs have lower loan-to-asset ratios. Table 5.5 breaks down the loan-to-asset ratio in the different categories of CDCUs.

Table 5.5
(Loans as Percentages of Total Assets)

Loan-to-Asset Ratios in Categories of CDCUs

	Assets		Total
	up to $500K	>$500K	
Church	39.1	55.2	44.8
Non-Church	44.8	60.3	53.7
Urban	37.8	57.1	48.3
Rural	49.3	63.9	55.7
NFCDCU	44.2	57.6	53.2
Non-NFCDCU	41.7	62.6	48.8
Total	**42.6**	**59.2**	**51.0**

Credit union size is not the sole variable associated with differences in the loan-to-asset ratios. Within each size group, church and urban CDCUs still have lower loan-to-asset ratios. National Federation affiliation largely disappears as an explanatory variable, however: among the small credit unions affiliation is associated with little difference in the ratios, and among the larger credit unions the ranking is actually reversed.

Size is still independently important as well. Within each of the six groupings in Table 5.5, the small credit unions have lower loan ratios than the large.

The difference in loan ratios by church affiliation is expected. Many church credit unions operate mostly as savings clubs rather than as borrowing clubs or community development agencies. Table 5.9 below shows that the ratio of number of loans to total membership is just 18 percent in the church CDCUs, compared to 28 percent in the others.[7] Informal evidence indicates that their members tend to be older than the members of other credit unions, and perhaps reluctant to borrow because of uncertainty about their ability to repay in the future. One of the purposes of the National Federation's organizing project among church credit unions has been to encourage them to become more aggressive lenders, in order to help meet the

[7] These figures are likely overestimates of the proportion of members who are borrowers since some members have more than one loan.

financial needs of their members as well as providing a safe place for their deposits.

The difference in loan ratios by urban-rural status is not expected. It is not immediately clear why loan ratios should be higher in rural areas. Nevertheless there is a significant gap, one which remains even after the credit unions are segregated by asset size.

The fact that smaller CDCUs have lower loan ratios than larger CDCUs is also unexpected. Such a relationship is not found among all U.S. credit unions. If the association had turned out to be the opposite—smaller credit unions with higher loan ratios—the obvious explanation would have been that the smaller credit unions were limited by their assets in meeting their loan demand while the larger credit unions had plenty of funds to go around.

A possible explanation of the actual relationship is that the smaller CDCUs have poorer members who have more difficulty establishing creditworthiness in order to qualify for a loan. The data provide only marginal support for this hypothesis, however: among the urban CDCUs, for example, the average median family income in the neighborhood was $12,026 for the small credit unions and $12,420 for the large in the 1980 census, hardly enough of a difference to create a major impact on loan demand.

It may be the case that the small credit unions are so small that their members simply do not think of them very often when they are in need of a loan. Or it may be that they are so small that they lack the resources to make informed judgments about loan requests and are therefore conservative in granting loans. They may lack a loan officer on the staff.

The ratio of loans to assets fluctuates in most credit unions, as the demand for loans responds to overall economic conditions. At the end of both 1981 and 1986, the average loan-to-asset ratio in community development credit unions in the United States was 59 percent. The significantly lower ratio in 1991 probably reflects the sustained recession of that year.

The bottom panel of Table 5.4 compares the allocation of assets in CDCUs and all credit unions. Compared to the industry as a whole, the loan ratio is much lower in the small CDCUs and slightly higher in the larger CDCUs. The larger CDCUs can be satisfied that they have done as well at getting loans out to their members during a serious recessionary period as have credit unions in general. But the comparison for the smaller credit unions indicates a serious difficulty.

Low loan ratios create two sorts of problems for credit unions. The first has to do with their mission of service. Credit unions are organized in large measure to provide a source of loans for their members, and this is particularly important in low-income neighborhoods that lack capital. To the extent that they are not recycling their members' savings in the form of loans back

into their communities, they are failing to meet at least part of their goal. Of course credit unions cannot by themselves overcome an economic recession; they cannot stimulate a demand for loans which is lagging. Furthermore, they will not survive if they push loans onto people who cannot make good use of them and lack the capacity to repay. Nevertheless, the low loan ratios at the beginning of the 1990s were a source of concern.

The second problem created by the low loan ratios is the income that the credit union forgoes. Resources that are not lent to the members can be invested in financial institutions but, as Table 5.11 below shows, the interest on investments is typically much less than the interest a credit union obtains by lending to its members. Most CDCUs struggle to meet their expenses, and they can ill afford the income loss implied by a low loan ratio.

Table 5.4 reveals several other features of interest, besides the loan ratios. The allowance for loan loss accounts are consistently higher in the CDCUs than in all U.S. credit unions. This confirms what was seen in the previous section.

Finally, the CDCUs have consistently higher amounts of non-earning assets, that is to say, cash and fixed and other assets, than do mainstream credit unions in the U.S. The relatively high level of cash may be a consequence of people in poor communities using the CDCU as a check cashing office rather than as a savings and lending institution. Or, it may indicate a lack of investment expertise in CDCUs; certainly the CDCUs are in no position to waste the income that their assets could be earning.

Since loans are so important to CDCUs—they are the largest item among the assets, and they represent the most important purpose of the institution—they are examined next in greater detail. Table 5.6 shows the distribution of loans by type. A word of caution is due here. The loan types in Table 5.6 refer to the collateral that is used to secure the loan, not to the purpose for which the loan proceeds are directed. Chapter 6 contains an estimate of loan purposes for seven CDCUs. The relationship between the two concepts can be confusing. For example, a home equity line of credit is treated in Table 5.6 as a real estate loan since it is secured by a house, but the borrower may use the funds for any purpose at all, including business expansion or the purchase of a car.

CDCUs concentrate heavily upon unsecured, personal signature loans. These are loans in which the borrower simply pledges to repay; in some cases a co-signer also pledges to repay if the primary borrower defaults. But the credit union does not take an ownership right to property that can be repossessed in the event of nonpayment. Almost half of the loan money in the average CDCU is unsecured. The ratio is much higher, in fact greater than two thirds, in the smaller credit unions with assets of less than a half

million dollars, while in the credit unions larger than a half million it is less than one third.

Table 5.6
Loan Types as a Percentage of Total Loans

Dollar Amounts of Outstanding Loans in CDCUs

Credit Union Category	Unsecured	New Auto	Used Auto	Real Estate	Other
Assets up to $500K	67.4	5.8	5.5	2.1	19.2
Assets > $500K	30.7	12.0	12.5	22.9	21.9
Church	59.9	11.1	7.7	6.0	15.3
Non-Church	43.9	8.1	9.7	15.6	22.7
Urban	48.4	9.2	8.2	12.4	21.8
Rural	49.3	8.6	10.6	13.3	18.2
Total	**48.7**	**9.0**	**9.1**	**12.7**	**20.5**
Summation Method					
CDCUs up to $500K	59.7	10.1	7.4	4.4	18.4
All CUs up to $500K	39.5	16.5	21.8	1.4	20.8
CDCUs $.51-50 Mil	28.1	9.3	8.0	37.4	17.2
All CUs $.51-50 Mil	24.0	26.9	16.7	18.4	14.1
CDCUs	29.4	9.3	8.0	36.0	17.3
All CUs	24.8	26.4	16.9	17.5	14.4

Compared to all American credit unions, the concentration on unsecured loans is significantly greater in the small CDCUs, and somewhat greater in the larger ones.

The size of the CDCU is strongly related to the concentration in other types of lending as well. The larger CDCUs, which do proportionately less unsecured lending, do more lending on automobiles and real estate. The difference is particularly striking in real estate.

The urban-rural distinction is not significant in terms of the type of lending. Church affiliation makes little difference in automobile lending, but church CDCUs tend to emphasize unsecured lending and correspondingly de-emphasize real estate lending.

Table 5.7 explores the question of whether church affiliation makes a difference in types of loans once credit union size has been corrected for. The table indicates that asset size is the most important variable associated with differences in unsecured and real estate lending. Within each size category, however, church affiliation continues to make a difference, with the church

CDCUs doing more unsecured lending and less real estate lending.

Table 5.7
(Percentage of Total Loans)

Loan Types by CDCU Size and Church Affiliation

	Unsecured Loans			Real Estate Loans		
	Assets		Total	Assets		Total
	up to $500K	>$500K		up to $500K	> $500K	
Church	74.8	32.5	59.9	1.0	15.4	6.0
Non-Church	62.5	30.2	43.9	2.9	24.9	15.6
Total	**67.4**	**30.7**	**48.7**	**2.1**	**22.9**	**12.7**

Table 5.8
($ in Thousands)

Average Loan Size for Credit Unions Making Each Type of Loan

Credit Union Category	Unsecured	New Auto	Used Auto	Real Estate	Other	All Loans
Assets up to $500K	1.3	7.0	3.2	5.8	1.8	1.6
Assets > $500K	1.6	7.4	3.7	21.4	3.5	4.2
Church	1.7	7.5	4.1	18.7	2.7	2.5
Non-Church	1.4	7.3	3.4	18.6	3.0	3.1
Urban	1.7	7.3	3.8	24.6	3.4	3.3
Rural	1.0	7.4	3.1	10.4	2.2	2.3
Total	**1.5**	**7.3**	**3.5**	**18.6**	**2.9**	**2.9**
Summation Method						
CDCUs up to $500K	1.2	6.5	3.3	6.5	1.3	1.5
All CUs up to $500K	1.3	6.1	3.3	6.0	2.0	2.0
CDCUs $.51-50 Mil	1.7	7.0	3.3	21.9	3.8	3.8
All CUs $.51-50 Mil	1.7	7.2	4.1	20.8	3.2	3.7
CDCUs	1.7	6.9	3.3	21.6	3.5	3.6
All CUs	1.7	7.2	4.1	20.4	3.1	3.6

The most likely explanation for the concentration of small and church CDCUs upon unsecured loans is that those credit unions have limited resources to lend and unsecured loans tend to be smaller than other loans. Not only are those credit unions smaller in terms of total assets, they are also

smaller in terms of assets per member; that is to say, they have less to go around to satisfy the loan demand. The average assets per member in the small CDCUs below $500,000 are $666, while in the larger credit unions the figure is almost three times as large, $1,783. Church CDCUs have on average $997 per member, compared to non-church CDCUs with $1,317. The smaller CDCUs have fewer assets per member than do all American credit unions of the same size; using the summation method, the respective figures are $607 versus $984.

CDCUs do considerably less lending for automobiles than do other credit unions. For most middle-class Americans, an automobile is the largest personal investment they make aside from their house, and many American credit unions specialize in providing the financing for that investment. Low-income people spend less on cars than do the middle-class, however, and their credit unions consequently do less car lending.

Table 5.9

Loans Per Member, December 31, 1991

Assets up to $500K	0.20
Assets > $500K	0.27
Church	0.18
Non-Church	0.26
Urban	0.20
Rural	0.30
Total	**0.24**
Summation Method	
CDCUs up to $500K	0.18
All CUs up to $500K	0.30
CDCUs $.51-50 Mil	0.29
All CUs $.51-50 Mil	0.43
CDCUs	0.28
All CUs	0.42

Table 5.8 shows the average size of loans, by loan type and CDCU category. The table shows the balance outstanding on the loans on December 31, 1991, not the amount for which the loans were initially made (an amount which would, of course, be larger). It shows that the average size of unsecured loans is significantly less than the average size of all other types of loans. Because small credit unions concentrate on unsecured lending, their overall average loan size, in the last column, is much lower than in the larger

CDCUs, in spite of the fact that their loans are of fairly comparable size within each category (with the exception of real estate). Similarly, church credit unions make smaller loans on average than do the non-church credit unions, because of their concentration on unsecured lending, in spite of the fact that within almost every category of lending, church credit unions make slightly larger loans.

Not only do small and church CDCUs conserve their resources by concentrating on unsecured loans; they also make fewer loans overall than do other kinds of CDCUs. Table 5.9 shows that, in addition, urban CDCUs lend to fewer members than do rural ones. Consistent with this finding, the bottom panel of Table 5.9 shows that CDCUs lend to many fewer of their members than do typical American credit unions.

