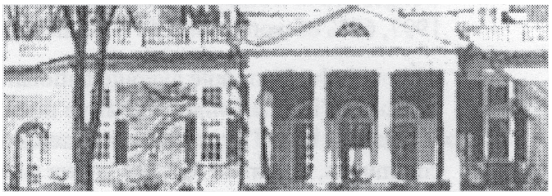

THE THOMAS JEFFERSON INSTITUTE FOR PUBLIC POLICY

An Assessment of the Competitive Environment Between Credit Unions and Banks

Prepared by
Chmura Economics & Analytics
9 South 12th Street
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May 2004

Thomas Jefferson Institute for Public Policy

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Foreword

As our economy continues to grow, the need for our citizens to have access to financial institutions is critical to the long-term health of our state and nation. And our financial institutions need to remain strong and viable and help build our personal and commercial economic infrastructure here in Virginia – businesses, home ownership, etc.

One of the fascinating and on-going debates within the financial community is the potential challenge that credit unions pose to commercial banks and the preferential tax treatment credit unions receive under the current law.

Many years ago I worked at the Federal Home Loan Bank Board as Administrative Assistant to one of the three regulators of the savings and loan industry. Much has changed since those years when the S & L industry began to broaden its lending practices in exchange for losing some of its industry-specific regulations and protections. S & Ls were becoming more like banks. Is this the case with credit unions today?

The Thomas Jefferson Institute wanted to review the credit union—commercial bank situation today to determine whether if areas of antiquated regulations or laws exist that should be reviewed since the financial strength and lending power of credit unions have increased.

This study by one of Virginia's top economic analysis firms, Chmura Economics & Analytics of Richmond, outlines three areas that need to be carefully monitored to ensure that credit unions continue to serve the communities as was intended:

1) There is preliminary evidence that credit unions are not serving the communities of "modest means" to the extent intended. Unfortunately, the surveys that have addressed this subject are inconclusive. Because serving those of "modest means" is a key reason for credit unions to exist under current tax law, this aspect should be carefully monitored in the future.

2) Two Presidents in the past 25 years from two separate political parties – Democrat Jimmy Carter and Republican Ronald Reagan – suggested that credit unions be taxed in a similar manner as banks. Although Congress disagreed, the fact that both of these presidents agreed on this matter indicate that this issue needs further review.

3) Congress has expanded the "membership base" for credit union far beyond the original intent allowing the asset size of some credit unions to match that of large community banks and to offer many of the same services. As such, this study suggests that these mega-credit unions be reviewed from time to time to see if they should be taxed at a similar rate as their commercial bank peers.

This study and its conclusions do not necessarily represent the views of the Thomas Jefferson Institute for Public Policy or its Board of Directors, and nothing in this study is meant to influence pending legislation.

Michael W. Thompson, Chairman and President
Thomas Jefferson Institute for Public Policy
May 2004

Table of Contents

Executive Summary

The competitive environment between banks and credit unions has changed significantly since the first credit unions were formed in the early 1900s. The earliest credit unions started as small groups of people who were associated by a common bond such as the neighborhood in which they lived or a church they attended. Many of these individuals were unable to obtain loans from financial institutions because of their low incomes and consequently their perceived high risk. However, credit union members were willing to take on the risks of loaning money to each other because they knew the character of their fellow members.

Even before signing the Federal Credit Union Act of 1934, President Roosevelt (then Governor of New York) emphasized credit unions' role in providing loans with reasonable interest rates to individuals that possessed low incomes. In a speech delivered to the annual convention of the Credit Union League of Georgia, President Roosevelt said, "I have a sort of a hunch that we owe a duty to our fellow citizens not to violate the biblical injunction against usury."[1]

Over the years, the environment for both banking and credit unions has changed along with the needs of society as well as technological advances. Changes in regulation, advances in financial markets, and developments in information technology have enabled banks to offer loans to more lower-income households than in the past. Credit unions have also benefited from these developments in finance and information. In addition, changes in legislation have given credit unions the opportunity to provide additional services, and the increased regulation that accompanied the expanded service that makes them look similar to banks.

This study takes an objective look at the competitive environment between banks and credit unions for the purpose of identifying policy implications. The study begins with an overview of the historical policies and changes in the environment between banks and credit unions and then provides a description of the current similarities and differences of the two financial institutions.[2] With an understanding of the characteristics of the financial institutions in hand, a summary of prior studies is provided. The fourth section considers the tax "subsidies" of credit unions and provides data on small and large credit unions. The final section concludes by proposing that further consideration be given to the following two issues that may result in changes to policies:

1. Measuring the degree to which credit unions serve those of modest means may result in the imposition of policies on credit unions similar to the Community Reinvestment Act imposed on banks
2. An exhaustive measurement of the services offered between banks and credit unions may lead to taxing credit unions that are most similar to banks

Ideally, this study would center on credit unions and banks in Virginia. However, because both banks and credit unions cross state lines, state-specific data are not always available. Moreover, data published as state-specific are not always purely reflective of the state. For example, the Navy Federal Credit Union, which is located in Arlington, Virginia, lists 2,305,116 members in December 2001 under Virginia. Additional information collected by the Credit Union National Association (CUNA), indicates that only 379,417 of those members possess Virginia addresses.[3] Where possible, state data used in this report are adjusted to account for idiosyncrasies that extend the data beyond state boundaries. However, it is not always possible to adjust the data accurately. In these cases, national level data are used. Further explanations of the issues surrounding state-specific data are in Appendix A.

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[1] "Roosevelt Reveals Own War On Usury." *New York Times*. May 27, 1929.

[2] Thrifts and mutual savings and loans are also considered where necessary.

[3] This discrepancy occurs because credit unions are not obligated to report data by state. For that reason, they typically report all membership at the 'headquarters' location.

Much of the criticism of credit unions is based on the belief that credit unions have evolved to a point where they are no longer serving the purpose and intent of the original legislation. In particular, critics argue that credit unions are not sufficiently servicing the financial needs of "individuals of small means" or limiting their membership to people sharing a 'common bond.'[4] Consequently, critics say that because credit unions have become indistinguishable from banks, they should no longer be granted tax-exempt status because it creates an unfair competitive advantage. Along a similar vein, they argue that banks are subject to more regulation than credit unions, which causes banks to incur more costs.

Despite the arguments of critics, new legislation has enabled credit unions to expand their operations beyond a single common bond and to provide additional services typical of banks. To lend insights into some key issues fueling the reformed tax-exempt status of credit unions, the historical development of the "small means" clause and the "common bond" definition is considered in addition to the reasons supporting tax-exempt status to credit unions.

Credit Unions – Initial Federal Legislation

Federal Credit Union Act of 1934

The preamble to the 1934 Federal Credit Union Act describes the intended purpose of the law:

> To establish a Federal Credit Union System, to establish a further market for securities of the United States and to make more available to people of small means credit for provident purposes through a national system of cooperative credit, thereby helping to stabilize the credit structure of the United States.[5]

Most opinions argue that legislation was drafted with individuals of small means in mind as the primary benefactors of a credit union system. This notion is consistent with the environment in which credit unions emerged in the United States. Lacking alternative means of financing goods, poorer segments of the population were either victimized by practices of usury or they resorted to loan sharks to obtain credit.

An example of the financial difficulties facing low-income citizens is found in a 1929 *New York Times* article in which President Roosevelt (Governor of New York at that time), while speaking at the annual convention of the credit union league in Georgia, describes the difficulties of a tenant farmer. Roosevelt explains that in the tenant farmers efforts to secure a mortgage, "The best he could do with the banks or individuals was 14 per cent interest. He decided this was pretty high, something unusual…"[6] The article continues, "At that time money rates were low and about all you could get on good bonds or for good mortgage was around 5 or 6 per cent." Evidently, the tenant farmer was correct in his assertion that he was being charged an unusually high rate of interest.

Although credit union membership does not exclude people of more than modest means, the *New York Times* example illustrates that the emergence of credit unions resulted from the needs of a lower income constituency. This point is reinforced by another *New York Times* article printed two years after the passage of the Federal Credit Union Act. The article notes, "The credit union movement is designed to promote regular thrift among working people and liberate the man without bank credit from the grip of usurious money lenders."[7]

The restrictions pertaining to credit union membership were put into motion in the same piece of legislation. Section 9 of the Federal Credit Union Act reads,

> …Federal credit union membership shall be limited to groups having a common bond of occupation, or association, or to groups within a well-defined neighborhood, community, or rural district.

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[4] In 1934, the common bond between credit union members was a connection through occupation, association, neighborhood, or other defined geographic area.
[5] Federal Credit Union Act, Chapter 750.
[6] "Roosevelt Reveals Own War On Usury." *New York Times*. May 27, 1929.
[7] Dorsey, R.C. "Credit Union Idea Spreading." *New York Times*. August 9, 1936.

Although this legal text codified "common bond" requirements for credit union memberships into federal law, the practice of creating a credit union around the foundation of a common bond had been commonplace since their inception at the state level in 1909 (See Federal Credit Union Timeline below).

Federal Credit Union Timeline

1908 With the help of Alphonse Desjardins the first credit union (St. Mary's Bank) is organized in New Hampshire. The credit union receives a charter from the New Hampshire state legislature in 1909 (*The Credit Union Industry: Trends, Structure, and Competitiveness.* Secura Group 183, Nov. 10, 1989). The first credit union law is passed in 1909 in Massachusetts with aid from Desjardins and Edward Filene.

1921 The Credit Union Extension Bureau, precursor to the Credit Union National Association (CUNA) is organized by Edward Filene. The main goals of the Bureau are to enact credit union laws, assist in the development of credit unions, and to promote credit union development (Secura Group 266).

1922 The Virginia General Assembly passes the state's credit union law on the last day of its annual session. The Hampton Institute Credit Union was chartered in November, but it was the national postal service union that truly brought the industry to Virginia.

