

Financial Institutions— Similarities and Differences

OBJECTIVES

Upon completion of this chapter, you will be able to

1. describe the different types of financial institutions;
 2. explain how these institutions have changed because of changes in legislation and regulation.
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TYPES OF FINANCIAL INSTITUTIONS

The financial structure of the United States is unique, given that there are many thousands of financial institutions providing various types of loans and deposits to the public. Other large countries have only a fraction of the number of financial institutions found in the United States.

Financial institutions are either depository or nondepository institutions. Depository institutions are those that offer deposit accounts, such as commercial banks, savings associations and mutual savings banks, and credit unions. Nondepository institutions include life insurance companies, finance companies, and mutual funds.

While the number of depository institutions in the United States is much greater than in any other country, the number is shrinking. As table 4.1 shows, the number declined significantly during the decade 1996–2006. Although the number of institutions fell, their total assets grew. Mergers have occurred within each category, and mergers (rather than institutional failures) account for most of the reduction in the number of institutions. While credit unions are the most numerous type of depository, their average asset size is relatively small, so their total assets are less than those of banks and savings associations.

Table 4.1 also shows the dramatic increase in the assets of mutual funds. While mutual funds are not depositories because their shares do not have the same legal characteristics as deposits and credit union shares, mutual funds definitely compete with depositories for consumers' savings dollars.

TABLE 4.1 Total Assets of Selected Financial Institutions, 1996–2006

Institutions	1996		2006	
	Number	Assets (in billions)	Number	Assets (in billions)
Commercial banks	9,528	\$4,582	7,401	\$10,090
Savings associations/mutual savings banks	1,926	\$1,029	1,279	\$1,770
Credit unions	11,884	\$336	8,662	\$733
Mutual funds	6,248	\$3,526	8,120	\$10,414

Sources: FDIC, CUNA, Investment Company Institute.

The passage of the Deposit Institutions Deregulation and Monetary Control Act of 1980 and the Garn–St. Germain Depository Institutions Act of 1982 had an impact on the asset distribution of financial institutions. These laws allowed credit unions to offer share draft accounts and long-term mortgage loans. In addition, savings associations could issue credit cards and NOW accounts (interest-bearing checking accounts), offer trust services, purchase municipal revenue bonds, and offer consumer loans.

Since the early 1980s, competition among banks, savings associations and credit unions has continued to intensify. The types of services that different institutions are allowed to offer have become more similar. Many institutions have grown beyond the local or state markets they originally served by opening new offices, acquiring other institutions by merger, or marketing through the Internet. This growth brought efficiencies through economies of scale. Also, new competitors have entered the market to pursue niches in business services, consumer credit cards, mortgage lending, and other banking services. The total number of institutions is likely to continue to fall as mergers outpace the creation of new depositories.

COMMERCIAL BANKS

Commercial banks have historically been treated as a separate entity when monetary and financial regulations have been examined in the United States. This special treatment was due to two major factors. The first is that commercial bank assets have been greater than those of all other depository institutions combined. This makes them the most important institution in monetary policy. The second factor is that for many years commercial banks were the only financial institution permitted to have transaction accounts (checking accounts). In the 1970s, savings associations began offering *negotiable order of withdrawal* (NOW) accounts, which pay interest and function as checking accounts. About the same time, credit unions began offering share draft accounts. The Monetary Control Act of 1980 also increased the opportunities for nonbank institutions to provide services similar to those of commercial banks. This legislation eliminated

many of the distinctions between commercial banks and other institutions and significantly increased competition.

Commercial banks have attempted to maintain their dominance in financial markets by stressing the varied services they provide to clients. The marketing of financial services, therefore, has become an important element in commercial bank operations. Banks attempt to increase their number of customers and assets by focusing on the convenience of using their facilities. They provide checking and saving accounts, traveler's checks, trust and estate services, safe-deposit boxes, and other services popular with individuals. In recent years, however, most nonbank institutions, including credit unions, have begun to offer the same array of services to their customers or members. This increased competition to banks from credit unions and other thrift institutions is changing the industry from a banking to a financial services industry.

While other institutions have started offering traditional bank products, banks (and some other depositories) have responded by diversifying into nontraditional services. In particular, sales of insurance products and investments such as mutual funds are now commonly available in banks (and larger credit unions, as well). Thus banks are maintaining their profitability in the face of increased competition.