Returning to Table 5.8, the bottom panel shows that CDCUs do not typically make smaller loans than other credit unions in the same size range.

How Do CDCUs Earn Their Income?

Credit unions generate most of their income by charging interest on the assets which they lend and invest. Table 5.10 shows the different categories of income as percentages of gross income.

The two principal sources of income for the CDCUs are interest earned on loans to members and interest earned on investments. Table 5.10 can be usefully compared with Table 5.4, which shows the loan-to-asset ratios by credit union size and by other characteristics. In credit unions in which the loan-to-asset ratio is higher, the proportion of income generated from loans is higher and the proportion generated from investments is lower. Note, however, that the proportion of income generated from loans is consistently greater, in all categories, than the loan-to-asset ratio. This occurs because member loans are the most profitable use that a credit union can make of its assets. Interest rates are consistently higher on member loans than on investments, and they are certainly higher than on fixed, non-earning assets such as buildings and computers that do not generate an income (although they may save rental expenses).

The larger CDCUs derive about the same proportion of their income from loans as do all credit unions of the same size. The smaller credit unions earn significantly less from loans. Interestingly, in all American credit unions, the proportion of income deriving from loans falls with the size of credit union, while in CDCUs it rises. The issue was discussed above in connection with Table 5.4; small credit unions in poor communities have difficulty generating loans.

Finally, Table 5.10 shows that CDCUs earn a much higher proportion of

their income from fees than do all American credit unions. This reveals something of the difficulty of conducting a financial business in a poor community. The leadership of CDCUs would prefer not to charge extensive fees since their members are all too familiar with the phenomenon that "the poor pay more," in both prices and extra fees, on many of their transactions. As will be shown below, however, CDCUs suffer systematically from higher expenses than do mainstream credit unions. To cover these expenses, they turn in part to fees.

Table 5.10
(Items as Percentages of Gross Income)

	The Components of Income			
Credit Union Category	**Net Loan Interest**	**Investment Income**	**Fees**	**Other Operating Income**
Assets up to $500K	56.6	36.7	2.9	3.9
Assets > $500K	71.0	20.8	4.9	3.3
Church	59.8	35.4	2.0	2.8
Non-church	65.7	25.7	4.7	3.9
Urban	61.0	32.3	3.3	3.4
Rural	68.9	22.3	4.9	3.9
Total	**63.9**	**28.6**	**3.9**	**3.6**
Summation Method				
CDCUs up to $500K	65.0	28.8	3.4	2.8
All CUs up to $500K	77.6	19.4	1.3	1.8
CDCUs $.51-50 Mil	72.5	17.8	7.1	2.5
All CUs $.51-50 Mil	73.4	21.8	2.9	1.9
CDCUs	72.2	18.4	7.0	2.5
All CUs	73.6	21.7	2.9	1.8

Table 5.11 shows the rates of interest that the CDCUs charged on different types of loans. Only credit unions which made each particular type of loan, and for which data are available, are included in the averages; the total in each category is shown in the row labeled N.

The first four columns of Table 5.11 show the rates that were charged by credit unions on four different types of loans at the end of 1991. The final column, showing the rate of return on investments, is not strictly comparable with the first four. Credit unions made countless different investments with many different rates. What the final column shows, therefore, is the actual income earned by the credit unions on their investments during the

calendar year 1991, divided by the average of the beginning and ending investment levels in that year. In a later section this same kind of information will be presented for loans. The actual rate of return on loans generally tends to be somewhat lower than the stated interest rate because of delinquencies in repayments and defaults. Thus the contrast between the figures in the first four columns and those in the last is somewhat overstated. Nevertheless the gap is huge—with the investment figures being typically less than half of the loan figures—and the adjustment to the loan figures would only make up a small portion of that gap.

Table 5.11
Annual Percentage Rates for the Last Week of December, 1991

Average Interest Rates Charged on Loans

Credit Union Category	Unsecured 2-Year Maturity	New Auto 4-Year Maturity	Used Auto 3-Year Maturity	First Mortgage 30-Year Maturity	Return on Fixed Rate Investments
Assets up to $500K	14.7	12.5	13.9	12.8	6.4
Assets > $500K	15.5	11.6	13.5	11.5	6.2
Church	14.0	11.8	13.1	11.7	5.7
Non-Church	15.6	11.8	13.8	11.7	6.5
Urban	14.7	11.4	13.3	11.2	6.5
Rural	16.0	12.5	14.2	12.3	6.0
Total	**15.2**	**11.8**	**13.6**	**11.7**	**6.3**
N	**167**	**98**	**99**	**46**	**157**
Comparison with All CUs*					
CDCUs up to $500K					6.1
All CUs up to $500K	14.3	11.2	12.7	12.3	5.9
CDCUs $.51-50					6.4
All CUs $.51-50	14.6	10.0	11.7	10.5	6.4
CDCUs					6.4
All CUs	14.6	10.1	11.8	10.6	6.3

*Since the first four columns are based on rates reported directly by the credit union, and not on ratios calculated from reported values, the summation method is not used. The rates shown for all credit unions are comparable to those shown for CDCUs in the panels above. For the last column, the summation method is used.

Several interesting conclusions emerge from Table 5.11. First, interest

rates vary considerably on different types of loans. They are highest on unsecured loans and lowest on new car loans and first mortgages. There are different reasons for this variation. To a certain extent it reflects the credit union's assessment of risk. The risk on a new car loan or a first mortgage is relatively low because even if the borrower defaults the collateral can be repossessed and sold, while the risk on an unsecured loan is correspondingly higher. The credit union attempts to compensate itself for the higher risk by charging a higher interest rate. To some extent, in addition, the variation in interest rates reflects general variations in the market. Those CDCUs that are in competition with other lenders for their members' business need to keep their rates in line with rates in the community.

Second, rural CDCUs charge consistently higher interest rates than do urban CDCUs. One can think of at least three different reasons why this might be the case. The rural credit unions might have higher delinquencies on loan repayments than the urban, and consequently have to charge higher interest rates to achieve an equal net rate of return. The rural credit unions might have higher expense ratios than the urban, and consequently charge higher interest rates in order to generate the income to meet their expenses. Or the rural credit unions might face less competition from other lenders and therefore be able to charge higher interest rates without driving their member-borrowers away. Table 5.12 below shows, however, that rural CDCUs have lower than average delinquency rates and only slightly higher default rates, so delinquency cannot be the explanation. Table 5.13 shows that rural CDCUs have about the same expense ratios, so expenses cannot be the answer. It is likely, therefore, that rural CDCUs charge higher interest rates because they face less competition from other lenders and their members have fewer options.

Third, interest on loans is much higher than interest on investments. Thus credit unions increase their profitability as well as serve their members better by keeping their loan ratio as high as possible and their investment ratio low.

While credit unions face a certain conflict in setting interest rates on loans—needing to balance the concern of the members as individuals in getting low rates against the concern of the members collectively in providing for a financially healthy credit union—they face no conflict in trying to secure as high a return on their investments as possible. That being the case, some of the differentials in the last column are quite interesting. It appears that church CDCUs and rural CDCUs are considerably less successful in maximizing the returns from their investment portfolios than are the nonchurch and urban CDCUs, respectively. One suspects that they take a rather

more amateur attitude towards financial management. Both small and large CDCUs keep up well with the performance of other credit unions, however.

Fourth, the interest rates charged by CDCUs are consistently higher than those charged by other American credit unions of the same size. This finding may be discouraging to people concerned that "the poor pay more." It is certainly a hope that CDCUs, established for the purpose of serving low- and moderate-income people, could offer loans at the same rates paid by middle-class Americans. Just as in the case of fees, however, the reality is that the poor pay more.

One cannot explain the higher interest rates by an intent to exploit the poor since the CDCUs are controlled by representatives of their own communities. As possible explanations of the gap, none of the factors listed under the second point above can be rejected. CDCUs tend to have both higher delinquency rates and higher expense ratios than mainstream credit unions. In addition, less competition from other lenders may account, at least partially, for the higher rates.

The finding that CDCU interest rates on loans are typically somewhat higher than those charged by other American credit unions needs to be put in context. First, the CDCU rates are generally the lowest that are available to people in low-income neighborhoods. The rates charged by pawnshops, finance companies, and other non-conventional lenders are almost always much higher than CDCU rates. So are rates on low-balance credit cards that are sometimes available to low- and moderate-income people. Second, the higher rates compensate at least in part for the higher costs of doing business in poor neighborhoods and the higher delinquency rates; it is because of these costs that many banks and savings and loan associations have left poor areas of the country. And third, any extra income that is earned by CDCUs stays in the local community; it is not siphoned away as is the case with some retail establishments that charge high prices and then export the profits.

A credit union's income is reduced to the extent that its borrowers fail to make the contractual payments on their loans. Table 5.12 shows the delinquency rates experienced by the CDCUs at the end of 1991, and the charge-off rates during 1991. A loan is considered to be in delinquent status if the repayments are two months or more in arrears. The first column shows the delinquency rate in dollar terms, that is to say, the average across the credit unions of the balance owing on the delinquent loans divided by the total balance outstanding on all loans. The second column shows the delinquency rate by number of loans, or the number of loans in delinquent status divided by the total number of loans.

Most loans that are in delinquent status are ultimately repaid, and since the credit union accrues interest on the outstanding balance it eventually

earns its due income on the loan, even if somewhat delayed. Some loans go into default, however, and must be charged off by the credit union. The credit union does this by reducing the allowance for loan loss, which as will be recalled is a negative asset on the balance sheet, by the same amount as it reduces its loan asset. The final column of Table 5.12 shows the loans charged off in 1991 as a percentage of total loans outstanding at the end of the year.

Table 5.12
As Percentages of Total Loans Outstanding on December 31, 1991

Delinquency and Charge-off Rates

Credit Union Category	Delinquency Rate		Charge-off Rate
	$	No.	
Assets up to $500K	9.0	12.5	2.7
Assets > $500K	8.1	9.8	2.1
Church	12.5	15.5	1.5
Non-Church	6.8	9.2	2.8
Urban	9.0	11.7	2.2
Rural	7.7	10.1	2.7
Total	**8.5**	**11.1**	**2.4**
Summation Method			
Assets up to $500K			
CDCUs	10.1	11.2	1.6
Church CDCUs	16.4	18.1	1.2
Non-Church CDCUs	6.4	8.7	1.8
All CUs	5.6	7.1	1.4
Assets $0.51 - $50 Mil			
CDCUs	5.4	7.5	1.8
Church CDCUs	9.0	10.3	1.7
Non-Church CDCUs	5.1	7.2	1.8
All CUs	2.4	3.0	1.0
All			
CDCUs	5.6	7.9	1.8
Church CDCUs	10.2	12.1	1.6
Non-Church CDCUs	5.1	7.4	1.9
All CUs	2.6	3.3	1.0

Table 5.12 shows that the charge-off rates are much less than the delinquency rates, indicating that most delinquent loans are eventually paid off. The delinquency rates are lower in terms of dollar balance than in terms of number of loans. This implies that the typical dollar balance on delinquent loans is smaller than the typical dollar balance on all loans outstanding.

The delinquency rate is somewhat higher in small CDCUs than in large, and somewhat higher in urban than in rural (although the charge-off rate in the urban credit unions is lower). The principal contrast comes in terms of church affiliation, with the church CDCUs having significantly higher delinquency rates (although, again, lower charge-off rates).

The average delinquency rates for the church credit unions conceal some extraordinarily high individual rates. The highest, 50 percent on the dollar balance of loans, is suffered by a small church credit union with just $35,000 in assets, located in a central city. Three other church credit unions had delinquency rates above 30 percent at the end of 1991.