1923 The Richmond Postal Credit Union Inc. is chartered, and still operates today.

1925 The postal service charters the Federal Employees Credit Union of Petersburg and Norfolk VA Postal Credit Union. Later that year, Lynchburg and Roanoke postal credit unions are established.

1926 The Danville Postal Credit Union was chartered.

1934 President Franklin D. Roosevelt signs the Federal Credit Union Act. The administration of federal credit unions is assigned to the Farm Credit Administration. Membership in federal credit unions is open to "groups having a common bond of occupation, or association, or to groups within a well-defined neighborhood, community, or rural district." Federal credit unions are set up as taxable entities with a tax burden "not to exceed the rate imposed upon domestic banking corporations." The 1934 law also gives credit unions the power to make loans to its members (loan maturities restricted to a maximum of two years) (Federal Credit Union Act, Chapter 750, Sections 2, 7, 9).

1934 The Credit Union National Association (CUNA) is formed, replacing the Credit Union Extension Bureau. CUNA's goals are to lobby for and provide services to credit unions (Secura Group 266).

1935 CUNA Mutual Insurance Society is formed to offer credit union life insurance to credit union members (Secura Group 266).

1937 The Federal Credit Union Act is amended to exempt credit unions from taxation by federal or state governments. In reference to credit unions, section 4 of the amendment states "their property, their franchises, capital, reserves, surpluses, and other funds, and their income shall be exempt from all taxation now or hereafter imposed by the United States or by any State,…" (Chapter 3, S. 2675, Public No. 416).

1949 Maturity limit on credit union loans is extended to three years (Secura Group 266).

1959 Recodification of the 1934 act increases maximum loan maturity to five years and authorizes federal credit unions to perform a broader portfolio of services. Credit unions are permitted to cash and sell checks, and also to

1968 Federal credit unions permitted to issue secured loans with maturities up to ten years (Secura Group 267).

1970 The National Credit Union Administration Act is passed. The act sets up the National Credit Union Administration as an independent federal agency to supervise federally chartered credit unions. Through separate legislation, the NCUA is designated to regulate and insure all federal credit unions and any state credit unions that apply and qualify for the insurance. The insurance is provided through the National Credit Union Share Insurance Fund (NCUSIF). (Public Law 91-206-Mar 10, 1970) (Public Law Oct. 19, 1970 91 P.L. 468; 84 Stat. 994).

1977 Federal Credit Union Act amendments expand savings, lending, and investment powers of credit unions. For example, loan maturities on nonresidential loans are increased to twelve years, and the reserve formula is lowered for larger credit unions (Secura Group 268).

1980 Depository Institutions Deregulation and Monetary Control Act defined credit unions as depository institutions and required them to maintain reserves against its transactions accounts in the ratio of 3% for that portion of its total transactions account of $25 million or less.[8]

[8] Transactions accounts are defined to include demand deposits, NOW accounts, telephone transfers, ATS, and share drafts.

1982 the National Credit Union Administration (NCUA) ruled that credit unions could open their doors to members from other businesses, organizations, and areas to help them cope with the recession. This policy decision added a new method of credit union growth through "multiple common bonds."

1998 February Supreme Court decision restricts credit union membership and rules that the NCUA interpretation of the 1934 Federal Credit Union Act does not allow for credit union membership to be based on multiple common bonds.

1998 Congress passes the Credit Union Membership Access Act. H.R. 1151 says credit unions, with regulator approval, may enroll members from outside their original membership groups. The act legalizes "multiple" and "community" common bond membership practices on the part of credit unions.

During early stages of the credit union industry, common bond requirements of membership were more than mere legal formalities. Alphonse Desjardins, a leader of the industry, believed that it was crucial for members of credit unions to know one another.[9] The local knowledge of members enabled credit unions to make accurate loan decisions based on its members' creditworthiness. In 1914, the *New York Times* explained the workings of the credit union:

> Credit unions are able to make loans safely…because its members are mutually acquainted and the association has an intimate knowledge of the personal character and responsibility of its borrowers, which could not be obtained by an impersonal commercial lending agency except at great cost.[10]

As evidenced by the above quotation, there was an inherently personal aspect to membership in a credit union as the industry took shape in the United States.

1937 Amendment

Under the original legislation, federally chartered credit unions were subject to taxation on their income. Tax policies of state charters varied on this point, but it was not until three years after the Federal Credit Union Act was passed that tax exemption was granted to federally chartered credit unions. The 1937 amendment to the Federal Credit Union Act[11] made the following exemption:

> The Federal credit unions organized hereunder, their property, their franchises, capital, reserves, surpluses, and other funds, and their income shall be exempt from all taxation now or hereafter imposed by the United States or by any State, Territorial, or local taxing authority; except that any real property and any tangible personal property of such Federal credit unions shall be subject to Federal, State, Territorial, and local taxation to the same extent as other similar property is taxed.[12]

A study prepared by the U.S. Treasury cites two primary reasons why the 1934 legislation exempts credit unions from paying taxes: 1) taxing credit unions on their shares, much as banks are taxed on their capital shares, "places a disproportionate and excessive burden on the credit unions" because credit union shares function as deposits; and 2) "credit unions are mutual or cooperative organizations operated entirely by and for their members…"[13] The "cooperative" status of credit unions refers to the fact that credit unions are owned by their customers in contrast to corporations which are owned by shareholders. In view of the fact that Treasury uses these two issues to justify the tax-exempt status of credit unions, they are examined in this study under "Tax Policies, Results, and Alternatives."

With regard to the intent of credit union membership, the 1937 amendment also makes a contribution to the development of credit unions as institutions servicing the financial needs of persons of small means. The amendment authorizes the Governor of the NCUA to study the credit issues facing lower income persons. Section 3 of the amendment notes:

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[9] Secura Group, 183.
[10] "Credit Union Idea Is Gaining Ground." *New York Times*. Oct. 26, 1914.
[11] The Federal Credit Union Act codified a 1935 attorney general opinion.
[12] Pub. L. No. 416, c.3, § 4 (Dec. 6, 1937).
[13] Summers, Lawrence H. *Comparing Credit Unions with Other Depository Institutions*. United States Department of the Treasury. January 2001. p.28.

> The Governor is hereby authorized to make investigations and to conduct researches and studies of the problems of persons of small means in obtaining credit at reasonable rates of interest, and of the methods and benefits of cooperative saving and lending among such persons.[14]

Although the law does not explicitly require such studies, the inclusion of this authorization supports the argument that credit unions were created to serve people of small means.

Evolution of Credit Union Policy

After the passage of the 1937 amendment, all the pertinent legislation relating to the commencement of the credit union industry and its intentions were in place. Since that time, many amendments and legislative proposals have marked the history of the credit union industry.

The remainder of this section traces key legislation and events that have shaped credit unions and molded the interpretation of the small means clause, the common bond requirement, and the tax exemptions stemming from the cooperative and non-profit status of credit unions. First, the major events relating to credit union membership as a function of the small means clause and the common bond requirement are examined. Three turning points in the development of credit unions have occurred:

- The implementation of the National Credit Union Share Insurance Fund in 1970,
- The 1998 Supreme Court ruling, and
- Credit Union Membership Access Act (CUMAA) of 1998.

After explaining how the laws and rulings noted above have influenced credit union membership, the major developments with regard to the cooperative and non-profit status of credit unions are traced. Finally, two critical events are examined that continue to uphold public policy extending the credit union tax exemption: the Revenue Act of 1951 and a 1988 Court of Appeals ruling from Michigan.

Small Means and Common Bond

The implementation of share (deposit) insurance for credit unions under a 1970 amendment to the Federal Credit Union Act is a critical point in credit union development because it shifted the burden of loan defaults from the credit union and its membership to an insurance fund backed by the government. By creating the National Credit Union Share Insurance Fund (NCUSIF), the amendment effectively eliminated the need for a common bond or any degree of "intimacy" amongst members. Previously, credit unions were subject to the risk associated with their loan portfolio; however, the insurance fund safeguarded credit union member deposits from not being repaid. As a result, members of credit unions no longer needed to be as intimately aware of the character or financial situation of other members because deposits would be available regardless of the soundness of the loans made by the credit union.

The safety net provision that the insurance fund created is frequently associated with a "moral hazard" problem. Moral hazard is a lending condition in which a financial institution takes on more risk than would otherwise occur because a safety net is present.[15] In an attempt to discourage any risky lending practices, the law establishing the insurance fund also imposed restrictions. One of the qualifications is:

> …whether the credit union is a cooperative association organized for the purpose of promoting thrift among its members and creating a source of credit for provident or productive purposes.[16]

Irrespective of any changes in the lending practices used by credit unions, the effective interpretation of the common bond requirement loosened substantially after the insurance fund was established. In particular, the NCUA pursued an expansionary policy in which multiple group charters would be permitted within a single credit union regardless of any associational or occupational bond between the distinct groups that compose the credit union. Although the use of multiple group charters (multiple common bond) emerged gradually, the

[14] Pub. L. No. 75-416, c. 3, § 3 (Dec. 6, 1937).
[15] In the case of credit unions, it can be argued that moral hazard is reduced somewhat by the fact that the insurance fund is a cooperative.
[16] Pub. L. No. 91-468, § 201 (Oct. 19, 1970).

NCUA did not formally pass the multiple common bond policy until 1982.[17] In defense of the expanding common bond definition, the NCUA argued that a narrow membership base subjected credit unions to significant risk during recessions. In a press release dated February 26, 1997 NCUA Chairman Norman D'Amours maintained the reasons for diversifying the membership of credit unions:

> The 1982 membership and expansion policy grew out of the need to stabilize credit union failures that drained the insurance fund. The recession of the early `80s fueled massive downsizings, closures and relocations of thousands of companies. Because the federal credit unions affiliated with these companies did not have a diverse membership base, they quickly experienced viability problems when out of work members could not pay back loans on time.[18]

As referenced in the above quotation, the stated intent of loosening the membership constraints was to prevent excessive credit union failures by enabling credit unions to diversify their membership base. At this point in the credit union history, the common bond membership restriction was no longer an integral feature of the individual credit union; rather, its definition was expanded to prevent the institution from failing on a widespread basis.