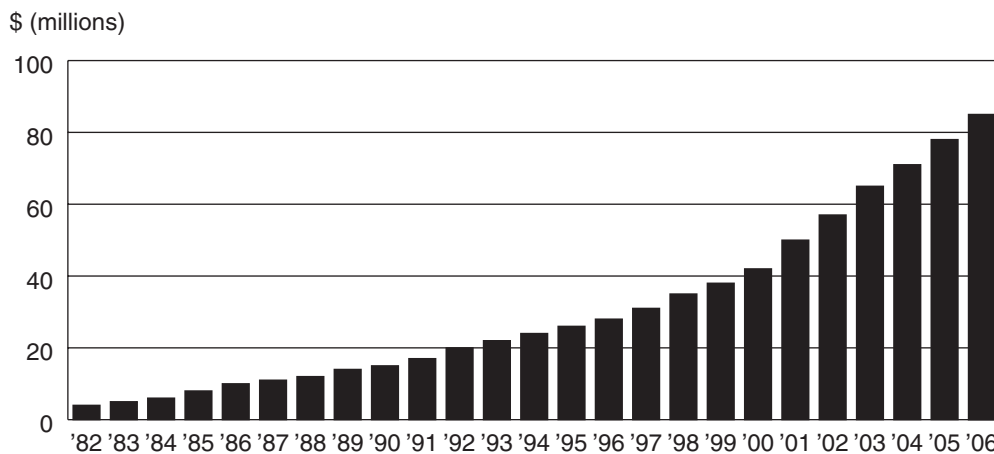
The primary source of funds to a bank is customer deposits. Deposits can be categorized as demand deposits (checking accounts), time deposits (certificates), or savings deposits. Banks obtain a relatively large amount of funding from demand deposits because of their business customers. Banks also use borrowed funds to supplement their deposit base to a larger degree than credit unions.

Bank loan portfolios contain consumer loans similar to credit union loans but also typically contain a great deal of business lending. The types of business loans made by banks vary by the size and location of the bank, with some more prominent in agricultural loans, others in real estate development or commercial property loans, and others in operating loans for businesses. Credit union business lending is growing, but credit unions still hold only a small fraction of the total business lending market.

CREDIT UNIONS

The first credit union in North America was founded in 1909. While the typical credit union is still small relative to the typical bank, credit unions have made tremendous strides in becoming full-service consumer financial institutions. Figure 4.1 illustrates the growth of credit unions in total assets since the early 1980s.

Credit union membership is limited to persons sharing some common bond. (The specific rules governing fields of membership depend on whether a credit union has a federal or state charter, and rules vary from state to state.) In most cases the common bond is related to employment, and many credit unions were formed to serve the employees of a single company. Others were formed to serve the residents of a geographic area or the members of an association such as a labor union.

FIGURE 4.1 Average Credit Union Total Asset Size

Source: CUNA.

During the 1980s and 1990s, many credit unions were granted the ability to expand their fields of membership to serve multiple groups, such as the employees of several companies. The expanded field of membership often helped a credit union to survive the downsizing of the original employee group it served. For example, if a military base closed, the credit union serving the base would sometimes apply to serve several local employers or the entire community. The broader field of membership would allow the credit union to absorb loan losses incurred due to rising unemployment among the original membership, while diversifying the membership to make the credit union more stable in the future. The growth of credit unions often allows them to expand the range of services offered to members, whether the growth comes from expanded fields of membership, mergers, or increased penetration of their existing fields of membership.

Credit unions' ability to expand their fields of membership was challenged in several lawsuits by the banking industry. As a result, credit unions asked for legislation to clarify fields of membership for federal credit unions, resulting in the Credit Union Membership Access Act of 1998. The Act defined the types of fields of membership that federal credit unions may serve, and also changed the regulations for credit union financial statement audits, business loans, and capital (net worth) requirements.

Credit unions obtain the great majority of their funding from member deposits (shares). The account types offered by credit unions are similar to those of banks, except that credit union shares carry with them the right to elect the credit union's board of directors (with one vote per member, rather than a number of votes proportional to the quantity of shares owned). The board of directors is selected from among the membership to represent the best interests of the members. Because credit union shares are considered a form of ownership, members of a liquidated credit union also receive any

residual value of the credit union after its obligations are paid off.

Credit unions traditionally concentrated their lending in consumer loans, typically personal loans and vehicle loans, but some credit unions have offered real estate loans or business loans for many years. Real estate lending and business lending have been the fastest-growing types of credit union loans in recent years, but those loans are still a smaller proportion of the typical credit union's portfolio than they are for the typical bank.