Why the church delinquency rates are so high is a matter of conjecture. Church CDCUs have lower loan-to-asset ratios than do the other credit unions, and it may be that they have simply not developed the expertise to make good judgments about lending because they have less experience. It may be particularly difficult for credit committees in churches to turn down loan applications from parishioners since fellowship is valued highly in a church context. A report by the National Federation of CDCUs shows that some borrowers, apparently confused about the relationship between the church and the credit union, think that the church is rich enough that they should not have to pay back their loan. Some leaders of church CDCUs have cited interference from the pastor as a factor impeding sound lending policies.[8] In any case, it is clear that delinquency rates are disturbingly high in some church credit unions.

The bottom panel of Table 5.12 shows that delinquency and charge-off rates are much higher in CDCUs than in all credit unions, for both small and large institutions. The bottom panel is expanded, in order to explore the question of whether church CDCUs alone are responsible for the difference in delinquency rates between CDCUs and all credit unions. The figures show that they are not. While the church delinquency rates are particularly high, the non-church rates are also above the average delinquency rates for all credit unions. For small credit unions the difference is just marginal: 6.4 percent in the non-church CDCUs compared to 5.6 percent in all credit unions. For the larger credit unions the difference is more significant: 5.1 percent compared to 2.4 percent.

The conclusion is inescapable and unsurprising. CDCUs have higher than average delinquency rates on their loans, no doubt because their members are poorer than average Americans. CDCUs make loans to people many of whom would not be deemed creditworthy at a mainstream credit union or

[8] National Federation of Community Development Credit Unions, "Final Report: Church-Based Credit Union Study."

other conventional financial institution; that is their principal reason for existence. Since poor people live so close to the margin of existence, even relatively small economic reverses can put them in a position in which they are unable to meet their financial obligations.

Turning to the last column of Table 5.12, one sees that for the most part the charge-off rates are higher in the CDCUs than in all credit unions. This is consistent with the information on delinquency just reviewed. Institutions with higher delinquency rates on repayments are likely to have to declare a larger number of loans in default and write them off the books.

The interpretation of charge-off rates is somewhat ambiguous, however. On the one hand, a high charge-off rate would seem to follow naturally from a high delinquency rate. On the other hand, a charge-off is sometimes an alternative to a delinquency. Once a non-performing loan has been written off the books, it no longer appears as a delinquency. One way credit unions have of lowering their delinquency rate is simply to let the loans go into default, provided that the allowance for loan loss is sufficient to cover the write-off.

Examining a similar data set to the one used here, Lindsay Neunlist of the NCUA has pointed out that although low-income credit unions have higher charge-off rates, their ratio of charge-off to delinquency rates is lower.[9] Given the caveats expressed in the previous paragraph, this may indicate that while CDCU borrowers fall behind in their payments more frequently, they tend to stick with their loans and eventually make good on them.

How do CDCUs Allocate Their Income?

Credit unions' income is allocated completely to three categories of uses: (1) operating expenses, (2) dividend and interest payments, and (3) transfer to reserve accounts. Table 5.13 shows how the income of the country's CDCUs was divided among the three categories during 1991. On average, CDCUs allocated 47 percent of their income for operating expenses, 34 percent for dividend and interest payments, and 19 percent for transfer to the reserve accounts.

The portion of income transferred to the reserve accounts does not differ much between the various categories of CDCUs. Larger CDCUs and church CDCUs tend to have lower expense-to-income ratios, and they use the savings in expenses to increase their dividend payments to their members.

The fact that the expense-to-income ratio falls with asset size among the CDCUs (as it does also among all credit unions) may indicate that there are

[9] Neunlist.

some economies of scale in providing financial services. That is to say, not all expenses have to be increased at the same rate that the membership and the assets are growing, and consequently the larger credit unions are able to realize some savings, at least proportionately.

Table 5.13
(Percentages of Total Income)

Average Uses of Total Income by CDCUs, 1991

Credit Union Category	Operating Expenses	Dividends and Interest	Transfer to Reserve Accounts
Assets up to $500K	48.8	31.2	20.0
Assets > $500K	44.6	36.6	18.8
Church	43.2	37.6	19.2
Non-Church	48.1	32.4	19.5
Urban	46.3	34.0	19.7
Rural	47.2	33.8	19.0
Total	**46.7**	**34.0**	**19.4**
Summation Method			
CDCUs up to $500K	48.0	30.8	21.3
All CUs up to $500K	44.4	39.4	16.2
CDCUs $.51-50 Mil	42.7	41.4	15.8
All CUs $.51-50 Mil	36.5	50.2	13.3
CDCUs	43.0	40.9	16.1
All CUs	36.9	49.6	13.5

Table 5.14
(Operating Expenses as Percentages of Total Income)

Expense-to-Income Ratios by Church Affiliation and Size

	Assets		Total
	up to $500K	> $500K	
Church	43.6	42.6	43.2
Non-Church	52.2	45.1	48.1
Total	**48.8**	**44.6**	**46.7**

The anomaly in Table 5.13 is that the expense-to-income ratio in church CDCUs is comparatively low in spite of the fact that church credit unions are typically smaller than their non-church counterparts, and the first two lines

of the table show that small CDCUs have on average higher expense-to-income ratios. Table 5.14 explores this by breaking out the church and non-church credit unions according to their size. It shows that the expense ratio in church CDCUs is quite consistent, whatever the asset size, while in non-church CDCUs the ratio falls considerably with size. The explanation may be that some of the more important fixed expenses in the non-church CDCUs—that is to say, expenses like rent which need to increase little if at all as the credit union grows—are paid for by the sponsoring church in the case of the church credit unions. In any case, the fact that small CDCUs have on average higher expense ratios is due entirely to the non-church credit unions.

Returning to Table 5.13, the bottom panel shows that CDCUs have consistently higher expense-to-income ratios than do other credit unions. This is the case whether the comparison is among small or large credit unions. It also shows that CDCUs allocate more of their income to reserves—probably in order to compensate for higher delinquencies and defaults in their loans. As a consequence, CDCUs have much less income (about ten percentage points less) to return to their members as dividends. To see the point in a different way, note that CDCUs allocate more of their income to operating expenses than to dividend and interest payments, while other credit unions typically allocate more to dividends and interest.

There are a number of reasons for the relatively high expense ratios of CDCUs. They normally have to spend more staff time dealing with members because fewer of their transactions occur in computerized payroll deduction form than in other credit unions. In some cases, CDCUs find it more expensive to determine the creditworthiness of their borrowers and to process their loans. The most fundamental reason, however, is that their members are poor, with relatively low savings balances.

To understand the consequence of low savings balances upon the expense ratio, one can envision the financial effect of a member upon a credit union. The member creates income for the credit union and also expenses. The income results from the member's savings deposits which the credit union lends or invests, thereby earning interest. The larger the savings deposit, the larger the interest income. The expenses come largely from the transactions the member engages in: each deposit, each withdrawal, each inquiry, each loan payment, requires the use of staff time, computer time, and supplies. Unfortunately, the level of transactions appears unrelated to the level of a member's savings. Members with $100 in their account engage in roughly as many deposits and withdrawals as do members with $10,000. If all members impose roughly the same expenses on the credit union, but only members with high deposits generate high income, then credit unions

with a preponderance of poor members will suffer from a relatively high ratio of expenses to income. This is the systematic and inescapable reason for the comparatively high expense ratios of CDCUs in Table 5.13.[10] More generally, any financial institution has difficulty thriving among a low-income clientele, and therefore banks are scarce in poor neighborhoods while pawnshops and loan sharks charge such high interest rates.

Table 5.15
(Percentages of Total Income)

Credit Union Category	Compensation and Fringes: Compensation	Other Expenses	Total Expenses
Assets up to $500K	10.0	38.8	48.8
Assets > $500K	20.1	24.5	44.6
Church	9.3	33.9	43.2
Non-Church	17.6	30.5	48.1
Urban	15.4	30.9	46.3
Rural	14.6	32.6	47.2
Total	**15.1**	**31.6**	**46.7**
Summation Method			
Assets up to $500K			
CDCUs	14.3	33.7	48.0
Church CDCUs	7.9	33.2	41.1
Non-Church CDCUs	18.3	33.9	52.2
All CUs	16.3	28.1	44.4
Assets $0.51 - $50 Mil			
CDCUs	21.1	21.5	42.7
Church CDCUs	18.4	27.3	45.7
Non-Church CDCUs	21.3	21.2	42.5
All CUs	17.2	19.3	36.5
All			
CDCUs	20.8	22.2	43.0
Church CDCUs	16.4	28.4	44.8
Non-Church CDCUs	21.2	21.6	42.8
All CUs	17.1	19.8	36.9

Another reason for the relatively high expense ratios in CDCUs may be that they offer more services to their members than do other credit unions,

[10] It is also why non-member deposits can be so important to a low-income credit union. Non-member deposits tend to be relatively large and they require few transactions (sometimes as few as one a year), so they can effectively cross-subsidize the small depositors who account for the bulk of CDCU funds.

but cover the cost by charging fees for the services. In 1993 the NCUA acknowledged this possibility by instructing its examiners to rate credit unions not on their overall expense ratio but on their net expense ratio, where net expenses are equal to total expenses minus fees. Table 5.15 permits a closer look at the expense-to-income ratio by dividing out the component of expenses that represents compensation and fringe benefits paid to employees. This is the largest single item among the expenses.[11]

The higher expense ratio for small CDCUs is not associated with higher levels of compensation to employees. To the contrary, small CDCUs spend only 10 percent of their income on staff compensation, while larger credit unions spend 20 percent. Church CDCUs spend much less on employees than do non-church CDCUs.

The bottom panel of Table 5.15 shows that the compensation ratio is actually less in the small CDCUs than in small credit unions generally, while it is greater in the larger CDCUs. The comparatively low compensation ratio for small credit unions can be seen, however, to be entirely due to the small church CDCUs. Once the church CDCUs are factored out, the remaining small non-church CDCUs devote a higher proportion of their income to compensation than do credit unions generally.

Table 5.16

Staffing in CDCUs

Credit Union Category	Credit Union	Full-time-equivalent Employees Per: 1,000 Members	$100,000 Income	$1,000,000 Assets
Assets up to $500K	0.6	2.5	6.5	5.6
Assets > $500K	3.2	2.0	1.5	1.5
Church	0.9	1.7	3.2	2.7
Non-Church	2.3	2.5	4.3	3.9
Urban	1.9	2.2	3.5	2.8
Rural	1.8	2.4	4.8	4.8
Total	**1.9**	**2.2**	**4.0**	**3.5**
Summation Method				
CDCUs up to $500K	0.6	1.9	3.3	3.0
All CUs up to $500K	0.8	3.3	3.4	3.4
CDCUs $.51-50 Mil	3.2	1.8	1.0	1.0
All CUs $.51-50 Mil	7.2	2.0	0.8	0.8
CDCUs	1.9	1.8	1.1	1.1
All CUs	6.9	2.1	0.9	0.9

[11] The other expense categories reported in the call data are travel and conference, office occupancy, office operations, educational and promotional, loan servicing, professional and outside services, member insurance, operating fees, and others.

Salary expenses reflect a combination of staffing levels and wage rates. Something about these can be inferred from the call reports but the inferences are imprecise. Credit unions report the number of full-time and part-time staff separately. They do not, unfortunately, report the hours for the part-time staff. Consequently the total number of hours—or, alternatively, the number of full-time-equivalent employees—is not known. In the tables that follow, the intermediate assumption is made that a part-time employee works half-time, and is equivalent to half a full-time employee. Using that assumption, Table 5.16 shows the average ratios of staff per CDCU, per 1,000 members, per $100,000 in income and per $1,000,000 in assets.

The typical CDCU has just less than two staff members. Naturally, the number is lower for the smaller credit unions and for the church-affiliated credit unions. CDCUs have fewer employees per credit union than is the case in the industry generally. They have somewhat fewer employees per member and somewhat more per dollar of income and assets.

Two features of Table 5.16 merit further exploration. First, church CDCUs have fewer employees per member, and per dollar of income and assets, than do non-church CDCUs, in spite of the fact that they are smaller. Second, small CDCUs have more employees per dollar of income than do larger CDCUs, in spite of the fact that the portion of income they spend on employees is considerably smaller (see Table 5.15).