The restrictions on membership eased further after the 1982 policy change. For example, other expansionary policies, including familial membership, were adopted. However, a 1998 ruling by the Supreme Court in *National Credit Union Administration v. First National Bank & Trust Co.* dealt a major blow, albeit temporary, to the expansion of credit unions. First National Bank (along with five other banks and the American Bankers' Association) charged that the NCUA violated the Federal Credit Union Act with its practice of allowing credit unions to adopt a multiple common bond membership policy. First National Bank held that the Federal Credit Union Act "unambiguously requires that the same common bond of occupation unite each member of an occupationally defined federal credit union."[19]

Writing the majority opinion, Justice Clarence Thomas noted the emergence of the multiple common bond:

> Until 1982, the NCUA and its predecessors consistently interpreted §109 to require that the same common bond of occupation unite every member of an occupationally defined federal credit union. In 1982, however, the NCUA reversed its longstanding policy in order to permit credit unions to be composed of multiple unrelated employer groups.[20]

Further, Justice Thomas notes, "If the intent of Congress is clear, that is the end of the matter; for the court, as well as the agency, must give effect to the unambiguously expressed intent of Congress."[21] The Court found that the intent of Congress in passing the Federal Credit Union Act is clear and that the same common bond must unite all members of a single credit union. In February of 1998, the Supreme Court ruled against the expansion of credit unions via multiple common bond membership policies. However, the ruling would not last long as the next critical piece of legislation in the litigious history of credit unions passed later that year.

Perhaps the most contentious legislation relating to credit union growth is the Credit Union Membership Access Act of 1998 (CUMAA). The CUMAA over-turned the Supreme Court ruling handed down just six months earlier and permitted multiple common bonds within a single credit union. The CUMAA also reaffirmed community common bonds.[22] Interestingly, much of the justification in CUMMA for an expansive common bond policy reverts back to the assumption that credit unions serve people of "modest" means as noted in the 1934 Federal Credit Union Act.

> By itself, using the term "modest" is a movement away from the original legislation because the 1934 act stated that credit unions were organized to service the needs of people of

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[17] Secura Group 193.
[18] National Credit Union Administration Press Release. February 26, 1997.
[19] *National Credit Union Administration v. First National Bank & Trust Co.* (1998).
[20] Ibid.
[21] Ibid.
[22] The boundaries for community credit unions must meet the requirements that the area is 1) well-defined, and 2) a local community, neighborhood, or rural district. However, the interpretation of community credit union boundaries has expanded such that metropolitan areas with populations up to 1 million may qualify as a community area.

"small" means.[23] Although this distinction may be minor, it is important to note the transition in the legal text because the new terminology may encompass a wider range of potential credit union membership.[24]

Although the Supreme Court ruled that multiple common bonds were not consistent with credit union law, Congress, in implementing CUMAA, adopted a loose interpretation of the common bond requirement based on an assumption that the unique characteristics of credit unions still existed in 1998 when compared with other financial institutions. Consequently, Congress affirmed that the NUCA could continue to grant multiple and community common bonds. By legalizing these practices, critics argue that the movement of credit union industry toward an environment that reflects that of banks accelerated. Based on this new point of comparison, a secondary question for credit union critics is whether credit unions have changed materially since 1998.

Policies Addressing Service to Individuals of Modest Means

Preliminary versions of CUMAA included legislation similar to the 1977 Community Reinvestment Act (CRA), which is intended to encourage banks and thrifts to help meet the credit needs of the communities in which they operate. Hearings from the Congressional Record indicate an awareness of the need to monitor the extent to which credit unions help people of modest means with their credit needs. For example, Senator Edward Kennedy of Massachusetts described the need of maintaining oversight of credit union lending practices to lower income individuals:

> A community reinvestment standard for credit unions has been in existence for 16 years in Massachusetts. The record there is that such a standard is both necessary and effective. CRA exams for Massachusetts credit unions have demonstrated that there were a number of institutions that did not have a good record. However, over time, with the scrutiny of this process, the community lending record of Massachusetts credit unions has improved. Quite simply, this requirement works.[25]

Despite the allegation that some credit unions had trailed away from a focus of aiding lower-income constituents, the final version of the bill did not include a community reinvestment provision. The NCUA temporarily resolved this issue by adopting a Community Action Plan (CAP) in 2000. However, the CAP, the main aim of which was to ensure that credit unions helped underserved communities, was repealed only days before the measure was to become effective.[26]

Conclusive evidence of credit union efforts to serve people of modest means is lacking. A study conducted by the National Community Reinvestment Coalition (NCRC) finds some support suggesting credit union lending

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[23] The "modest means" clause is used in CUMAA as a key ingredient to justify credit union expansion. However, as used in CUMAA, the modest means clause takes on little more than rhetorical value. In the Congressional Record referencing the passage of the law, the definition of modest means is not cited, nor is there any evidence other than anecdotal comments pertaining to the degree to which credit unions service people of modest means. However, the general sentiment of the Congressional Record indicates that the priority of the bill reflects a consumer desire for diversity and increased competition in the financial services industry. See Congressional Record: April 1, 1998 Vol. 144, No. 40 and July 28, 1998 Vol. 144, No. 103.

[24] The rationale in CUMAA for allowing multiple common bonds included the following justifications (excerpts from Credit Union Membership Access Act. Pub. L. No. 105-219 [H.R. 1151], Aug. 7, 1998):

(1) The American credit union movement began as a cooperative effort to serve the productive and provident credit needs of individuals of modest means. (2) Credit unions continue to fulfill this public purpose, and current members and membership groups should not face divestiture from the financial services institution of their choice as a result of recent court action. (3) To promote thrift and credit extension, a meaningful affinity and bond among members, manifested by a commonality of routine interaction, shared and related work experiences, interests, or activities, or the maintenance of an otherwise well-understood sense of cohesion or identity is essential to the fulfillment of the public mission of credit unions**.** (4) Credit unions, unlike many other participants in the financial services market, are exempt from Federal and most State taxes because they are member-owned, democratically operated, not-for-profit organizations generally managed by volunteer boards of directors and because they have the specified mission of meeting the credit and savings needs of consumers, especially persons of modest means. 5) Improved credit union safety and soundness provisions will enhance the public benefit that citizens receive from these cooperative financial services institutions.

[25] Cong. Rec. 1 Apr. 1998: H1868.

[26] *The Credit Union Journal Daily*. December 14, 2001.

records to lower income households are poorer than comparable records for institutions governed by the CRA.[27] According to the study:

> NCUA lenders consistently lagged behind CRA-covered lenders and all lenders in home purchase loans to minority and low and moderate income (LMI) borrowers, as well as to residents of minority and LMI neighborhoods.[28]
>
> In both 1999 and 2000, CRA-covered lenders made a significantly higher percentage of their loans to LMI borrowers and census tracts than NCUA-covered lenders. In 2000, CRA-covered lenders made 27.8% of their conventional mortgage loans to LMI borrowers, while NCUA-covered lenders made 22.4% of their mortgage loans to LMI borrowers. In 1999, CRA-covered lenders and NCUA-covered lenders made 22.1and 18.7 percent of their loans, respectively, to LMI borrowers.[29]

A study by the Woodstock Institute found mixed results based on a survey from 3,000 respondents in the Chicago metropolitan area:

> …after controlling for education, race, and age, both banks and credit unions are much less likely to provide lower-income households with basic banking services. While credit unions may do somewhat better at serving middle and lower-middle-income households, they still do poorly in the lower-income segment of the population—those with incomes below $30,000. Credit unions appear to serve African-Americans at substantially higher rates than banks. Hispanics are less likely than whites to have accounts at either credit unions or banks, but they have better access at credit unions than banks. Moreover, as income declines to lower levels, the probability of African-Americans having credit union accounts drops dramatically.[30]

More recently, the GAO (2003) concluded, "limitations in the available data preclude drawing definite conclusions about the income characteristics of credit union members."[31] Specifically, their assessment of the available data (the Federal Reserve's 2001 Survey of Consumer Finances, 2001 Home Mortgage Disclosure Act data, and other studies) "provided some indication that credit unions served a slightly lower proportion of households with low and moderate incomes than banks."[32]

Although source material pertaining to the relative effectiveness of banks and credit unions servicing the credit needs of modest means constituents is inconclusive, this justification for credit union expansion via multiple common bonds was one of several factors influencing the passage of CUMAA. The legislation, and the proceedings surrounding its passage, justified the use of multiple common bond membership requirements based on the assumption of the general consumer benefits that credit unions provide and their contribution to diversity with respect to consumer choice for financial services. This sentiment is demonstrated in the Congressional Record covering the deliberations for the Act.[33] To this end, recent growth of the credit union industry displays its success in meeting the serving the needs of a broader group of consumers, whether or not they are of modest means, and is consistent with the 1998 membership act's support for multiple and community common bonds in credit union development.

Cooperative, Non-Profit, and Tax-Exempt

As referenced earlier, a U.S. Treasury study found that there were two predominant reasons for granting tax-exempt status to federal credit unions in 1937:

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[27] The methodology used by the NCUA led the GAO to conclude that the findings are not conclusive. General Accounting Office, *Credit Unions: Financial Condition Has Improved, but Opportunities Exist to Enhance Oversight and Share Insurance Management*. 2003, pp. 28 – 29.

[28] National Community Reinvestment Coalition News Release. "Study exposes failure to ensure service to low-income & minority communities." January 31, 2002.

[29] *NCRC Analysis of National Lending Trends of Credit Unions and CRA-Covered Lending Institutions.* National Community Reinvestment Coalition. 2002. p. 1.