Credit unions are generally exempt from paying corporate income taxes. However, they pay most other taxes, such as property taxes and employer taxes. State chartered credit unions also pay the federal unrelated business income tax (UBIT) on certain types of income that is considered unrelated to credit unions' tax-exempt purposes. The banking industry has challenged credit unions' tax status many times, but Congress and the courts have continued to support the exemption from federal corporate income taxes.

SAVINGS INSTITUTIONS

Savings associations and mutual savings banks (we'll refer to both types collectively as "thrift institutions," or "thrifts") originally served consumers and specialized in financing purchases of residential property. The great majority were originally mutual organizations, rather than stockholder organizations, and they relied on short-term consumer deposits for their funding. (In a *mutual* company, profits are set aside for the benefit of depositors or policyholders—not stockholders. While a mutual company's depositors elect the board of directors, the votes are typically proportional to the amount held on deposit, unlike the "one member, one vote" system in credit unions.)

Using short-term deposits to fund long-term, fixed-rate mortgage loans led to a crisis during the 1970s and 1980s. As interest rates rose to unprecedented levels, many thrifts found themselves paying higher rates on their deposits than they were earning on their loan portfolios. Large operating losses caused the failure of many institutions and led to reform legislation during the early 1980s.

Unfortunately, the reforms didn't provide permanent solutions, and another wave of failures occurred during the late 1980s. Rather than being caused by interest-rate increases, most of these failures were related to defaults on real estate and commercial loans. The taxpayers were called upon to pay off depositors in failing thrifts when their insurance fund, the Federal Savings and Loan Insurance Corporation (FSLIC), was unable to meet its obligations. Congress then eliminated FSLIC and the thrifts' primary regulator and assigned their responsibilities to the banking agencies. New laws and regulations were written to try to prevent "another S&L crisis," and for better or worse, many of these laws apply to credit unions and banks as well as thrifts.

Over time, thrift institutions have become more similar to banks. Many converted from mutual to stockholder-owned status, thereby

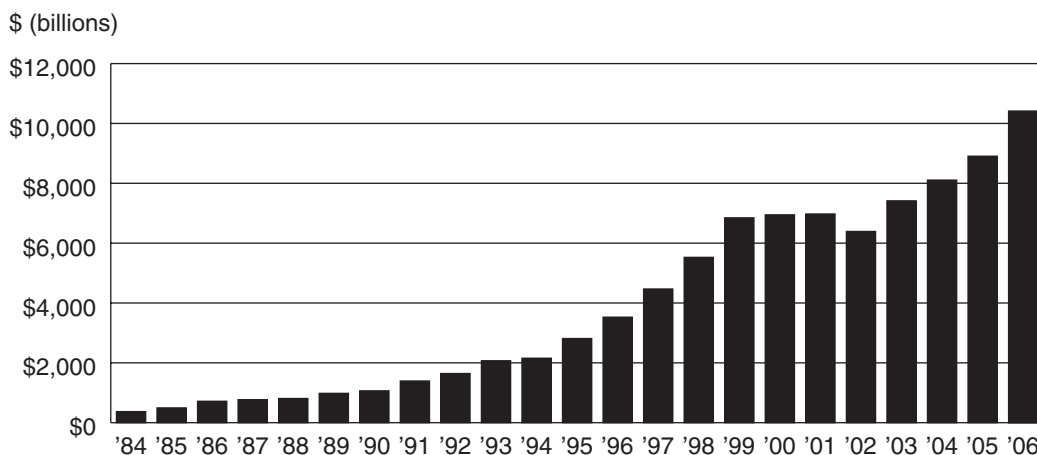
ending a characteristic they shared with credit unions. The loan portfolios of thrift institutions are more diversified now than before their crises, with most thrifts making consumer and business loans as well as real estate loans.

MUTUAL FUNDS

Assets managed by the mutual fund industry expanded almost sevenfold during the 1990s (figure 4.2), greatly intensifying competition for deposits. Mutual funds now hold more assets than the commercial banking industry. Investors in mutual funds buy shares of a company that exists solely to purchase and sell assets for investment purposes. The funds' managers purchase securities with the investors' money. The income and any increase or decrease in the price of a fund's securities are passed along to the mutual fund shareholders in the form of dividend payments, capital gains distributions, and changes in the price of the mutual fund's shares. In most cases, shares can be redeemed at prices that reflect the current value of the fund's securities by selling the shares back to the mutual fund; in other cases, the shares of the mutual fund are traded (bought and sold) among investors in a secondary market. Because mutual fund shares are not considered deposits, mutual funds are not technically part of the "depository institution" market despite the fact they compete so directly for consumer savings.