Table 5.17
(Number of Credit Unions in Parentheses)

Employees Per Hundred Thousand Dollars in Income by Credit Union Size and Church Affiliation

	Assets		Total
	up to $500K	> $500K	
Church	3.9 (35)	1.9 (19)	3.2 (54)
Non-Church	8.2 (54)	1.4 (72)	4.3 (126)
Total	**6.5 (89)**	**1.5 (91)**	**4.0 (180)**

Table 5.17 explores the first issue by looking more closely at employees per $100,000 of income in church and non-church CDCUs. It shows that the staffing gap between the two types of credit unions is huge at the smaller size, and this compensates for the fact that most church credit unions are small and that smaller credit unions have higher proportionate staffing levels. Among the larger credit unions, the church staffing ratio actually exceeds the non-church ratio, but since there are so few church credit unions in this category, it does not pull the overall church ratio above the non-

church. Put simply, small church credit unions make do with many fewer employees than do non-church credit unions of a similar size. The explanation is likely that they rely more heavily on volunteers, and also that they take on fewer tasks, including less lending.

The second issue is that while small credit unions have more staff per $100,000 of income, they spend a smaller proportion of their income on staff. There are two possible explanations of this, both of which likely have some validity. The first is that many staff members in small CDCUs are paid by a sponsoring agency and not from the earned income of the credit union. The second is that wages are lower in the small credit unions.

The second explanation, that wages are lower in the small credit unions, is no doubt true, but a simple calculation shows that it cannot be the sole explanation. If all employees are paid from the credit unions' own income, then the wage rate, or compensation per employee, is equal to the ratio of compensation to income (in Table 5.15) divided by the ratio of employees to income (in Table 5.16). Performing the division, one sees that the implied annual wage rate is $13,224 in the large credit unions and $1,536 in the small. Even if the assumption about part-time employees is changed so that part-time is counted as one quarter rather than one half of full-time, the implied wages are $16,891 and $2,538 respectively. Under either assumption, the calculated wages in the large credit unions are quite low, and this probably indicates that they get some supplementary help from sponsoring agencies. The calculated wage in the small credit unions is impossibly low, indicating that they get the majority of their staff support dollars from sponsoring agencies, grants, or other outside sources.

How Do CDCUs Create a Spread Between Income and Outgo?

One way to understand the financial condition of a credit union is to identify the spread, that is to say, the gap between the income generated by its assets, on the one hand, and the cost of those assets, on the other hand. From this spread, the credit union must pay its operating expenses. Any surplus that is left over after the operating expenses can be transferred to the reserve accounts. This section analyzes the spread.

Almost all of the components of the spread have been looked at already. This section adds little new data, but it looks at the data from a different perspective.

The spread analysis is conducted in relationship to the assets of the credit union. The income, expenses, and surplus are all stated as ratios to assets. For example, the interest return on loans is the income derived from loans during 1991 as a percentage of loans outstanding. The gross income

return on assets is the total of all the credit union's income as a percentage of its total assets. So far in this chapter, the assets used in calculations have been the figures as of December 31, 1991. This sole date is not adequate for rate-of-return studies, however. The loan interest income during 1991 was generated by the loans outstanding throughout the entire year, not just at the end of the year. As an estimate of this quantity, the asset amounts for December 31, 1990 and December 31, 1991 are averaged throughout this section.

During 1991, the typical CDCU achieved a rate of return on all assets of 10 percent. This is shown in column 4 of Table 5.18. Compared to all American credit unions of the same size, the CDCUs' rate of return was one percentage point higher.

Looking at the CDCUs by category, the larger CDCUs, the non-church CDCUs, and the rural CDCUs all had higher rates of return on assets than did the smaller, church, and urban CDCUs, respectively. Some of the reasons for these differences are revealing.

Table 5.18
(Percentages)

	Rates of Return			
	1	2	3	4
Credit Union Category	Net Return on Loans	Return on Investments	Interest Return on Earning Assets	Total Return on All Assets
Assets up to $500K	12.7	6.4	9.5	9.4
Assets > $500K	12.6	6.2	10.4	10.9
Church	12.2	5.7	9.1	9.1
Non-Church	12.9	6.5	10.2	10.5
Urban	12.3	6.5	9.7	9.7
Rural	13.2	6.0	10.3	10.7
Total	**12.7**	**6.3**	**9.9**	**10.1**
Summation Method				
CDCUs up to $500K	12.9	6.1	9.6	9.6
All CUs < $500K	12.6	5.9	10.3	9.9
CDCUs $.51-50 Mil	12.5	6.4	10.5	11.1
All CUs $.51-50 Mil	11.9	6.4	9.9	10.0
CDCUs	12.5	6.4	10.5	11.0
All CUs	11.9	6.3	9.9	10.0

Looking first at the rate of return on loans in column 1—the interest earned by the CDCUs on their loans divided by the loans outstanding—the non-church and the rural credit unions both did better because they charged

higher interest rates on loans (as was seen in Table 5.11), and because they enjoyed lower delinquency rates on loans (Table 5.12). There was almost no differential in rate of return on loans by size of credit union since, although the smaller CDCUs charged higher interest rates on some categories of loans, they suffered from somewhat higher delinquency rates.

The rates of return on investments were previously seen in Table 5.11. The small differences in column 2 are probably due to differences in skills in financial management.

Column 3, interest return on earning assets, is a weighted average of the first two columns, showing total interest earnings divided by both loans and investments outstanding. The final column adds fees and other income to the numerator of column 3, and fixed and other non-earning assets to the denominator. For the most part, these additions cancel out, leaving few differences between the third and fourth columns.

An interesting feature of Table 5.18 is that the differences in overall rate of return, shown for example in column 4, are generally greater than the differences in the rates of return on either loans or investments. The reason for this is that a very important determinant of the overall rate of return is the proportion of assets that are devoted to loans. Note, for example, the difference between small and large credit unions. On loans and on investments, looked at separately, the rates of return are very similar, marginally higher for the small CDCUs in one case, marginally lower in the other. Yet the overall rate of return on assets is much lower for the small CDCUs. The clue is back in Table 5.4, showing that the loan-to-asset ratio was 43 percent in the small CDCUs and 59 percent in the large ones. Since the return on loans is so much higher, this puts the large CDCUs in a stronger financial position. In terms of the church and non-church distinction, while a gap exists in columns 1 and 2, the greater gap in columns 3 and 4 is due to the lower loan-to-asset ratio in the church CDCUs shown in Table 5.4. Similarly in the urban-rural contrast, the lower loan-to-asset ratio in the urban CDCUs has the effect of lowering the overall rate of return.

The fact that the rate of return on assets was higher for CDCUs than for all credit unions of comparable size is due primarily to the higher interest rates that they charged on loans, as shown in Table 5.11. CDCUs had a slightly higher loan-to-asset ratio (Table 5.4), but not enough to cause much difference in the overall rate of return. Their return on investments was just barely higher and their delinquency rates were actually significantly worse. So the CDCUs' policy of charging higher interest rates on loans resulted in a higher overall rate of return.

When the CDCUs are segmented by size, however, it can be seen that the

overall rate of return on the smaller CDCUs was below that of small credit unions generally. In this case, the culprit is the low loan-to-asset ratio shown in Table 5.4, which far more than compensated for the higher interest rates that the small CDCUs charged.

The second component of the spread analysis is the cost of funds. Column 1 of Table 5.19 shows the cost of member savings: the dividend payments divided by the shares outstanding during 1991. Column 2 is a more comprehensive estimate of the cost of funds. To the numerator of column 1 is added the interest cost of borrowed funds, and the denominator in column 2 is the credit union's total assets.

The most interesting feature of Table 5.19 is how much lower the cost of funds is for CDCUs than for credit unions generally of the same size. In 1991, small CDCUs paid only about three quarters as much for their funds as did all small credit unions; larger CDCUs, over a half million dollars in assets, paid about 90 percent of what all larger credit unions paid.

Table 5.19
(Percentages)

	Cost of Funds	
Credit Union Category	**1 Cost of Shares**	**2 Dividend and Interest Cost of Total Assets**
Assets up to $500K	3.3	2.7
Assets > $500K	4.3	3.9
Church	3.7	3.2
Non-Church	3.8	3.3
Urban	3.6	3.2
Rural	4.1	3.5
Total	**3.8**	**3.3**
Summation Method		
CDCUs up to $500K	3.4	2.9
All CUs up to $500K	4.6	3.9
CDCUs $.51-50 Mil	5.0	4.6
All CUs $.51-50 Mil	5.6	5.0
CDCUs	4.9	4.5
All CUs	5.5	5.0

The relatively low cost of funds is a mixed blessing for the CDCUs. Table 5.13 above showed that CDCUs have relatively high operating expenses and that they devote a high proportion of their income to reserves in order to compensate for loan defaults, leaving them with significantly less to return

to their members in dividends. Now Table 5.19 shows the consequence of this squeeze; CDCU members in fact earn less on their savings than do members of other credit unions.

This may help to explain why many CDCUs have stayed so small; potential members prefer to deposit their funds elsewhere to get a higher return. Still, the CDCUs retain a deposit base, and this requires an explanation, too, in view of the relatively low returns on savings that they offer. Part of the explanation may be loyalty. Members often feel a connection to an institution that has been established by their neighbors and for their benefit, and they are willing to forego a little income on their savings in order to support it. They may stick with the CDCU in order to qualify for loans themselves. Another part of the explanation is that in at least some poor neighborhoods few financial institutions are competing for people's deposits, and consequently savers may not be able to obtain higher rates of return than the CDCU offers, at least not very easily. Sometimes they cannot meet the minimum deposit requirements at other institutions.

Among the CDCUs themselves there are some differences in the cost of funds. Small CDCUs and urban CDCUs pay less for their funds than large and rural CDCUs do, respectively.

Table 5.20
(Percentages of Average Assets During 1991)

	Net Spread				
Credit Union Category	**1 Gross Return on Assets**	**2 Cost of Funds**	**3 Gross Spread**	**4 Operating Expenses**	**5 Net Spread**
Assets up to $500K	9.4	2.7	6.7	4.8	1.9
Assets > $500K	10.9	3.9	7.0	5.1	1.9
Church	9.1	3.2	5.9	4.1	1.8
Non-Church	10.5	3.3	7.2	5.2	1.9
Urban	9.7	3.2	6.6	4.8	1.7
Rural	10.7	3.5	7.2	5.1	2.2
Total	**10.1**	**3.3**	**6.8**	**4.9**	**1.9**
Summation Method					
CDCUs up to $500K	9.6	2.9	6.7	4.7	1.9
All CUs up to $500K	9.9	3.9	6.0	4.4	1.6
CDCUs $.51-50 Mil	11.1	4.6	6.5	4.7	1.8
All CUs $.51-50 Mil	10.0	5.0	5.0	3.6	1.3
CDCUs	11.0	4.5	6.5	4.7	1.8
All CUs	10.0	5.0	5.0	3.7	1.4

Church affiliation makes no difference to the cost of funds, in spite of the fact that church CDCUs devote a significantly higher portion of their income to dividends than do non-church CDCUs (see Table 5.13). The answer to the puzzle lies in Table 5.18, which shows church CDCUs doing significantly worse in terms of overall return on assets; the result of this is that they must devote more of their income to dividends just to stay even in terms of dividend payments on shares.The gross spread is equal to the gross return on assets, from Table 5.18, minus the total cost of assets, from Table 5.19. The net spread is equal to the gross spread minus the ratio of operating expenses to assets, as shown in Table 5.20.[12]

Remarkably, there is very little variation in the net spread among the different categories of CDCUs. The differences in gross return in column 1 are partially compensated for by differences in cost of funds in column 2. For example, the gross return in small CDCUs is 1.5 percentage points less than in larger CDCUs, but the cost of funds is 1.2 percentage points less, leaving a difference in gross spread of just 0.3 points. Nevertheless, some significant differences in gross spread remain, with non-church doing better than church CDCUs, and rural doing better than urban. The gross spread in column 3 is correlated with the expense-to-asset ratio in column 4, however, categories with high gross spreads having high expense ratios. Consequently the net spreads come out quite close together around the overall average of 1.9 percentage points.