[30] Katy Jacob, Malcolm Bush, and Dan Immergluck. *Rhetoric and Reality: An Analysis of Mainstream Credit Unions' Record of Serving Low-Income People*. February 2002. Woodstock Institute.

[31] General Accounting Office (2003), p. 16.

[32] Ibid, p. 16.

[33] Cong. Rec. 1 Apr. 1998: H1868. Cong. Rec. 24 Jul. 1998: S8956. Cong. Rec. 4 Aug. 1998: H7037.

1) that taxing credit unions on their shares, much as banks are taxed on their capital shares, "places a disproportionate and excessive burden on the credit unions" because credit union shares function as deposits; and
2) that "credit unions are mutual or cooperative organizations operated entirely by and for their members…[34]

These two justifications for credit union tax exemption held up in the Revenue Act of 1951 while mutual savings banks and savings and loans societies lost their tax-exempt status. There is extensive documentation of the reasons for revoking the tax-exempt status from selected financial institutions; however, there is little documentation why credit unions retained their tax exemption.[35] An examination of the reasons put forth to remove the tax exemption from some financial institutions can be used to determine if similar factors apply to credit unions today.

A United States General Accounting Office (GAO) study in 1991 cites several reasons for the tax exemption removal from mutual savings banks. It notes, "the exemption of mutual savings banks was repealed in order to establish parity between competing financial institutions."[36] The report also indicates that mutual savings banks had an unfair advantage over taxed competitors because the mutual savings banks could finance their business out of untaxed retained earnings, while commercial banks had to pay income tax on their earnings. Similar arguments held for the removal of the tax exemption from other institutions such as savings and loans.

The lack of credit union discussion at the time other financial institutions lost their tax exemption makes it difficult to contrast the cooperative and non-profit status of credit unions against the characteristics of those financial institutions. However, one of the reasons for removing the savings and loan tax exemption was that "savings and loan associations were no longer self-contained mutual organizations…" and that "investing members were simply becoming depositors who received relatively fixed rates of return on deposits…"[37] Credit unions, on the other hand, have remained cooperative institutions in the sense that they are owned by the members (depositors) and their loans are only available to members. Even so, cooperative and non-profit status does not always lead to tax exempt status. For example, farm cooperatives and the non-profit Automobile Association of America (AAA) are subject to federal income tax. In contrast, credit unions are not-for-profit and tax-exempt under §501(c)(1) of the Internal Revenue Code and under the Federal Credit Union Act.

Another development concerning credit union's tax-exempt status occurred in a 1988 Court of Appeals case, *United States v. State of Michigan*. In that case, Michigan had imposed a sales tax on credit unions and the United States challenged the tax. In determining its approach to decide the case, the court stated that "the leading cases suggest that we examine the purpose for which federal credit unions were created, that we determine whether they continue to perform that function…"[38] After reviewing the function of credit unions, the court determined:

> …through federal credit unions, therefore, the federal government makes credit available on liberal terms and at low rates of interest to middle-class Americans who, because they frequently lack adequate security, might otherwise have to turn to small loan financiers who can extort excessive interest rates in times of unexpected need.[39]

In this ruling, the Court of Appeals found that credit unions still performed the services for which they were originally established. The court also rejected a Michigan state argument that credit unions should be taxed because their offering of financial services had increased such that they operated just like private banks. Regardless of the variety of services offered, the court held that "federal credit unions were designed and continue to perform important governmental functions."[40]

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[34] Summers, Lawrence H. Comparing Credit Unions with Other Depository Institutions. United States Department of the Treasury. January 2001. p.28.
[35] U.S. General Accounting Office. *Credit Unions: Reforms for Ensuring Future Soundness.* GAO/GGD-91-85. July 10, 1991, 289.
[36] Ibid, p. 291.
[37] Ibid, p. 291.
[38] Ibid, p. 295.
[39] Court opinion excerpt from: U.S. General Accounting Office. *Credit Unions: Reforms for Ensuring Future Soundness.* GAO/GGD-91-85. July 10, 1991, p. 295.
[40] GAO/GGD 91-85 Credit Union Reform. p. 296.

Characteristics and Services Provided by Credit Unions and Commercial Banks

Notwithstanding the changes that have occurred in the competitive environment of credit unions and banks, the two institutions remain distinctly different from an organizational perspective as shown in the table below. With regard to services, however, credit unions (particularly those with more than $100 million in assets) are becoming more similar to banks.

Perhaps one of the most unique aspects of credit unions that lead to other organizational traits is its cooperative status. As a cooperative, credit unions are owned by their customers as opposed to their shareholders as is the case with banks. As noted earlier, the cooperative status of the institution has played a significant role in its tax-exempt status under §501(c)(1) of the Internal Revenue Code and under the Federal Credit Union Act. In addition, credit unions are not-for-profit entities. "Profits" made by the credit union are redistributed to members (who are also owners and customers) through lower rates on loans, higher rates on deposits, higher dividends, or retained earnings.

A bank, on the other hand, is a for-profit entity, where earnings are distributed to the owners as dividends or are retained and reinvested. Due to the fact that banks' owners are not necessarily its customers, the bank must balance the needs of both.

Table 1: Organizational Characteristics of Credit Unions and Banks

Credit Unions	Banks
Credit unions are cooperative institutions with a limited field of membership. Credit unions are owned and operated by their members, who are also depositors.	Banks are owned by shareholders and can serve customers belonging to the general public. Depositors in a bank retain no ownership and are only customers.
Credit unions are not-for-profit institutions. Income earned after expenses are kept as retained earnings to support credit union growth, to provide better rates on services, or returned to members in the form of dividends.	Banks are for profit enterprises with the profits distributed among the shareholders.
The governance of credit unions is conducted by a board of directors elected by and from the membership of a credit union. Credit union members each have one vote in electing board members.	Voting privileges pertaining to governance of a bank is limited to their shareholder owners. The governance of banks is conducted by a board elected by its shareholder owners.
Only one credit union board member can be compensated.	All board members can be compensated.
Federally chartered and some state-chartered credit unions are insured by the National Credit Union Share Insurance Fund (NCUSIF). NCUSIF is managed by the Administration (NCUA). Deposits are protected up to $100,000.	Banks are insured by the Federal Deposit Insurance Corporation of the federal government. Deposits are protected up to $100,000.
Net worth ratio of 7.0% must be maintained in order to be considered well-capitalized.	Banks are considered well capitalized if their total risk-based capital/asset ratio is at least 10% and Tier 1 risk-based capital/asset ratio is at least 6%.[41]

Deposit insurers also provide another distinction between credit unions and banks. Federally insured credit unions are members of the NCUSIF. Credit unions contribute premiums of up to 1.0825% of total deposits that are placed in the insurance fund.[42] Under the Federal Credit Union Act, NCUSIF is authorized to assist potentially failing credit unions to avoid involuntary liquidation.[43] However, during years when few credit unions access the fund, excess reserves that build up are redistributed to member credit unions.

[41] Federal Deposit Insurance Corporation Improvement Act of 1991. Note: Tier 1 capital consists of the book value of a bank's stock plus retained earnings.

[43] National Credit Union Administration. *Federal Credit Union Handbook*. NCUA-8055 M-4033. 1999, p. 30.

Deposit insurance for the banking industry is provided through the Federal Deposit Insurance Corporation (FDIC). The premium that banks pay for deposit insurance is a business expense.[44] Prior to 1993, a bank's deposit insurance premium varied directly with its volume of deposits. Early in 1993, the FDIC assigned premiums on a risk-based basis, with riskier banks paying a higher proportion of total deposits than less-risky banks.

Despite the differences in the characteristics of credit unions and banks, the services provided by the largest credit unions (asset size of $100 million or more) are similar to those offered by banks . For example, almost all of the largest credit unions with an asset size of $500 million or more provide credit cards, IRAs, certificates of deposit, and first mortgages. The only two services in the list below that fewer than half the largest credit unions provide is life insurance and business checking. According to a GAO study (2003), the larger credit unions (those with more than $100 million in assets) "appeared to be offering very similar services to peer banks."[45]

[44] The tax treatment of deposit insurance premiums also differs between credit unions and banks. Credit unions treat deposit insurance as an asset while banks treat it as an expense, which helps to reduce their taxable income. If credit unions were subject to taxes on net income, treating deposit insurance as an asset avoids the expense deduction, and therefore would expose the credit union to higher taxes.
[45] General Accounting Office (2003), p. 124.