Most mutual funds fall into the general categories of money market funds, bond funds, and stock funds. Money market mutual funds invest in short-term bonds that have low risk of default and very little price fluctuation, thereby making these the least risky type of mutual fund. Within each broad category of mutual fund type, subgroups exist—money market funds that purchase tax-exempt municipal bonds versus regular taxable bonds, bond funds that purchase domestic versus foreign bonds, stock funds that purchase stocks of technology companies versus utility companies, and so on.

FIGURE 4.2 Total Mutual Fund Assets



Source: Investment Company Institute.

While most funds specialize in investing in some particular sector of securities, they still attempt to diversify within that sector by buying stocks of a large number of utility companies, for example, rather than the stock of a single utility. This gives the mutual fund's shareholders a diversified investment and reduces the risks of concentrating too much of their assets in a single company's stocks or bonds. There are also funds that invest in a combination of sectors, such as those that invest in both stocks and bonds, thereby providing additional diversification.

In addition to providing diversification, mutual funds can give individual investors access to professional money management skills and reduced transaction costs. While investors must do research to select appropriate mutual funds to meet their needs, that's less work than researching each individual security to purchase in building a portfolio. Fund managers also buy and sell stocks in large blocks, at lower transaction costs than individual investors can obtain. Mutual fund investors pay management fees and sometimes fees to sales representatives, but these fees are typically smaller than the cost to invest in securities directly.

The sustained "bull market" of rising stock prices boosted the growth of mutual funds during the 1990s. Rising stock prices directly increased the number of dollars under management and also encouraged investors to purchase more shares. As investors placed a larger portion of their savings into mutual funds, they relied less on deposits provided by banks, thrift institutions, and credit unions. While mutual fund shares aren't federally insured as deposits are, the attractive potential returns offered by mutual funds in the 1990s more than made up for the risk of loss in the eyes of record numbers of consumers.

Mutual fund assets hit a plateau and then dropped in the period 2000–2002. Stock prices fell as the economy went through a recession, directly reducing the assets managed by stock mutual funds. Some investors also lost enthusiasm for stocks and mutual funds during that period when it became apparent that many large companies and technology-based companies failed or had much dimmer prospects than investors had been led to expect. But stock prices and mutual fund investments recovered, and mutual funds now play such a large part in money management that their total assets exceeded that of commercial banks by the year 2006.

One way the depository industry responded to this shift was to get into the mutual fund business. It's now common to be able to purchase mutual fund shares through investment representatives in the lobbies of banks, thrift institutions, and credit unions. The mutual funds are sold by companies affiliated with the depository, rather than the depository itself, and special disclosures must be given to point out that the mutual fund shares are not federally insured. The depository earns some income from the sale and also hopes to enhance its full-service relationship with the customer.

Some large banks have taken the additional step of creating their own mutual fund companies to perform investment management, which is in some ways an extension of their traditional management of customers'

trust funds. Because credit unions have neither the economies of scale nor the history of investment management found in large banks, they have not yet entered this arena.

LIFE INSURANCE COMPANIES

Life insurance companies compete with depositories. Term life insurance policies provide only insurance—in exchange for premium payments, they provide a benefit to the beneficiary when the insured person dies. However, other types of life insurance provide investment services as well as death benefits. The premium payments are higher than in the case of term life insurance, with the extra funds being invested on the policyholder's behalf. The invested funds can be borrowed back from the insurance company at a later date. The policies therefore provide competition for depositories on both the lending and deposit-gathering sides of the balance sheet.

Because policyholders don't typically withdraw their funds suddenly, a life insurance company's source of funding is more stable than that of a depository that attracts consumers' short-term savings. Of course, the exception to not withdrawing funds suddenly is the payment of death benefits. Life insurance companies can predict these payments accurately for different classes of policyholders by using statistical and actuarial techniques. In general, however, life insurance companies have long-term sources of funds, and their investments are frequently long-term in nature, such as long-term bonds, stocks, and real estate. Life insurance companies make loans to businesses as well as to policyholders.

FINANCE COMPANIES

Finance companies come in all shapes and sizes. Some finance companies are an extension of a corporation's sales operations and deal primarily in a specific type of loan, such as auto loans. General Motors Acceptance Corporation is one example of this type of operation. Finance companies may lend in either the business or consumer market. More than commercial banks, those firms that concentrate in the consumer loan market usually lend to the higher-risk borrower and, therefore, charge a higher rate of interest than other financial institutions.