A substantial difference exists between the net spreads of the CDCUs and all American credit unions of the same size, with the CDCU spread being higher by about half a percentage point. The higher net spread is required because the demands on the CDCUs' net income are greater, as shown in Table 5.21.

The loans in default are charged off from the net spread (column 2), leaving the net income which is retained by the credit union (column 3). Part of the net income is allocated to the allowance for loan loss (column 4), which is held as a negative asset, and the remainder (column 5) is transferred to one of the reserve or capital accounts.

The amount to be transferred to the allowance for loan loss is stipulated by the federal or state examiners; it depends upon the amount currently in the allowance for loan loss, as well as the examiner's assessment of the quality of the loans that are on the books.

In CDCUs, the required provision for loan loss is frequently greater than net income, leaving a negative balance for transfer to other reserve accounts. Table 5.21 shows that on the average in 1991 the reserve accounts actually

[12] Because of rounding, some of the figures in Tables 5.20 and 5.21 appear to be subtracted incorrectly.

shrank in CDCUs because transfers to the allowance for loan loss exceeded net income. Further examination shows, however, that only a minority of the CDCUs experienced this shrinkage. Of the 157 CDCUs on which the rate of return tables are based, 58 lost reserves in 1991 after the provision for loan loss was transferred.

Table 5.21
(Percentages of Average Assets During 1991)

	Allocation to Capital				
	1	2	3	4	5
Credit Union Category	Net Spread	− Net Loans Charged Off	= Net Income	= Provision for Loan Loss	+ Other Transfers to Capital
Assets up to $500K	1.9	0.7	1.2	1.1	0.1
Assets > $500K	1.9	1.1	0.8	1.3	-0.5
Church	1.8	0.6	1.2	1.2	0
Non-Church	1.9	1.0	1.0	1.2	-0.3
Urban	1.7	1.0	0.8	1.4	-0.7
Rural	2.2	0.7	1.4	1.0	0.5
Total	**1.9**	**0.9**	**1.0**	**1.2**	**-0.2**
Summation Method					
CDCUs up to $500K	1.9	0.6	1.4	1.1	0.3
All CUs up to $500K	1.6	0.7	1.0	0.7	0.2
CDCUs $.51-50 Mil	1.8	1.1	0.7	1.2	-0.5
All CUs $.51-50 Mil	1.3	0.5	0.8	0.5	0.3
CDCUs	1.8	1.0	0.7	1.2	-0.5
All CUs	1.4	0.5	0.9	0.5	0.3

In summary, the spread analysis shows that CDCUs enjoyed a higher return on assets than did all American credit unions, and paid less for their funds. Consequently, their gross spread was substantially larger—by one measure, one and a half percentage points. Their expenses were substantially higher, however, as was the dollar amount of loans charged off, and as a result their net income was roughly on a par with other credit unions. Because the required provisions for loan loss were higher in CDCUs than in other credit unions, the amounts left over for transfer to the other reserve accounts were substantially less, and in many cases actually negative. Consequently, one of the most important tasks facing many CDCUs is to build their capital base.

How are CDCUs Rated by Their Examiners?

Each credit union in the country is rated by its federal or state examiners using the CAMEL system, where CAMEL stands for:

Capital Adequacy
Asset Quality
Management
Earnings
Liquidity Management

Each component is rated on a 1 to 5 scale, with 1 being the strongest and 5 being well below the minimal acceptable standard. In addition, the credit union as a whole is given a numerical rating. The CAMEL ratings are intended as a measurement of the risk that each credit union presents to the National Credit Union Share Insurance Fund.

Table 5.22
Percentages, Using the Summation Method

CAMEL Ratios*

Ratio	Assets up to $500K		Assets > $500K		Total	
	CDCU	All CU	CDCU	All CU	CDCU	All CU
Capital Adequacy:						
Net capital/assets	13.0	13.8	7.1	9.0	7.5	9.2
Reserves/assets	15.4	15.6	8.7	9.8	9.1	10.1
Asset Quality:						
Loan delinquency ratio ($)	10.1	5.6	5.4	2.4	5.6	2.6
Loan charge-off ratio	1.6	1.4	1.8	1.0	1.8	1.0
Non-earning assets/assets	1.1	0.7	3.0	1.9	2.9	1.8
Earnings:						
Net income/assets (before prov. for loss)	1.4	1.0	0.7	0.8	0.7	0.9
Net income/assets (after prov. for loss)	0.3	0.2	-0.5	0.3	-0.5	0.3
Op. expenses/assets	4.7	4.4	4.7	3.6	4.7	3.7

* The first two rows of figures are from Table 5.3, the third and fourth from Table 5.12, the fifth from Table 5.4, the sixth and seventh from Table 5.21 and the eighth from Table 5.20.

The ratings are communicated in confidence to the management and board of directors of the credit unions and are not available to the public.

The information on which many of the assessments are made is, however, available. The Capital, Asset, and Earnings ratings are based largely on ratios that have been shown in the tables in this chapter. The Management and Liquidity ratings are heavily influenced by more subjective criteria.

Table 5.22 brings together the most important figures for the CAMEL ratings, displaying them by asset size of the credit union and comparing them to all American credit unions of the same size.

Table 5.22 shows that, according to at least some of the criteria generally used to assess the health of credit unions, CDCUs are typically weaker than other credit unions. In terms of capital adequacy, CDCUs usually have lower ratios of net capital to assets (first row). When the allowance for loan loss is added to the reserves, the gap between the two groups is reduced but not eliminated.

In terms of asset quality, the CDCUs have much higher levels of loan delinquency and somewhat higher levels of loan charge-offs (third and fourth rows). In addition, more of their assets are in non-earning form (fifth row).

In considering earnings, the CDCUs do just about as well as credit unions generally, except in the case of larger credit unions, when the provision for loan loss is deducted. They do, however, have higher expense ratios.

While the actual CAMEL ratings are not available, Table 5.22 makes it clear that CDCUs are typically rated lower than other credit unions. In view of the difficulties of doing business in poor communities, this is hardly surprising.

Conclusions

Some of the interesting findings of this analysis of financial data lie in the details and need not be repeated. Lest the reader be lost in the details, however, some of the central points bear highlighting.

Taken as a whole, CDCUs do nearly as well financially as do mainstream credit unions of the same size; they are capable of managing the risk inherent in their business, generating income, keeping expenses under control, and accumulating reserves. But they do not do quite as well, and for predictable reasons. Working as they do in poor neighborhoods, CDCUs find that their expenses are higher, that their net profitability is lower, that more of their loans must be written off, and that as a consequence they are forced to charge more for their services.

Among the most striking findings are the following:

- Loan delinquency rates are substantially higher in CDCUs than in mainstream credit unions, but charge-off rates are only

slightly higher (Table 5.12). It follows that the proportion of delinquent loans ending up in default is relatively low in CDCUs. This may indicate that the high delinquency rates are a consequence of economic distress, not irresponsibility, and that when CDCU members are capable of it, most eventually make good on their loans.

- CDCUs devote a higher proportion of their income to operating expenses than do other credit unions (Table 5.13).
- CDCUs charge somewhat higher interest rates on their loans than do other credit unions (Table 5.11), probably in order to compensate for the greater loan losses and the higher expenses.
- The consequence of the relatively high expenses in CDCUs is that less is available to be paid to the members as dividends on their savings (Table 5.19). CDCUs reduce the dividend rates, but they do not skimp on transfers to the reserve accounts (Table 5.13). On the other hand they sustain greater losses from their reserves, and therefore the ratio of reserves to assets in CDCUs is close to, but not quite as high, as in other credit unions of comparable size (Table 5.3).
- CDCUs generate a greater spread between income and cost of funds than do other credit unions. The demands on that spread are greater, however, as a consequence of higher operating expenses, higher loan charge-offs, and higher required provisions for loan loss, the consequence being that the income available for transfer to the reserve accounts is lower in the CDCUs, and sometimes negative (Tables 5.20 and 5.21).
- CDCUs have higher staffing levels, relative to assets, than do other credit unions (Table 5.16) and devote a higher proportion of their income to employee compensation (Table 5.15).
- Compared to other credit unions, CDCUs make more unsecured loans and fewer automobile loans (Table 5.6). Within each category of loans, the size of loans is about the same (Table 5.8). CDCUs lend to a relatively small proportion of their members (Table 5.9).
- The facts that CDCUs suffer higher defaults on their loans, incur higher expenses, charge higher interest rates on loans, and pay lower dividend rates on savings make it difficult for them to at-

tract middle- and high-income members, who have the option of doing business with financial institutions that offer them better rates. While it is not impossible to develop a credit union membership that is a mixture of low- and higher-income people, it is difficult.[13] It follows that CDCUs need to reach out to socially responsible investors and institutions.

- In some respects, small CDCUs face more difficult problems than do large ones. A smaller proportion of their assets are lent to their members (Table 5.4), and their operating expenses are a higher proportion of their income (Table 5.13). Still, they compensate for this, in part by paying lower dividends to their members (Table 5.20), and, as a consequence, they are able to keep up with their transfers to reserves (Table 5.21) and are able to maintain a ratio of reserves to assets that is actually higher than in the larger CDCUs (Table 5.3).
- Church-affiliated CDCUs are as strong financially as other CDCUs as measured by their reserve ratios (Table 5.3). They lend fewer of their assets (Table 5.4) and as a consequence generate less income (Table 5.20), but they compensate for this by incurring lower expenses (Table 5.13) and, in particular, lower wage payments (Table 5.15).
- The most important single indicator of the financial health, stability, and expected longevity of a credit union is its reserve ratio. Table 5.3 shows that CDCUs' reserve ratios are close to, although not quite as high as, the reserve ratios in mainstream credit unions of comparable size. In spite of the many difficulties they face, CDCUs are typically doing reasonably well.
- These data lead one to conclude, therefore, that financial institutions can be successful operating in low-income communities. They just cannot be quite as profitable as those operating in richer neighborhoods. Although this study does not deal with banks, it is likely that the flight of banks from poor neighborhoods is caused by a search for higher profits, and is not a consequence of actual losses. Or, at the very least, losses need not be sustained by a financial institution that takes seriously the mission of serving the financial needs of low-income people.

[13] This point is made in Neunlist.

CHAPTER 6

THE LENDING PRACTICES OF CDCUs

There's not many who are willing to give the small operator a chance, and at the credit union everybody has been willing to take a chance on me.

—James (Moose) Morgan[1]

The banks around here are just keepers of black folks' money. Just like everyone else, we need a lender and that is why the credit union was started.

—James Gilliam, St. Luke Credit Union, North Carolina[2]

The most important impact of community development credit unions results from their lending. This chapter explores the lending practices of seven diverse CDCUs in order to illustrate the sorts of loans that they make and the sorts of people who borrow from them. [3]

Seven Credit Unions

The seven credit unions are

- Central Appalachian People's Federal Credit Union, in Berea, Kentucky. Its field of membership includes people associated

1 Quoted in Central Appalachian People's Federal Credit Union, Annual Report, 1990 (Berea, Kentucky: 1991).

2 Quoted in Tholin and Pogge, 2.

3 This chapter is largely based on a previously published report, Isbister with the assistance of Thompson. It extends the study by Rosenthal and Schoder. Thanks to Joy Agcongay, Christina Cavazos, and Javier Tapia for help in collecting the data.

with 35 community organizations in the southern Appalachian mountains. Each of the 35 organizations functions as a branch of the credit union.