Table 2. Credit Union Services by Asset Size, In Millions

	$0-$.2	$.2-$.5	$.5-$1	$1-$2	$2-$5	$5-$10	$10-$20	$20-$50	$50-$100	$100-$200	$200-$500	$500+	All CU's
Common bond includes community	40.5%	35.1%	32.5%	28.1%	24.4%	26.8%	34.1%	47.5%	55.0%	59.9%	63.6%	51.7%	37.7%
Stock/bond brokerage	1.1%	0.5%	0.0%	0.5%	1.2%	4.6%	9.3%	21.1%	37.8%	58.2%	75.5%	84.7%	16.1%
Mutual funds	0.0%	0.5%	0.6%	0.4%	1.3%	3.2%	7.0%	18.5%	33.9%	60.6%	77.1%	86.6%	15.1%
Savings bonds	0.0%	1.4%	2.0%	2.5%	5.0%	11.3%	19.2%	30.1%	43.5%	57.0%	63.8%	55.7%	20.3%
Life savings insurance	49.4%	58.4%	56.6%	60.2%	55.4%	50.2%	49.3%	44.8%	42.7%	35.5%	39.5%	36.5%	49.5%
Direct Deposit													
Federal recurring payments	5.6%	7.7%	17.2%	29.8%	52.0%	75.2%	86.8%	92.8%	91.4%	96.1%	95.9%	94.0%	68.3%
Net pay	6.9%	14.6%	23.4%	36.0%	53.9%	74.9%	86.2%	92.2%	91.8%	95.2%	95.1%	96.6%	69.5%
Home Banking													
Audio Response	0.0%	0.5%	0.6%	2.6%	7.6%	30.9%	59.5%	82.0%	93.6%	97.3%	98.0%	97.3%	45.8%
Personal Computers	0.0%	0.0%	0.0%	1.8%	6.2%	17.2%	35.1%	62.3%	85.3%	93.3%	98.0%	98.7%	35.8%
Have Web Site	0.0%	2.6%	2.9%	5.2%	18.2%	36.9%	62.9%	85.2%	94.2%	97.7%	98.7%	100.0%	49.9%
Cashier's Checks	1.1%	4.3%	5.8%	9.6%	24.2%	45.4%	60.0%	75.3%	83.7%	88.1%	89.6%	96.7%	49.0%
Travelers Checks	0.0%	1.9%	5.7%	11.9%	34.3%	59.0%	77.9%	90.5%	95.2%	94.9%	98.4%	97.3%	59.3%
Safe deposit boxes	0.0%	1.9%	0.9%	0.5%	0.9%	1.8%	9.5%	27.6%	47.6%	62.0%	67.7%	66.7%	17.1%
Credit Counseling	25.8%	19.4%	16.7%	21.7%	26.7%	35.1%	41.7%	46.7%	49.0%	55.6%	65.4%	68.5%	37.6%
Formal financial planning	2.2%	1.9%	1.2%	0.9%	1.5%	3.7%	6.7%	15.7%	28.0%	53.3%	65.7%	64.4%	13.2%
ATM cards	0.0%	0.5%	0.6%	4.2%	21.7%	50.9%	74.4%	89.1%	95.2%	97.3%	98.8%	100.0%	54.6%
Credit cards	0.0%	1.4%	0.9%	5.4%	19.0%	39.7%	66.8%	86.4%	92.0%	94.3%	95.6%	96.0%	50.5%
Share drafts	0.0%	0.9%	3.5%	13.1%	41.9%	71.8%	88.1%	95.7%	96.4%	98.3%	98.7%	100.0%	65.0%
Visa / Mastercard debit cards	0.0%	0.0%	0.9%	3.9%	18.4%	41.7%	66.8%	82.1%	89.8%	94.5%	97.2%	98.0%	49.8%
Certificates	1.2%	8.9%	20.8%	35.1%	54.1%	71.9%	84.1%	92.3%	96.6%	97.3%	98.7%	96.4%	68.8%
Individual Retirement Accounts (IRAs)	0.0%	3.2%	6.5%	15.2%	30.8%	56.1%	77.2%	90.7%	96.6%	95.7%	100.0%	99.3%	58.9%
ROTH IRAs	0.0%	2.4%	5.7%	8.8%	21.5%	42.0%	66.8%	84.5%	91.5%	94.3%	97.6%	99.3%	51.6%
Business checking	0.0%	1.0%	1.7%	4.9%	11.8%	20.9%	32.2%	39.0%	44.9%	47.8%	52.4%	33.2%	25.0%
First mortgages	0.0%	0.0%	2.3%	4.1%	11.2%	25.5%	45.3%	72.1%	84.3%	93.1%	94.0%	98.0%	41.0%
Plane/boat/recreational vehicle loans	6.8%	32.2%	49.0%	60.0%	73.6%	83.3%	87.5%	90.7%	93.4%	97.0%	97.2%	95.2%	78.1%
Guaranteed student loans	0.0%	0.0%	1.8%	2.4%	3.7%	12.8%	21.1%	30.8%	42.7%	43.8%	47.2%	52.0%	19.2%
Other Student Loans	1.2%	2.9%	4.7%	4.6%	6.3%	13.8%	18.5%	27.7%	31.6%	36.9%	41.2%	52.4%	17.9%

*Data taken from December 2002 Credit Union National Association (CUNA) Yearbook Survey.

Source: CUNA Credit Union Report, July 2003.

Did CUMAA Lead To Faster Credit Union Growth?

Critics of credit unions argue that loosening the membership restrictions surrounding credit unions along with their special tax treatment has given credit unions a competitive advantage enabling them to grow faster than banks.[46] Where possible, growth rates are measured in this section before and after 1998, which is the year Congress passed the CUMAA to monitor whether credit union growth accelerated after the passage of CUMAA. Faster growth at credit unions relative to other financial institutions would provide some evidence that the CUMAA gave credit unions a competitive advantage over banks. Such a finding would not be definitive, however, because trends do not prove causation. Faster growth at credit unions could be attributed to a higher level of service provided, marketing, or other factors. Similarly, constant credit union growth before and after the CUMAA or slower growth relative to banks, provide preliminary but not definitive evidence that the CUMAA did not lead to a competitive advantage.

This section considers several key measures of change within the financial institution industry over the past twenty years[47] and finds that the trends are mixed when comparing credit unions to other financial institutions (commercial banks and savings institutions[48]). The following trends were identified using national data:[49]

- Total credit union assets grew at a faster annual average pace from 1998 through 2002 when compared with 1984 through 1998 and grew faster than assets at commercial banks over the entire period. However, the pace of growth accelerated more at commercial banks than at credit unions post-1998 when compared with pre-1998. In contrast, deposits at savings institutions fell from 1984 through 1998.

- The annual average growth in the average asset size of credit unions and commercial banks was fairly constant during the pre- and post-1998 periods with credit unions growing at a faster rate. The average asset size of savings institutions grew at the slowest rate of the three financial institutions.
- The number of institutions declined for credit unions, commercial banks, and savings institutions.

Expansions in multiple common bonds and community boundaries are also considered. Changes in policies around multiple bonds have clearly expanded the potential market for credit unions and some credit unions have taken advantage of those changes. In addition, loose terminology surrounding the membership requirements for community credit unions has created opportunities for larger community credit unions to arise. From 1998 through 2002, membership in credit unions grew 10.4% but membership at credit unions with multiple common bonds dropped 11.4% over the same period. Meanwhile, membership rose substantially at community credit unions increasing from 3.5 million members in December 1998 to 8.4 million in December 2002. The number of community credit unions exhibited similar growth-–rising from 423 in 1998 to 855 in 2002 (see Table 7 in Multiple Common Bond and Community Expansions).

Trends in Size

From 1984 through 2002, assets at credit unions in the United States grew faster than either commercial banks or savings institutions (see chart below). Over this period, assets held at credit unions increased by 193.8% in real terms while those at commercial bank grew by 62.0% and savings institution assets dropped 31.1%.[50] Assets in credit unions expanded an average 6.2% a year from 1984 through 2002 (see table 3) compared with 2.7% annual average growth at commercial banks and an annual average decline of 2.0% at savings institutions.

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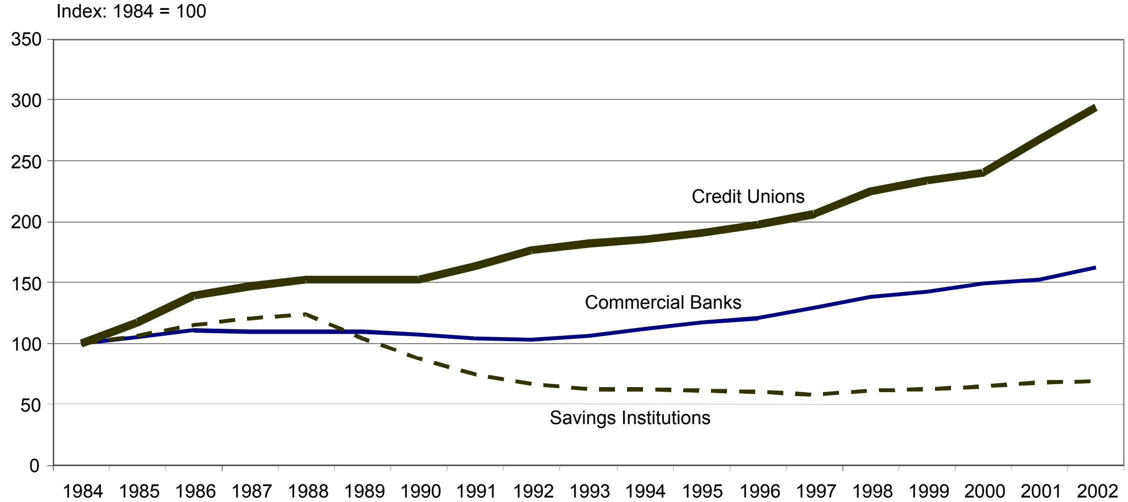
[46] Aside from the looser membership regulations for credit unions, financial institutions in the United States operate in an entirely different environment today than twenty years ago. Deregulation of the banking industry in the 1980's opened portals for technology advancements and improvements in communications and information exchanges resulting in fierce competitive strategies between financial providers.
[47] Trends in financial institution growth are shown from 1984 through the present. The start date was chosen because it is the latest date for which data are available for all three types of financial institutions (banks, credit unions, and savings institutions). Credit union data are available from 1939, bank data from 1966, and savings institution data from 1984.
[48] Savings institutions are insured by either the Bank Insurance Fund (BIF) or the Savings Association Insurance Fund (SAIF) that operate under state or federal banking codes applicable to thrift institutions.
[49] See Appendix A for an explanation of why national rather than Virginia-specific data are used in this analysis.
[50] Assets are inflation adjusted using the consumer price index.

Real Asset Growth in Depository Institutions



Source: FDIC and CUNA.

Splitting the period at 1998 when the CUMAA was passed does not provide strong support that the CUMAA spurred growth in credit union assets. From 1994 through 1998, credit union assets increased an annual average 6.0% compared with 6.9% from 1998 through 2002—an increase of 0.9 percentage points. Within the banking industry, the annual average pace of growth picked up from 2.3% to 4.2% over the same period—a gain of 1.8 percentage points.

Since bank deposits grew at a faster rate than those at credit unions, it is difficult to conclude that the CUMAA gave credit unions a competitive advantage over banks. In fact, part of the expansion in financial institution deposits occurred as investors temporarily diverted funds away from the declining stock market and into insured instruments at financial institutions.[51] The trends in table 3 suggest that banks probably benefited more than credit unions from funds that were diverted away from the stock market.