Finance companies rely on commercial paper—funds raised by issuing short-term securities—as their primary source of funds. The funds are then used to meet the loan demand of their clients. A smaller finance company has a greater probability of relying on commercial banks as its source of funds than does a large, established firm.

SUMMARY

The financial industry in the United States is divided into depository and nondepository institutions. Commercial banks are the most prominent entity in this industry. Banks also have the most diversified portfolios. Credit unions, although having the greatest number of institutions, are a small segment of the industry when compared to other types of institutions. Mutual fund companies sell shares to investors and use the proceeds to purchase securities, passing along the income, gains, and losses to the funds' investors. Life insurance companies provide insurance benefits in return for premiums and may also invest funds for policyholders. Finance companies operate in the highest-risk consumer loan market and usually charge the highest rate of interest of any financial institution.

Commercial banks, credit unions, thrift institutions, mutual savings banks, and life insurance companies rely on deposits or premium payments as their sources of funds. Finance companies, on the other hand, acquire their funds from the commercial paper market. For both regulatory and economic reasons, the differences among different types of depositories have been shrinking. The S&L crises led to two waves of regulatory reform and encouraged thrift institutions to become more diversified. Differences between depositories and other financial institutions have also shrunk, as each type of institution expands its lines of business in search of growth and diversification.

REVIEW QUESTIONS

True/False

1. There are more credit unions in the United States than any other type of financial institution.
2. Commercial banks, in terms of financial assets, are the largest type of depository in the United States.
3. In recent years, credit unions have declined in numbers and asset value.
4. Credit unions lend primarily in the long-term mortgage market.
5. Commercial banks are the only financial institutions permitted to have demand deposits.
6. The primary source of funds to a bank is the commercial paper market.
7. Regulatory responses to problems in one sector of the financial industry are applied only to institutions within that sector.
8. Commercial banks tend to have the most diversified loan portfolio of any financial institution.

9. Because of the not-for-profit, cooperative structure of credit unions, Congress has exempted them from federal income taxes.
10. One advantage of credit union mergers is that they allow the merged credit unions to provide more services to their members.
11. Savings associations (thrifts) represent the largest financial institution in terms of financial assets.
12. Although savings associations (thrifts) deal in the home mortgage market, they loan primarily to commercial institutions.
13. Life insurance companies obtain most of their funding from consumers' demand deposits.
14. Life insurance companies may invest in stocks and bonds.
15. Finance companies acquire most of their funds by issuing commercial paper.

Multiple Choice

1. Which of the following financial institutions is the largest in terms of the number in existence?
 - a. commercial banks
 - b. savings associations (thrifts)
 - c. credit unions
 - d. mutual savings banks
2. Which of the following financial institutions is the largest in terms of financial assets?
 - a. mutual fund companies
 - b. savings associations (thrifts)
 - c. commercial banks
 - d. credit unions
3. Of the following financial institutions, the organization that traditionally lends in the home mortgage market is
 - a. commercial banks.
 - b. credit unions.
 - c. savings associations (thrifts).
 - d. finance companies.

4. Which of the following is most like a checking account at a commercial bank?
 - a. passbook saving account
 - b. share draft account
 - c. share certificate
 - d. Treasury bill
5. The financial institution that elects its board of directors in a “one vote per person” election is
 - a. a commercial bank.
 - b. a savings association (thrift).
 - c. a credit union.
 - d. the Federal Reserve Bank.
6. Which of the following has the smallest fraction of its assets invested in business lending or business securities?
 - a. credit unions
 - b. banks
 - c. mutual fund companies
 - d. savings associations (thrifts)
7. A characteristic of a savings association (thrift) is that it
 - a. primarily makes short-term loans.
 - b. primarily makes business loans.
 - c. lends in a high-risk market and charges the highest interest rates.
 - d. lends primarily in the home mortgage market.
8. A mutual fund may invest in
 - a. stocks of U.S. companies.
 - b. stocks of foreign companies.
 - c. bonds.
 - d. all of the above.

Problem Solving

1. Describe two reasons mutual fund assets increased rapidly during the 1990s.
2. What were the primary causes of the two waves of savings association (thrift) failures?
3. Credit unions and finance companies compete for consumer loans. What are the differences between these two types of institution?
4. Describe how the assets of a credit union and a life insurance company are different.
5. What is likely to be the effect of credit union mergers on their operations and competitive stance in financial markets?