- First American Credit Union, whose head office is in Window Rock, Arizona, on the Navajo Reservation. It is the largest Indian credit union in the country. While its field of membership includes all Indians whose tribal headquarters are in Arizona, the files examined in this chapter come only from the Window Rock office where the majority of the members are Navajo.
- Mission Area Federal Credit Union, in a predominantly Latino neighborhood of San Francisco. It grew out of the political struggles of local community organizations in the 1970s. After a difficult early period, it rescued itself and grew slowly into a stable institution focusing on the needs of people living in a poor, central area of the city.
- Northeast Community Federal Credit Union, in the Chinatown area of San Francisco. It serves Asian immigrants who move into the center of the city. It was chartered in 1970 and initially served an almost exclusively Chinese population, but with changing immigration patterns significant numbers of Vietnamese have joined.
- North East Jackson Area Federal Credit Union, serving an African American rural community in the Florida panhandle. It was founded in 1965 with the assistance of the federal Office of Economic Opportunity as part of the War on Poverty. Many of its members are independent farmers.
- Santa Cruz Community Credit Union, serving a mixed-income population in Santa Cruz, California. It was founded by political activists concerned both with the environmental preservation of their coastal community and with social services for the poor. It has a particular commitment to community economic development.
- Watts United Credit Union in the Watts area of Los Angeles, a predominantly African American community. Founded just after the Watts riots of 1965, as a response to the terrible economic and social conditions in the area, it has been one of the few commercial successes in a neighborhood that remains devastated.

For each of the seven CDCUs, Table 6.1 shows the membership, assets,

and outstanding loans, plus two ratios: assets per member and reserves to assets. Assets per member is an indicator, albeit imperfect, of the relative wealth of the credit union and its members, while the ratio of reserves to assets is an indicator of the credit union's financial condition.

Table 6.1

Seven Credit Unions: Basic Comparisons
As of December 31, 1991

Credit Union	Members	Assets	Loans	Assets/ Member	Reserves/ Assets*
		($000)	($000)	($)	(%)
Appalachian	1,682	2,306	1,232	1,371	3.5
First American	9,999	26,024	16,061	2,603	7.3
Mission Area	950	2,093	1,744	2,203	4.0
Northeast Community	834	3,209	1,947	3,847	10.6
NEJA	819	658	437	803	8.5
Santa Cruz	6,233	18,365	11,586	2,946	5.1
Watts United	2,185	1,454	1,258	665	13.6

*Includes the allowance for loan loss

Data were collected from loan files in each of the seven credit unions. An attempt was made to look at approximately 200 loans in each credit union, disbursed during 1990. The data are described more fully in the appendix.

Table 6.2

Median Values of Loans and Borrower Characteristics

	Appal.	First Amer.	Mission Area	North East	NEJA	Santa Cruz	Watts United
Amount ($)	504	300	5,000	5,500	1,500	3,108	2,600
Interest (%)	15.0	16.0	15.5	13.0	15.0	15.9	18.0
Term (months)	9	—	48	24	12	36	36
Purpose*	used auto	used auto	debt consol.	busi-ness	farm	credit card	used auto
Age	31	36	39	38	43	36	41
Sex	F	F	F	M	M	M	F
Income/Month	1,000	1,260	1,920	2,500	1,096	2,349	1,577

* The loan purpose shown is not the median, but rather the most frequently cited purpose.

Table 6.2 selects the median value for each of seven variables in the loan files of the credit unions. The first four rows are characteristics of the loans, while the last three are characteristics of the borrowers. The table allows a quick overview of some of the findings.

The Loans

Tables 6.3 and 6.4 analyze the loans in each credit union according to their purpose.[4] Table 6.3 shows the percentage distribution of the dollar amount of loans, while Table 6.4 shows the average size of loans, by purpose.

Table 6.3
(Percentage Distribution)

Dollar Amount of Loans by Loan Purpose

Purpose	Appal.	First Amer.	Mission Area	North East	NEJA	Santa Cruz	Watts United
New auto	3.5	—	13.7	3.9	—	15.8	27.2
Used auto	50.0	22.9	13.5	2.1	20.9	7.1	25.7
Home improvement	6.1	13.2	2.2	8.8	8.2	10.2	6.2
Debt consolidation	11.4	11.4	31.4	5.5	1.3	3.5	6.6
Medical	0.1	1.2	0.3	—	1.4	1.7	0.6
Travel	2.5	7.3	3.0	0.8	—	0.3	8.4
Furniture	2.6	2.3	0.2	0.0	0.6	0.1	4.2
Christmas	4.9	3.2	0.5		—	0.4	—
—							
Business	0.4	1.6	16.8	48.0	44.2	28.1	—
Real estate	5.3	6.3	6.4	14.4	14.9	0.2	—
Taxes	1.8	2.5	2.4	2.3	0.2	0.3	—
School	4.6	14.6	0.4	—	4.1	—	3.6
Credit card	—	—	—	—	—	30.7	—
Other	6.7	13.5	9.3	14.1	3.9	2.0	17.5

Table 6.3 demonstrates that most CDCUs do a substantial amount of lending for automobiles, with CAPFCU and Watts United directing over half of their money to this purpose. The category "used auto" in these tables includes repairs as well as purchases. Other fairly large categories in some credit

[4] These tables are not directly comparable with the data on loan purpose compiled by NCUA and CUNA. The latter classify loans by collateral type, not by the real purpose for which the proceeds will be used. Thus, for example, an unsecured, personal loan which a borrower expects to use to purchase or repair an automobile will be classified by the NCUA as "unsecured" but in Tables 6.3 and 6.4 as "automobile." Note also that the loan purpose is stated in the borrower's own words on each application. Construction of Tables 6.3 and 6.4, therefore, required some interpretation in borderline cases, particularly when more than one purpose was given.

unions are business loans, debt consolidation, and, in one case, credit cards.

Table 6.4

Average Size of Loan by Loan Purpose

Purpose	Appal.	First Amer.	Mission Area	North East	NEJA	Santa Cruz	Watts United
New auto	7,977	—	10,401	12,783	—	10,995	12,145
Used auto	1,738	483	5,333	4,229	2,328	5,535	3,695
Home impr.	938	683	15,400	24,938	1,564	28,539	2,790
Debt cons.	1,191	336	6,533	7,844	820	5,685	3,547
Medical	250	400	1,648	—	1,513	13,247	808
Travel	562	577	1,936	2,250	—	2,215	2,690
Furniture	542	394	950	1,000	900	2,654	2,429
Christmas	414	370	3,000	—	1,198	—	—
Business	502	538	4,969	19,782	6,213	22,669	—
Real estate	2,448	651	4,577	29,760	5,337	6,076	—
Taxes	682	527	3,587	12,875	300	2,723	—
School	889	522	2,450	—	3,275	—	2,870
Credit card	—	—	—	—	—	1,819	—
Other	1,027	423	3,885	7,132	841	4,911	2,343
Average size	1,189	481	5,568	13,486	2,936	7,992	3,623
Median size	504	300	5,000	5,500	1,500	—	2,600
Industry							
Av. size	3,581	4,214	3,164	3,581	2,618	4,054	3,164
Av. term (mo)	15	—	43	44	17	48	40
Median term	9	—	48	24	12	36	36

Table 6.4 shows that in two of the credit unions, Central Appalachian and First American, the average size of a loan is considerably smaller than in typical United States credit unions of the same asset size.[5] In five of the credit unions, including the four that devote significant resources to business loans, the loans are on average larger than in other credit unions.

The lending experience of each credit union is considered in order.

Central Appalachian People's Federal Credit Union

At CAPFCU the typical loan size is very small. Only First American has smaller loans, and this is because of specific constraints that the latter's board of directors has placed on the lending policies in that credit union. At

[5] The data on industry-wide averages, calculated by asset size of the credit unions, come from Credit Union National Association, *Operating Ratios and Spreads, Year-End 1991.*

CAPFCU, the loans are small in most cases because the borrowers are poor and cannot afford to go deeply into debt. Signature loans, without collateral, were available in 1990 for amounts up to $500 (plus loan fees), and the median loan was in fact for that amount.

Not only is the typical loan size small, but the term, or length of time for repayment, is short; the usual loan is paid back in less than a year.

The loans are so small (and the borrowers so poor), that few if any of them would be attractive to commercial banks. And few of the members, the author was told, qualify for credit cards at other financial institutions. So the only alternatives that CAPFCU members have for this sort of loan are non-conventional lenders, all of whom charge much higher real interest rates than the credit union does.

The small size and short term of most loans impose a burden on the credit union. Each loan, no matter how small, requires staff time and attention, and those are not free. A $500 loan for nine months at 15 percent annual interest generates about $25 income for the credit union, and that $25 may barely cover the staff time used to evaluate the loan, to say nothing of the credit union's other financial costs such as insurance, supplies, rent, reserves, etc. The CAPFCU board and manager are aware of this problem and understand that since the credit union makes so many small loans it must find other ways to generate the income it needs to stay solvent.[6]

Over one-third of the loans and one-half of the loan money at CAPFCU are used for the purchase and repair of automobiles, and these are among the largest of the loans. This reflects the rural and isolated geography in the southern Appalachian mountains. Mountain people depend upon their vehicles for access to work and for much of their social interaction as well; for many people a working automobile is a necessity. The poverty of the area is reflected in the facts that almost none of the vehicles is new, and that the size of the auto loans, while large in comparison to most of the CAPFCU loans, is quite small when compared to the other credit unions.

Over 10 percent of the loans at CAPFCU are made for debt consolidation. As is the case at most of the other CDCUs, members find that they can turn to the credit union to organize and rationalize their debts when they get in over their heads.

CAPFCU makes more Christmas loans than the other credit unions. These are normally small signature loans to pay for Christmas presents and celebrations. The board of directors has debated whether this is a proper use of credit union loan funds. There is a high demand for loans for this purpose;

6 In 1992, the CAPFCU board of directors instituted a $15 loan application fee, to help recover some of the costs of making small loans.

in December 1990, Christmas loans represented more than half of the loan requests. The fact that so many people need to borrow several hundred dollars to get through the Christmas season is another indicator of the marginal economic conditions in the area and of the personal way that the credit union can help people.

CAPFCU makes almost no business loans. As discussed below, however, an affiliated community development loan fund finances small businesses in the southern Appalachian mountain region.

First American Credit Union

First American is the largest of the credit unions in this study, and yet the striking feature of its loans is how small they are. The average loan at First American in 1990 was just $481, and the median $300. This is a consequence of policy decisions made by the board of directors.

All loans at First American are "line-of-credit" loans. A member is allocated a loan limit, after which he or she is able to borrow as often as desired, up to that limit. There is no set term on the loans; rather there is a minimum payment requirement of 3 percent of the loan balance each month, remitted through payroll deduction.

The loan limits are kept quite low. In no case do they exceed $2,500, and in the great majority of cases they are lower. Some members have loan balances higher than this, but only if the excess over the loan limit is secured by their own savings in the credit union.

For the initial loan, and to establish the credit limit, a member at First American fills out a standard loan application form, much the same as is found at other credit unions. Thereafter the member can request extensions over the phone or by dropping in at the office, and a staff person will fill out a very short, supplementary form. The funds are usually available the next day, if not immediately. In some respects, therefore, First American's lending procedure is similar to a credit card program.

The credit union lends this way for two principal reasons. First is a decision made many years ago by the board that, since funds were limited, it should try to spread them to as many members as possible, rather than concentrate them in just a few hands. The policy has been successful; approximately sixty percent of the members are borrowers, a very high proportion for any credit union. The board thought that, if the loan limits were kept quite low, members would use the money only for their most pressing needs, and would not be tempted to waste it or use it for low priority needs.

Secondly, the credit union has difficulty taking collateral, and therefore judges it prudent to keep the loan limit to any one member low. Real estate is

not privately owned on Indian reservations, and therefore the credit union cannot establish liens against real property.

Automobiles are privately owned, but the laws governing repossession on the Navajo reservation make it almost impossible for the credit union to lend against automobiles. Under the standard laws of most states, lenders can engage in what is sometimes called "self-help repossession." If a borrower is in arrears on payments, the lender can simply collect the vehicle, provided that such collection does not provoke violence. On the reservation, in contrast, a lender can repossess only after a court hearing. Since the court process typically takes half a year, lenders understandably fear that not much will be left of the vehicle once they have authorization to collect it. As a consequence, First American seldom lends to Navajos using automobiles as security.[7]

For these reasons, First American makes almost exclusively small, signature, line-of-credit loans. It does, however, make a large number of such loans. In June of 1991, for example, 2,500 new loans or extensions were made.