Table 3: Annual Average Growth of Real Assets Before and After CUMAA

	Commercial Banks	Savings Institutions	Credit Unions
1984 – 1998	2.3%	-3.5%	6.0%
1998 - 2002	4.1%	3.1%	6.9%
1984 – 2002	2.7%	-2.0%	6.2%

Note: Pre-CUMAA growth shown as 1984-1998 period while post-CUMAA growth shown from 1998-2002.

In real dollar terms, commercial banks have added most significantly to their asset base with an increase of nearly $2.7 trillion since 1984 (see Table 4). In contrast, credit union assets have grown by $379.1 billion over the same period.

Table 4: Size of U.S. Financial Institutions

2002	Commercial Banks	Savings Institutions	Credit Unions
Real Assets	$7.0 Trillion	$1.4 Trillion	$574.7 Billion
# Institutions	7,871	1,466	10,041
Average Asset Size	$890,471,639	$927,247,735	$57,234,066
1998	**Commercial Banks**	**Savings Institutions**	**Credit Unions**
Real Assets	$6.0 Trillion	$1.2 Trillion	$440.2 Billion
# Institutions	8,756	1,687	11,392
Average Asset Size	$616,744,223	$644,930,831	$35,018,032

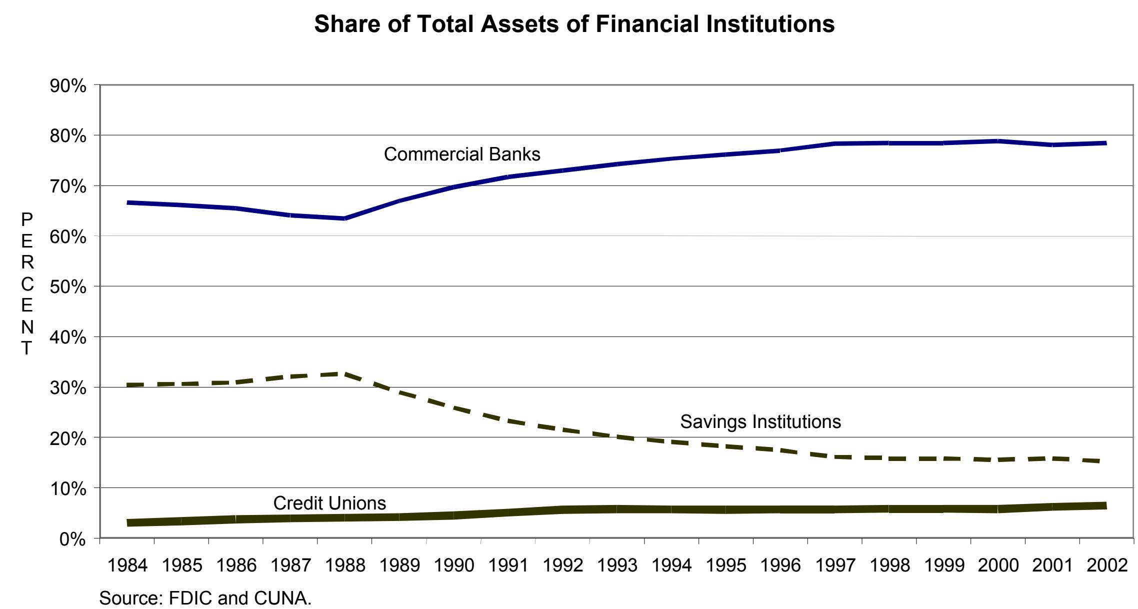
[51] The Dow Jones Industrial Average (DJIA) fell 18% from July 17, 1998 through September 4, 1998 and rose to 11,723 on January 14, 2000 before declining 29% through year-end 2002. The NASDAQ hit 5,049 in March 2000 and fell by 77% through October 2002.

1984	Commercial Banks	Savings Institutions	Credit Unions
Assets	$4.3 Trillion	$1.9 Trillion	$195.6 Billion
# Institutions	14,469	3,404	18,375
Average Asset Size	$172,732,334	$334,791,908	$6,147,475

Source: FDIC and CUNA.

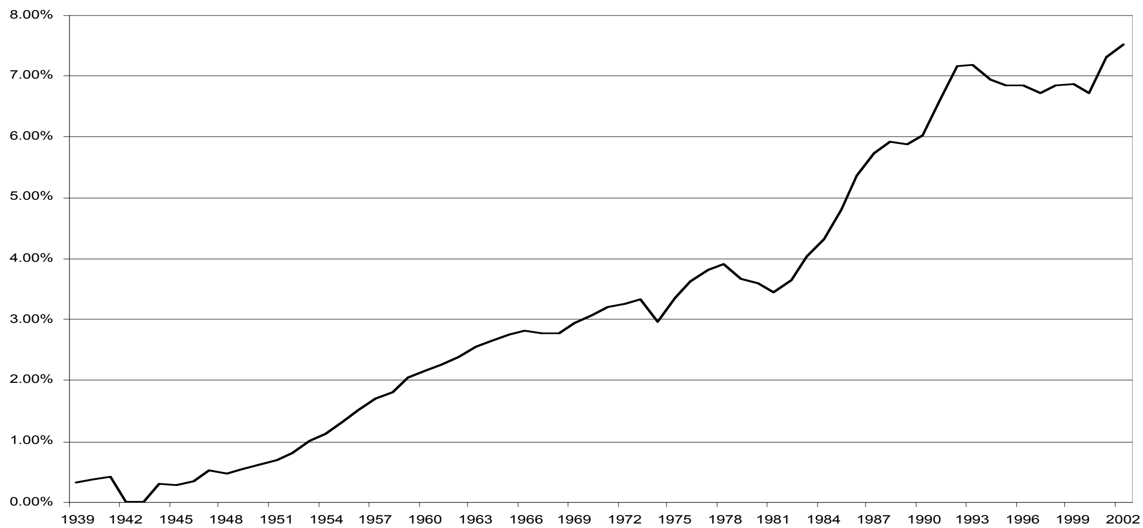
Despite the relatively fast growth of credit union assets, banks account for 78.0% of all assets in financial institutions in 2000 while credit unions only account for 6.4%. Commercial banks possess $7.0 trillion in assets with an average asset size just under $900 million. Credit unions, on the other hand, account for $574.7 billion in assets with average assets of $57.2 million. In terms of the number of institutions, credit unions remain the most prevalent with 10,041 institutions compared with 7,871 commercial banks at the end of 2002.

Meanwhile, credit unions captured a smaller portion of the savings institution fallout, and their market share advanced from 4% in 1988 to 6% in 2002.
By examining the long-term trends, it is clear that the market share of credit unions have grown steadily since the 1940's. The chart below shows the credit unions' relative share of assets as compared to banks from 1939 through 2002. Savings institutions are omitted because data are not available prior to 1984. Credit union relative market share growth was



stagnant during the 1970's and late 1990's while the 1980's and early-to-mid 1990's were a period of rapid increase in credit union market share.

Credit Union Share of Bank and Credit Union Assets



Source: FDIC and CUNA

In light of the small changes in market share, it is not surprising that the annual average change in the average asset size or number of credit unions does not provide evidence that there was a significant shift with the passage of the CUMAA. As shown in Table 5, growth in the average asset size of credit unions and banks did not change materially after 1998. However, the average asset size of credit unions grew 13.1% a year from 1998 through 2002 at credit unions compared with a 9.5% growth rate at commercial banks.

Table 5: Annual Average Change in Average Real Asset Size and Number of U.S. Financial Institutions

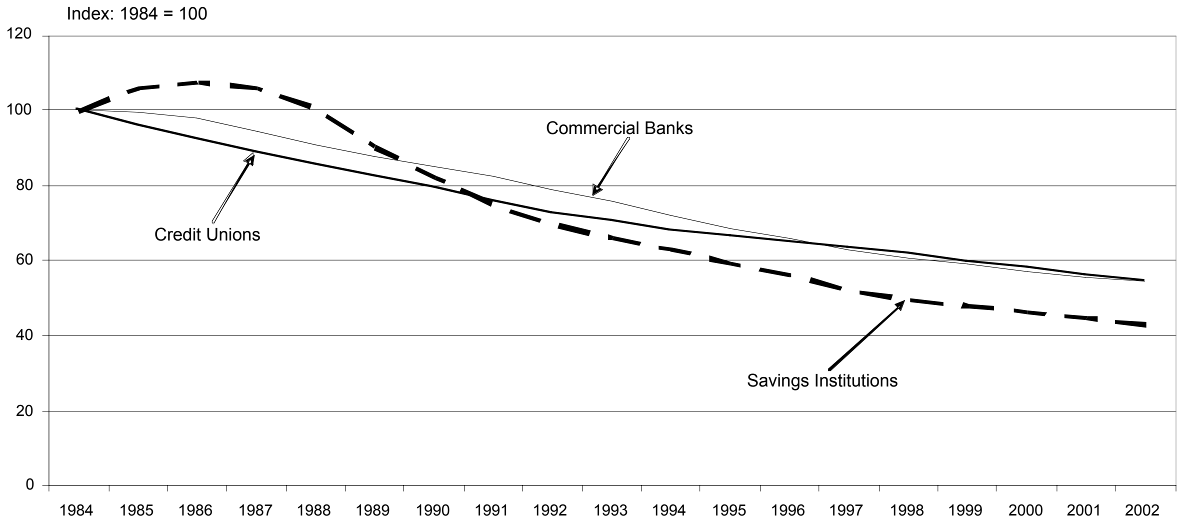
1984 - 2002	Commercial Banks	Savings Institutions	Credit Unions
# Institutions	-3.3%	-4.6%	-3.3%
Average Asset Size	9.5%	5.8%	13.2%
1984 - 1998	**Commercial Banks**	**Savings Institutions**	**Credit Unions**
# Institutions	-3.5%	-4.9%	-3.4%
Average Asset Size	9.5%	4.8%	13.2%
1998- 2002	**Commercial Banks**	**Savings Institutions**	**Credit Unions**
# Institutions	-2.6%	-3.4%	-3.1%
Average Asset Size	9.6%	9.5%	13.1%

Source: FDIC and CUNA.

Table 5 also indicates that the annual average decrease in the number of credit unions and commercial banks post-1998 slowed more at commercial banks than at credit unions. Economies of scale, mergers,[52] and changes in membership requirements have all served to increase consolidation within financial institutions. The number of commercial banks and credit unions has dwindled by the same rate since 1984 while savings institutions have receded somewhat more rapidly (see following chart). In 1984, there were 14,469 commercial banks in operation compared with 7,871 in 2002. Over the same period, the number of credit unions fell from 18,375 to 10,041 while the number of savings institutions fell from 3,404 to 1,466.

[52] The number of mergers among federally insured credit unions has decreased over the last twelve years. From 1990 through 2002, an average 324 credit unions merged each year. During the first five years of the period, an average 405 credit unions merged each year compared with an average 282 over the last five years of the period.

Decline in Number of Depository Institutions



Source: FDIC and CUNA.

Multiple Common Bond and Community Expansions

Credit unions have benefited from multiple common bonds[53] and community common bond[54] expansions because these definitions increase the number of people who can belong to a particular institution. In fact, through the expansion of multiple common bonds, Table 6 shows that federal credit unions have added about 2 million potential members per year from 1999 through 2002. Despite the gains made in potential membership for multiple common bond credit unions, the membership growth seen over the past several years has really occurred within community-chartered credit unions. With relatively loose definitions governing the membership criteria of community credit unions, both growth in the number of community credit unions and conversions from other charter types have boosted community credit union membership by over 142% from 1998 through 2002. In their *Community Conversion Study*, the National Credit Union Association notes the following four reasons for the increase in community charters.[55]

- The need to diversity the membership and economic base in order to withstand sponsor problems, such as plant closings and employment cutbacks, and to reflect the mobility of the U.S. workforce.
- Reaction to large field of membership expansions by state-chartered credit unions.
- Desire to expand services.
- Changes to NCUA chartering regulations to ease the burden on applicants for community charters, expansions or conversions.

Although credit unions added over 16,000 groups as multiple common bonds in 1999, the number of federal credit unions adding groups has declined since then.[56] However, there has been a substantial increase in the largest groups added (over 3,000 potential members), from 8 in 1999 to 73 in 2002. Consequently, the average accepted group size increased from 95.4 to 170 potential new members over the same period. There has also been a sharp decline in the number of denied applications.

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[53] Multiple common bonds are a type of membership designation for credit unions in which more than one group is served. However, each group served has a common bond of occupation and/or association.

[54] The boundaries for community credit unions must meet the requirements that the area is 1) well-defined, and 2) a local community, neighborhood, or rural district. However, the interpretation of community credit union boundaries has expanded such that metropolitan areas with populations up to 1 million may qualify as a community area.

[55] *Community Conversion Study*. National Credit Union Association. Accessible at http://www.ncua.gov/ref/CommunityConvStudy/CommunityConversionStudy.pdf as of Feb. 23, 2004.

[56] The NCUA began reporting the expansion in membership in federal multiple common bond credit unions in 1999. The NCUA only reports the multiple common bond expansions for federal credit unions. Therefore, these data underestimate the total impact of multiple common bond expansions because they exclude state chartered credit unions.

Table 6. Multiple Common Bond Federal Credit Union Expansions

	1999	2000	2001	2002
Number of Credit Unions	1,431	1,444	1,363	1,180
Number of Groups Added	16,290	14,716	13,595	11,661
1-200	14,883	13,158	11,881	10,304
201-500	868	952	1,128	900
501-1,000	309	352	326	225
1,001-1,500	112	114	87	69
1,501-2,000	58	53	51	44
2,001-3,000	53	63	52	46
Over 3,000	8	43	70	73
Potential New Members	1,544,416	1,905,844	2,312,222	1,981,994
Average Size of Groups Added	95.4	129	170	170
Applications Denied	338	109	57	49

Source: NCUA Annual Reports

Growth in the number of credit unions and membership varies greatly by type of credit union. As shown in Table 7, the number of credit unions fell by 1,311 from 1998 through 2002 with federal single and multiple common bond institutions both declining by over 600. In fact, federal community credit unions were the only type to show an increase in institutions from 1998 through 2002. As noted earlier, the community charter allows credit unions to serve the general population in a well-defined community, neighborhood, or rural district general while the single and multiple common bonds restrict membership to groups such as occupations, associations, or industries.

The number of members at credit unions increased by 7.7 million from 1998 through 2002. Surprisingly, however, the number of members at multiple common bond credit unions declined by 3.8 million over the same period. The decline was caused, in part, by a switch from multiple common bonds to community bonds as well as a decline in the number of people employed in the military and manufacturing industries. According to NCUA data, about 1.1 million of the net decline in membership occurred in multiple common bond credit unions that are 'primarily military' and 630,000 that are 'primarily other manufacturing.'[57]

The strongest growth in new and potential members from 1998 and 2002 is in federal community credit unions and state chartered credit unions. Membership in federal community credit unions increased from 3.5 million in 1998 to 8.4 million in 2002 – a gain of over 142%. During the same time period, membership in state chartered credit unions climbed from 29.7 million to 36.3 million – an increase of 22.5%. Community field of membership requirements have spurred growth in these credit unions because they provide existing federally chartered credit unions a way to attract new members. In fact, 96 federally chartered credit unions converted to community charters in 2002 and over 125 have made the conversion in 2003.[58] Overall potential membership for community credit unions and state chartered credit unions more than doubled between 1998 and 2002 setting the stage for much more growth into the future.

[57] Other manufacturing excludes chemical, petroleum refining, primary and fabricated metals, machinery, and transportation equipment.
[58] Bruce, Laura. *The changing face of credit unions*. www.Bankrate.com. Dec. 19, 2003.

Table 7: Members By Type of Credit Union

December 2002

	Type of Credit Union	Credit Unions	Members	Potential Members	Saturation
Federal	Community	855	8,418,882	94,712,918	8.9%
	Single Common Bond	2,256	7,041,080	17,049,602	41.3%
	Multiple Common Bond	2,842	29,134,801	92,683,213	31.4%
State	State Chartered	3,735	36,336,258	393,054,535	9.2%
	Not Federally Insured	121	1,130,660	8,930,723	12.7%
	TOTAL	9,809	82,061,681	606,430,991	13.5%

December 1998

	Type of Credit Union	Credit Unions	Members	Potential Members	Saturation
Federal	Community	423	3,472,549	20,742,818	16.7%
	Single Common Bond	2,880	7,496,418	14,994,963	50.0%
	Multiple Common Bond	3,511	32,895,884	78,878,157	41.7%
State	State Chartered	4,181	29,673,998	147,713,746	20.1%
	Not Federally Insured	125	801,322	2,530,464	31.7%
	TOTAL	11,120	74,340,171	264,860,148	28.1%

Change from December 1998 to December 2002

	Type of Credit Union	Credit Unions	Members	Potential Members	Saturation
Federal	Community	432	4,946,333	73,970,100	-7.9%
	Single Common Bond	-624	-455,338	2,054,639	-8.7%
	Multiple Common Bond	-669	-3,761,083	13,805,056	-10.3%
State	State Chartered	-446	6,662,260	245,340,789	-10.8%
	Not Federally Insured	-4	329,338	6,400,259	-19.0%
	TOTAL	-1,311	7,721,510	341,570,843	-14.5%

Source: NCUA Call Report Data Files found under Freedom of Information Act (FOIA).
Note: Not credit union submission of call reports is voluntary.

Literature Review

Many studies have assessed the competitive environment of credit unions and banks and offered opinions regarding the need for changes to 'level the playing field.' Typically, studies commissioned by banks point to an outcome that favors the banking industry while those commissioned by credit unions conclude in favor of credit unions. Independent studies from the United States General Accounting Office (GAO) and the U.S. Treasury provide mixed reviews. The 2003 GAO study recommended further regulation of credit unions in light of the changes that occurred in the industry and called for measures to determine whether credit unions are serving people in underserved areas while the 2001 U.S. Treasury study found no reason to offer recommendations for administrative or legislative changes.

This section provides a brief overview of the contribution and conclusions of some of the more recent studies on credit unions and banks. Most of the studies assess the environment at the national level. However, three are reviewed that consider Virginia. Finally, a survey provided in one of the Virginia studies was updated.

National Studies

The following five studies are reviewed in this section:

1. *Credit Unions: Reforms for Ensuring Future Soundness*, United States General Accounting Office Report to the Congress, July 1991.
2. *Comparing Credit Unions with Other Depository Institutions*, United States Department of the Treasury, January 2001.
3. *Rhetoric and Reality: An Analysis of Mainstream Credit Unions' Record of Serving Low-Income People,* Katy Jacob, Malcolm Bush, and Dan Immergluck of the Woodstock Institute, February 2002.
4. *Credit Unions in a 21st Century Financial Marketplace: Economic and Organizational Underpinnings of Institutional Success,* Mark Cooper of the Consumer Federation of America, October 2003.
5. *Credit Unions: Financial Condition Has Improved, but Opportunities Exist to Enhance Oversight and Share Insurance Management,* United States General Accounting Office Report to the Congress, October 2003.

U.S. General Accounting Office

The General Accounting Office (GAO) produced two studies of credit unions since 1991. The first was a comprehensive study of the credit union system as required by the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA). The report considers the financial condition of credit unions and their federal share insurance fund, regulation and supervision of credit unions, the structure of the credit union industry, and the evolving role of credit unions in the financial marketplace.