For First American, Tables 6.3 and 6.4 refer to extensions of existing loans as well as to completely new loans. When a member requests $150 to be added on to an existing loan balance of $900, the transaction is treated in the tables as a $150 loan.

The largest single category of loans at First American is for used autos. These are exclusively for auto repairs; as just explained, the credit union does not lend for the purchase of autos. Significant amounts are lent for home improvements and for debt consolidation. Included in the category of "other" is a large number of loans for religious ceremonial purposes.

School loans occupy a more important part of the loan portfolio at First American than at the other credit unions. These loans are for tuition and supplies, school clothes, and graduation expenses.

Mission Area Federal Credit Union

Of the five lowest income credit unions in the study—CAPFCU, First American, Mission Area, NEJA, and Watts United—Mission Area makes the largest loans, and for the longest term.

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[7] The author was told that Navajos usually finance their vehicles from dealers and finance companies that are located off the reservation, for example, in nearby Gallup, New Mexico. These dealers are, of course, subject to Navajo law when they come onto the reservation. In order to repossess, they typically wait until the borrower drives off the reservation, for example, to go to a grocery store in Gallup, and repossess the car there. There are stories of Indian women walking out of a store to find their car vanished. It was because First American was unwilling to engage in this sort of practice that it decided not to lend against vehicles on the Navajo reservation. In 1992, it did begin making a few automobile-secured loans to members living on other reservations in Arizona where the Navajo repossession law does not apply.

Table 6.4 shows that the typical loan amount is relatively high in almost all of the loan categories. An additional reason for the relatively high average size of loans at Mission Area is that lending is concentrated in several categories that tend to have high amounts, in particular, automobiles and debt consolidation.

Over a quarter of the funds are lent for the purchase of automobiles. Of these loans, half of the money goes for the purchase of new cars which are, of course, more expensive than used cars.

The largest single category of lending at Mission Area is debt consolidation, and the average loan in this category is relatively high, $6,533. The credit union also does substantial lending for business development.

Mission Area prides itself on its financial counseling and advocacy services. These services are concentrated in the loan categories of debt consolidation and automobiles, the categories in which most of the loans are made. When the manager, Raquel Castillo, provides a debt consolidation loan, she is often able to spend time talking with the member about how better to manage his or her affairs.

In the area of automobile loans, the manager frequently works with members to help them understand the market better and make more informed choices. She also works with automobile dealers in the neighborhood to get favorable deals for members, and is willing to go to bat for them when she thinks they have been cheated. One story she tells is of a member who requested a loan for a car she had agreed to purchase from a neighborhood lot. When Ms. Castillo looked at the papers, she discovered that the price exceeded the published Blue Book price by $3,000. She called the lot manager to complain, and he in turn explained, in some embarrassment, that the deal had been made by a new salesman who had not realized that this customer was a Mission Area member. The lot manager agreed immediately to a $3,000 rebate and the deal went through. Poor people are susceptible to being cheated, Ms. Castillo believes, and through this sort of advocacy work, she tries to provide them some protection.

Northeast Community Federal Credit Union

Northeast Community has the highest borrower incomes of the credit unions in the study, and it makes the largest loans.

Northeast Community concentrates on business lending, directing almost half of its money to this purpose. Again, this is considered more fully below.

An interesting feature of the Northeast Community loans is how little of the money, just 6 percent, is lent for automobiles. The reason for this is not that the members cannot afford autos, since credit unions that have much

poorer borrowers concentrate more heavily on auto loans. The reason may be that the credit union's geographical area is such a highly congested urban neighborhood that members would find automobiles to be an expensive bother, not an asset.

A considerable amount of the loan money at Northeast Community is invested in homes. Table 6.3 shows that home improvement and real estate loans together account for almost one-quarter of the funds lent. These are typically quite large loans; Table 6.4 shows the average home improvement loan to be almost $25,000, and the average real estate loan to be almost $30,000. For the most part, the real estate loans are not first mortgages; rather they are second mortgages or supplementary loans of some other kind to help a member buy real estate. Home improvement loans are also typically quite large in Santa Cruz, but note in contrast how small they tend to be in the three rural credit unions, CAPFCU, First American, and NEJA. This difference is reflective of the large difference in housing costs between rural America and urban California, and it is also reflective of differences in member incomes.

North East Jackson Area Federal Credit Union

NEJA is the smallest of the credit unions in the study and, with the exception of CAPFCU, the one with the poorest borrowers.

The most distinctive feature of the lending at NEJA is the heavy concentration on business loans: 29 percent of the loans, amounting to 44 percent of the funds. These are crop loans to independent, African American farmers.

The emphasis on crop loans helps to raise the typical loan size above that found in the other rural credit unions. It keeps the loan term fairly short, however, since crop loans are almost never extended for more than one year.

Aside from the farm loans, the largest single category of loans is for automobiles. These loans are exclusively for used cars. There appear to be two reasons for this: the low-income status of the members effectively precludes them from the market for new cars, and the limited size of the credit union, together with its commitment to relatively large agricultural loans, reduces its ability to lend in the amounts necessary to finance new cars.

Santa Cruz Community Credit Union

Santa Cruz is the only CDCU in the study that has a credit card program, and Tables 6.3 and 6.4 give an indication of how important it is. Almost a third of the money was lent on credit cards. These tables count as a credit card loan not an individual purchase made with a VISA card, but rather the

authorization of a new card or an increase in the credit limit on an existing card. The amount of the loan is taken to be the credit limit; since many members do not use their cards to the limit, this means that the tables somewhat overstate the amount of credit card lending in Santa Cruz.

While a credit card program might seem, at first glance, to be a kind of "upscale" feature, appealing to higher income, professional members, in fact the function of the credit card program at Santa Cruz Community has been the opposite. The VISA card has been the vehicle by which the credit union has been able to make smaller loans, to lower income members, including a higher proportion of women. Table 6.5 compares conventional personal loans in Santa Cruz to VISA loans (business loans are excluded from this comparison).

The role of the credit card program in Santa Cruz, of permitting smaller loans to lower income people, did not occur by happenstance; it was an explicit goal of the credit union management when the program was instituted. The fact that credit cards do not necessarily perform this function in typical financial institutions is shown by comparing Table 6.5 with Table 6.6. Table 6.6 shows the relative incomes, and the gender ratio, of VISA and conventional loan borrowers at an occupational credit union in central California that is given the pseudonym "Mainstream Credit Union." At Mainstream, the incomes of the VISA borrowers are no lower, and in terms of the median, are actually higher, than the incomes of the conventional borrowers. The VISA credit limits are somewhat less than the typical conventional loans, but not remarkably so. And the proportion of female borrowers is significantly smaller in the VISA program than in the conventional loans. By comparison, Santa Cruz has used its credit card program to target a lower-income stratum of its membership, including a higher proportion of women, and to make smaller-sized loans.

Table 6.5

Comparison of Conventional and VISA Loans
Santa Cruz Community Credit Union

	Conventional Loans	VISA Loans	Ratio of VISA to Conventional
Average borrower income	$3,199	2,370	.74
Median borrower income	2,520	2,076	.82
Average loan size	8,989	1,767	.20
Median loan size	5,906	1,500	.25
Ratio of female to total borrowers	.40	.51	

Table 6.6

Comparison of Conventional and VISA Loans Mainstream Credit Union

	Conventional Loans	VISA Loans	Ratio of VISA to Conventional
Average borrower income	$2,791	2,787	1.00
Median borrower income	2,100	2,400	1.14
Average loan size	7,106	5,493	.77
Median loan size	5,824	5,000	.86
Ratio of female to total borrowers	.54	.44	

Santa Cruz does a lot of small business lending. Approximately 20 percent of the lending is for automobiles and 10 percent is for home improvement. The average amount of a home improvement loan is quite large, again reflecting the high value of housing in urban, coastal California.

Watts United Credit Union

The typical size of a loan at Watts United falls roughly in the middle of the credit unions studied. The loan size is the lowest, however, of the urban credit unions, and this doubtless reflects the poverty of the area and the relatively low incomes of the members.

The most notable feature of the lending at Watts United is that over half of the money is used for automobiles (including repairs). This is consistent with the freeway culture of Los Angeles and the notoriously poor quality of public transportation in that city. Without a car, residents of Watts are almost as isolated as the mountain people of eastern Kentucky (the other area where automobile loans exceed 50 percent of the loan portfolio). By far the largest loans at Watts United are made for new autos.

Business Loans

Four of the seven CDCUs make a substantial commitment to business loans, and a fifth is associated with a business lending institution.

As Chapter 7 will discuss in more detail, the NCUA discourages business lending, regarding it as "speculative" and responsible for most of the financial problems of credit unions. Its member business loan regulations are quite restrictive. Nevertheless, a number of CDCUs concentrate fairly heavily upon business lending.

Table 6.7 outlines the business lending programs of Mission Area, NEJA, North East Community, and Santa Cruz Community credit unions. The first two lines show the proportion of business to total loans in the four credit

unions, both by number of loans and by dollar volume. The latter proportion always exceeds the former, reflecting the fact that the typical business loan is greater in size than the typical consumer loan.

Table 6.7

Business Loans in Four Credit Unions

	Mission Area	North East	NEJA	Santa Cruz
Proportion of business loans to total loans				
by number of loans	.11	.33	.21	.11
by dollar amount	.17	.48	.44	.28
Average loan amount	$4,969	19,782	6,213	22,668
Median loan amount	$5,000	20,000	6,870	10,000
Average term (months)	14	54	16	25
Average interest rate	14.2	12.8	15.3	13.4
Average borrower income	1,939	3,685	1,788	——
Average borrower age	50	40	50	39
Proportion female	.54	.25	.26	.31

Of these four credit unions, the smallest commitment to business loans is made by Mission Area. Among the sample of loans studied were several to buy equipment or merchandise for a small business. Most of the business loans in this credit union, however, went to non-profit organizations, for purposes such as covering the time gap between grants or purchasing merchandise for a fund-raising sale.

North East Jackson Area FCU in Florida is organized principally for the purpose of making business loans to independent African American farmers. Twenty-one percent of the loans, amounting to 44 percent of the dollar volume, are for this purpose. The loans range in size from several hundred dollars to $10,000.

By the nature of their business, farmers are debtors. They incur costs at the beginning of the growing season, and must then wait a number of months to sell their product. They borrow to cover their costs of production, and not infrequently they also borrow to cover their living expenses in the period before they sell their crops.

Almost all of the agricultural loans at NEJA are made to peanut farmers. Usually they are used for purchasing fertilizer, seeds, and chemicals at the beginning of the growing season. They are sometimes also used to buy

equipment, to repair equipment, or to cover living expenses. The loans are usually quite short-term: sometimes less than a year, and seldom more than a year and a half; they are intended to carry the farmer over until the revenue accrues from the next crop. The payment schedules are generally unconventional. Rather than make monthly payments of equal amounts, the farmers undertake to make just one or two payments during the harvesting season.

In some cases the credit union takes farm machinery or vehicles as collateral. In most cases, however, it takes a lien on both the crop contract and the farmer's crop insurance. Thus the credit union has double protection, with security that is valuable whether or not the crop is successful.

North East Community FCU and Santa Cruz Community CU both specialize in loans to small, primarily urban, locally-owned businesses. Table 6.7 shows a higher concentration, in terms of both number of loans and dollar amount, at North East Community. This is in part a statistical artifact, however, resulting from the fact that Santa Cruz has a large credit card program while North East Community does not. If credit cards are omitted from the Santa Cruz loans, then Santa Cruz makes 26 percent of its loans for business purposes and it devotes 41 percent of its loan dollars to businesses. When this adjustment is made, the two credit unions are fairly comparable in terms of concentration on businesses.

The typical business loan at North East Community is relatively large, about $20,000, and it is made for a much longer term than is found at any of the other CDCUs, over four years. The sorts of businesses that the credit union deals with are mostly small retail establishments in the Chinatown and nearby downtown areas. They include a number of restaurants, laundries, bakeries, grocery stores, and print shops. Some of the loans are for start-ups, but most are for working capital, equipment, and expansion of already existing firms.

While Santa Cruz directs a slightly smaller proportion of its loans to business borrowers than does Northeast Community, still the actual volume of business lending is considerably larger in Santa Cruz because the credit union is larger.

Business lending, or more broadly, community development lending, is the principal purpose of the Santa Cruz credit union. It was founded in 1977 by a group of people who were dedicated to progressive social change in their community. Two years after opening their doors, they adopted what became the main identity of the credit union, the "60-40" policy. Under this policy, the goal was to allocate 60 percent of the loan money for community development purposes and just 40 percent for personal loans. Community development loans included loans to consumer and worker cooperatives, nonprofit organizations, and small and locally-owned businesses that were

making a positive contribution to the life of the community. The thinking of the credit union leaders was that loans to encourage the creation and expansion of locally-owned businesses, especially businesses that provided decent working conditions for employees, would make a more permanent contribution to the community than would strictly personal consumer loans. Personal loans were not to be excluded, but they were given a lower priority.

The credit union tried to adhere to the 60-40 policy throughout most of the 1980s, although not always successfully. By the 1990s the policy had to be abandoned. Business and community development loans were actually at an all time high in terms of dollar volume. The credit union had grown so fast that community development lending could not keep up, however, particularly in view of increased regulatory constraints on business lending which took effect in 1987.

The variety of business loans is considerably broader at Santa Cruz Community than at the other credit unions. As at Northeast Community, there are restaurants, grocery stores, and print shops. Loans are also made to retail stores (toys, clothing, musical instruments, and others), to professionals (attorneys, chiropractors, and therapists), to small construction and trucking firms, and to farmers. Among the less conventional borrowers are alternative weekly newspapers and non-profit associations in such fields as food and nutrition, public radio, nursing, women's health, and peace. The credit union has put special emphasis on loans to low-income cooperative housing projects.

The three other CDCUs in this study—Central Appalachian People's, First American, and Watts United—do not engage in business lending except very occasionally. In the case of First American, the reason is that the credit union has decided to restrict itself to small, personal, signature, line-of-credit loans. In the case of Watts United, the credit union manager told the author that he does not believe the institution has the expertise to evaluate potential business borrowers adequately, and that its cash flow is still too small to embark upon such a program. He is interested, however, in exploring the possibility of working with a state loan guarantee program as a way of starting into the business loan field.

Central Appalachian People's stays away from business loans for quite a different reason. It works in partnership with an institution that is devoted solely to small business lending in the southern Appalachian mountains. The two groups divide the lending tasks, one specializing in business loans and the other in personal loans.

The cooperating business lender in Appalachia is the Human Economic Appalachian Development Corporation Community Loan Fund. The HEAD Corporation was created by a task force on poverty in 1974. Since its found-

ing, it has sponsored a variety of community development activities, including the credit union. In 1987, it began the Community Loan Fund. The Fund accepts deposits from socially responsible investors throughout the United States. These investors include individuals, corporations, churches, community organizations, and foundations that have an interest in contributing to economic development in Appalachia. The deposits are made for a specific term and they receive interest; both the term and the interest rate are negotiated separately with each investor. Unlike deposits at a credit union, the deposits at the Community Loan Fund are not insured. As of mid-1991, the assets of the Fund stood at about $400,000.

Between 1987 and 1991, the Community Loan Fund provided technical assistance to 75 entrepreneurs and made loans to 45 individuals or businesses, totalling over $600,000. These included loans aimed at revitalizing Appalachian culture, for example, Shaker crafts, pottery, quilting, rugs, and homemade specialty foods. The Fund has lent to small businesses in monuments, printing, motor repair, landscaping, video, and T- shirt design. Loans have also been made to non-profit organizations in housing, childcare, and other social services.

The HEAD Community Loan Fund works closely with the credit union. Until recently, the HEAD Corporation was the nominal sponsor of the credit union; in 1993 the positions were reversed, and the credit union took over supervision of the loan fund. While in a formal sense the Appalachian credit union does not make business loans, it is part of an organization that puts considerable emphasis on economic development in the area.

In short, while community development credit unions are by no means uniform in this respect, many of them devote a considerable portion of their resources to business loans. They are rightfully concerned, therefore, that the NCUA's business loan regulation may restrict them unduly from achieving some of their principal goals.

Borrower Ages

Table 6.2 shows that the typical age of the borrowers varies considerably from credit union to credit union. The age differences are not related to differences in the age composition of the different ethnic groups in the United States. In 1989, the median ages of African Americans, Hispanics, and whites were 27.7, 26.1 and 33.6 years, respectively,[8] the differences being caused largely by the higher proportion of children in the non-white groups. In this study, in contrast, the highest borrower ages were found in the predomi-

[8] U.S. Department of Commerce, *Statistical Abstract of the United States, 1991* (Washington: 1992), Table 12.

nantly African American and Hispanic credit unions.

The oldest borrowers are found in the NEJA Federal Credit Union where the median is 43. This is probably a reflection of the social conditions of this area of the Black South; there is a reasonable living to be made by farmers who make a commitment to the area, but young people typically choose to leave because rural employment opportunities are so limited. The next oldest borrowers are found in the other African American credit union, Watts United. Here the likely explanation is not that the young people leave the area, since the average age of the entire Watts area is actually quite young. It is more apt to be that young African American men and women have so few economic opportunities that they cannot qualify for loans.

The high age of borrowers in the two predominantly African American credit unions, when taken together, is a reflection of the desperate conditions in which many young Black people find themselves today. Because of the absence of opportunities, they are leaving the rural South, as they have for generations. In the cities to which they migrate, however, they typically do not find much in the way of employment opportunities.

The youngest borrowers are found in the Central Appalachian People's Federal Credit Union. Although Appalachia is also an area of the country that loses many of its young people, the relative youth of the borrowers in this credit union is probably a consequence of the membership of the particular organizations that make up the field of membership.

Borrower Incomes

One of the purposes of gathering the data was to discover the extent to which CDCUs succeed in directing their lending to low- and moderate-income people. In this section, the information on the borrowers' incomes is presented, and then adjusted for differences in the borrowers' ages and the local cost of living in order to make more accurate comparisons.

Table 6.8 displays the percentage of borrowers in different income categories in each credit union, as well as the overall median and average incomes of the borrowers. The table shows significant contrasts between the credit unions.

The lowest borrower incomes were found in the three rural credit unions. Of these, the lowest was the Central Appalachian People's Federal Credit Union, with a median income of $1,000 per month and an average of $1,165 (the gap between the two measures indicates the extent to which the range of incomes above the median is greater than the range of incomes below). Half of the borrowers at CAPFCU earned less than $1,000 a month, and a significant portion actually earned less than $500. Only 4 percent of the borrowers earned more than $2,500.

Table 6.8
(Percentage Distribution)

Income of Borrowers

Gross Monthly Income	Appal.	First Amer.	Mission Area	North East	NEJA	Santa Cruz	Watts United
$ 0–499	8	3	1	1	8	0	1
500–999	42	23	7	2	33	5	13
1,000–1,499	29	37	16	13	26	9	30
1,500–1,999	10	21	27	22	18	19	24
2,000–2,499	8	9	16	8	5	20	13
2,500–2,999	2	3	17	16	5	13	6
3,0006–3,499	1	1	7	8	0	12	8
3,5006–3,999	0	1	2	11	3	7	1
4,000+	0	1	7	19	2	15	4
Total	**100**	**100**	**100**	**100**	**100**	**100**	**100**
Median Income	$1,000	1,260	1,920	2,500	1,096	2,349	1,577
Average Income	1,165	1,426	2,149	3,084	1,318	2,842	1,850

At NEJA the typical borrower incomes were just slightly above the CAPFCU incomes, and at First American, on the Navajo Reservation, the incomes were a bit higher still.

The four urban credit unions had higher borrower incomes. Watts United stood lowest, while Mission Area came next; Santa Cruz Community and Northeast Area had significantly higher borrower incomes.

Table 6.9 shows the median incomes of full-time workers in the United States in 1989, by ethnic group.[9] While these data are not directly comparable with the figures in Table 6.8, they show roughly how the incomes of the credit union borrowers compare with those of Americans generally. In five of the credit unions, the borrowers are poorer than workers in the country as a whole, while in Santa Cruz they are about the same and in Northeast Community they are somewhat better off. When compared to their respective ethnic groups, the borrowers at Appalachia, NEJA, and Watts are worse off, at Santa Cruz they are about the same, and at Mission Area they are better off.

Table 6.10 shows that in each of the seven credit unions, the median income of the male borrowers significantly exceeds the median income of the female borrowers. Taking all seven credit unions together, males' incomes are 31 percent above females'.

[9] Ibid., Table 736.

Table 6.9

Median Monthly Income of Full-Time Workers United States, 1989

Ethnicity	Female	Male
White	$1,656	$2,487
Black	1,492	1,726
Hispanic	1,334	1,548
Total	**1,637**	**2,384**

The income difference by gender is consistent with the situation in the country as a whole. Table 6.9, for example, showed that among full-time workers in the United States in 1989, males' earnings exceeded females' by 45 percent. The economic literature on this phenomenon concludes that the male-female income gap is caused in part by the fact that women are more likely than men to move in and out of the labor force, in part by discrimination and in part by the lower educational attainment and hence the lower level of "human capital" on the part of women.

Table 6.10

Median Monthly Income by Gender

	Women	Men
Appalachian	$ 860	$1,170
First American	1,150	1,400
Mission Area	1,510	2,000
Northeast Comm.	2,000	2,745
NEJA	850	1,300
Santa Cruz	2,020	2,630
Watts United	1,490	1,710

The comparison in Table 6.8 between the incomes of the borrowers in the different credit unions may be distorted somewhat by the factors of borrower age and regional cost of living. Elsewhere, in a more complete presentation of these data, the author has shown that the borrowers' incomes tend to rise with age (except at the very highest ages) in most although not all of the seven CDCUs.[10] Some of the variation in median incomes may therefore be due not so much to fundamental differences in the social conditions of the borrowers as to differences in their ages. When a correction is made in the data for age differences, the principal adjustment is that the incomes at Central Appalachian People's credit union rise to about the level of the other two rural credit unions.

[10] Isbister.

A second adjustment is needed because of differences in the cost of living. According to data on regional price differences in 1990, it appears that the cost of living in a California city was about 40 percent higher than in Southern rural areas.[11]

Table 6.11 shows the average incomes of the borrowers in the seven credit unions, adjusted for both factors, age and cost of living. First, it is assumed that the age distribution of borrowers at all the credit unions is the same as at First American. Second, the incomes of borrowers at the three rural credit unions are raised by 40 percent, because of the cost of living differential, to make them comparable with the urban populations.

Table 6.11

Average Borrower Incomes Adjusted for Differences in Age and Cost of Living

Credit Union	Total	Female	Male
Appalachian	$1,730	$1,488	$2,034
First American	1,996	1,834	2,223
Mission Area	1,822	1,685	2,047
Northeast Comm.	3,125	2,485	3,437
NEJA	1,798	1,564	1,994
Santa Cruz	2,846	2,434	3,209
Watts United	1,842	1,718	2,071

When adjustments are made for the cost of living and for differences in the ages of the borrowers, the credit unions fall neatly into two income categories. Five of the credit unions are low-income, the three rural credit unions plus Mission Area and Watts United. In this group, average adjusted monthly borrower incomes range from $1,730 to $1,996, a difference of 15 percent. The second group consists of two more moderate-income credit unions, Santa Cruz Community and Northeast Community. In this group the average income range is $2,846 to $3,125, or 10 percent. The overall gap between the bottom of the first group and the top of the second is $1,395, or 81 percent.

The Importance of the Non-Poor

The data show clearly that five of the seven credit unions make most of their loans to poor people. A question arises about the other two credit unions, Northeast Community and Santa Cruz Community, where the me-

[11] American Chamber of Commerce Researchers Association, *Cost of Living Index: Comparative Data for 246 Urban Areas* (Louisville: Fourth Quarter, 1990), 23.