The GAO found that in 1991, "The condition of today's federally insured credit unions is better than that of banks and thrifts."[59] It noted that the following trends contributed to the industry's strength:

- Expansion in the type and length of loans credit unions may offer
- Expansion in the type of accounts credit unions may offer
- Relaxed membership (common bond) restrictions

GAO acknowledged that the credit union growth into a new environment exposes it to new risks. Thus it recommended, "…numerous changes related to organization, regulation, supervision, and insurance that would help assure continued safe and sound operations and also protect NCUSIF."[60] In addition, it suggested that Congress provide guidance, "to specify the outer limits of an occupational, associational, or community common bond."[61] (Guidance was provided in 1998 with the passage of the Credit Union Membership Access Act (CUMMA).) About 50 recommendations were made by GAO, and the report indicated that NCUA "agreed with most of them."

The second GAO report, published in 2003, was undertaken because of the changes and the evolution of the credit union industry, which allowed for an expansion of membership and mandated safety and soundness controls. In the second report, GAO found that the financial condition of the credit union industry improved since 1991 and its federal deposit insurance funds was financially stable. Even so, based on the growing concentration of the industry assets in large credit unions, it recommended increased risk management on the part of NCUA.

The GAO report also considers whether credit unions are serving people with modest means.[62] The limited data available indicates that credit unions served a slightly lower proportion of low- and moderate-income households than banks. No definite conclusions could be drawn due to the limitations of the data. However, GAO recommends that NCUA use tangible indicators to determine whether credit unions are serving people in underserved areas.

U.S. Treasury Department

Sections 401 and 403 of the CUMAA directed the U.S. Department of the Treasury to study several depository institution issues including an evaluation of the differences between credit unions and other federally insured financial institutions, the potential effects of applying Federal tax laws on credit unions in the same manner as those laws are applied to other federally insured financial institutions, and to provide recommendations for legislative and administrative action as deemed appropriate. The 2001 report notes that:

> Despite their relatively small size and their restricted fields of membership, federally insured credit unions operate under banking statutes and rules virtually identical to those applicable to banks and thrifts. Significant differences have existed in the past, but have been gradually disappearing. Recently, most of the remaining major regulatory differences between credit unions and other depository institutions were removed.[63]

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[59] General Accounting Office (1991), p. 3.
[60] Ibid, p. 3. Recommended changes are summarized on pages 5 – 12.
[61] Ibid, p. 9.
[62] General Accounting Office (2003), pp. 16 – 29.
[63] U.S. Department of Treasury (2001), p.1.

Secretary of Treasury Lawrence H. Summers concludes,

> At this time, we do not believe these differences [NCUA's loan-to-one-borrower restriction and credit union exemption from the CRA] raise any particular safety and soundness competitive equity concerns. Therefore, we offer no administrative or legislative recommendations.[64]

Woodstock Institute

The Woodstock Institute, which is an institute that promotes community reinvestment and economic development in low-income and minority communities, considers whether credit unions, "…honor the mission stated in the Federal Credit Union Act to meet the savings and credit needs of 'persons of modest means.'"[65] (The study was funded by the Annie E. Casey Foundation and the Ford Foundation.) A survey of about 3,000 respondents in the Chicago metropolitan area provided the basis of its study. Major findings are as follows:[66]

1. Credit unions in the six-county Chicago region serve much lower percentages of lower-income households than they do middle- and upper-income households.
2. Both banks and credit unions are much less likely to serve lower-income households with basic banking service than other income groups when other variables are controlled.
3. Similar percentages of African-Americans and whites are credit union members. After controlling for income, age, and education level, being African-American more than doubles the odds of a person having a credit union account. It also reduces his or her odds of having a bank account by more than one-half. The credit union finding is partly explained by the fact that African-Americans are "over-represented" in public sector jobs or other highly-unionized industries.
4. Belonging to a labor union almost doubles the odds of belonging to a credit union.
5. The larger the firm a person works in, the greater that person's chance of being a credit union member.
6. Working in the retail sector greatly reduces the odds of being a credit union member.

Consumer Federation of America

A Consumer Federation of America (CFA) report[67] was funded by the Florida Credit Union League to assess credit unions in the current financial marketplace partially in response to an analysis by Florida Tax Watch that concluded, "Lawmakers should consider the value of tax exemptions and decide if they would be willing to fund a program at that level to produce the same benefits and whether the absence of funding would reduce or eliminate those desired public interests benefits."[68]

The CFA report includes the following conclusions:[69]

- Credit unions provide benefits to the public that far exceed the cost of the tax exemption. The benefits of credit unions are mainly measured in terms of the higher interest rates on deposits relative to banks and lower interest rates on loans.
- The credit union tax exemption does not create the basis for unfair competition because the value of subsidized insurance and loans for banks and tax exemptions for small banks exceeds the value of the credit union tax exemption.
- Substantial tax revenue would not be raised by eliminating the tax exemption because credit unions would change their behavior. In the case of a state tax, state-charted credit unions would switch to federal charters. In the case of federal taxes, credit unions, which are non-profit institutions, would reduce their income to reduce their tax liability.
- The success (strong growth) of credit unions comes from their non-profit, democratically controlled, and member-focused principles which create trust between members and credit unions ad elicits great cooperation and voluntary services on the part of members.

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[64] Ibid, p. 2.
[65] Woodstock Institute, p. 1.
[66] Ibid, pp. 1-2.
[67] Cooper, Mark (Consumer Federal of America), "Credit Unions in a 21st Century Financial Marketplace: Economic and Organizational Underpinnings of Institutional Success," October 2003.
[68] Florida Tax Watch Research Report, "Florida Credit Unions Receive Tax Exemptions Worth $102 Million, April 2003.
[69] Consumer Federation of America, pp. i – iii.

Virginia Studies

The following three studies are reviewed in this section:

1. *A Study on the Comparative Growth of Banks and Credit Unions in Virginia: 1985-1995, Neil B. Murphy and Dennis M. O'Toole*, School of Business Virginia Commonwealth University, August 27, 1997.
2. *A Study of State-Chartered Credit Unions in Virginia*, Robert W. Cook, January 1998.
3. *A Study on the Evolution and Growth of Credit Unions in Virginia: 1997-2002, Neil B. Murphy and Dennis M. O'Toole*, School of Business Virginia Commonwealth University, November 2003.

The two Murphy and O'Toole studies were funded by the Virginia Bankers Association for the purpose of examining "if the credit union industry in Virginia has adhered to its original mission and if the three reasons for granting special government benefits to credit unions still exist today."[70] According to Murphy and O'Toole, credit unions are provided tax-exempt status and exemption from the obligation of CRA for three principal reasons:

1. Credit unions were seen as being restricted to a well-defined or narrow common bond serving a small number of members that were well known to each other;
2. Credit unions were seen as being small sized institutions;
3. Credit unions were seen as offering only a very limited number of products and services.[71]

Murphy and O'Toole conclude that the increasing size, the expansion to multiple and community common bonds, and the broadened list of products offered by credit unions cause them to serve much of the same public served by banks and savings institutions. Therefore, the government benefits (principally tax and CRA exemption) "translate into a substantial competitive advantage for credit unions over Virginia's banks and savings institutions, frustrating an efficient, free-market allocation of resources."[72]

The Cook report was commissioned by the Virginia Credit Union League in response to the Murphy and O'Toole (1997) study. The Cook report considers only federally-chartered credit unions[73] and inflation-adjusted[74] historical data whereas the Murphy and O'Toole study use both state and federally chartered credit unions while utilizing nominal data. Cook argues that there is no legislative intent linking tax exemption to the special purpose characteristics of credit unions noted by Murphy and O'Toole and criticizes them for not acknowledging that the demise of the savings and loan industry supported the growth of banks and credit unions from 1987 through 1996. He concludes, "If public policy is intended to treat these two institutions equally, all advantages enjoyed by either institution must be eliminated."[75]

Virginia Survey

The 1997 Murphy and O'Toole study surveyed household use of credit unions in Virginia to assess financial service usage patterns of Virginia households in late 1996. The underlying reason for the survey was to assess whether credit unions are serving individuals of modest means. They found that the respondents who use credit unions tend to be more highly educated and are more highly represented in the upper income groups when compared with banks. Murphy and O'Toole conclude that the survey results are "inconsistent with the traditional notion that credit unions serve people of small means who might not otherwise be able to secure financial services."

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[70] The 1997 study references four reasons for granting special government benefits (p. 1) while the 2003 study references three reasons (p. 1). The reason that was included in the first report and dropped in the second is: "credit unions were seen as serving households with low to moderate incomes" (p. 3).
[71] Murphy and O'Toole (2003), p. 3.
[72] Ibid, p. 24.
[73] Cook does not include federally-chartered credit unions because Virginia can only tax state-chartered credit unions.
[74] Using constant (inflation-adjusted) dollars rather than nominal is important when estimating the number of credit unions by asset size. The use of nominal dollars causes a larger number of credit unions to fall into a bigger asset size.
[75] Cook, p. 36.

Brooks Adams Research surveyed Virginia residents late in 2003 to determine whether the demographics of credit union and bank users had changed since 1996 and whether credit unions in Virginia served the low-income and less-educated population when compared with banks.[76]

Overall, the survey found that nearly a third of Virginians use credit unions (32%) for their financial service provider while 84% use banks. In addition, the survey results shown in Table 8 provide some evidence that credit unions in Virginia are not serving the low-income population as well as banks. Specifically, the customer mix of credit unions in Virginia is skewed toward individuals that make $70,000 or more while, as a percentage of total customers, banks serve a larger percentage of customers whose income is under $20,000. Similar trends are evident when education is considered.

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[76] Brooks Adams Research performed a telephone survey among 800 randomly selected households throughout Virginia. The questions replicated those used in the Murphy and O'Toole (1997) study. Statistical tests have been performed to determine any "statistically significant" differences among responses and between various demographic segments. The total sample of 800 yields a maximum statistical error of ±3.5% at the 95% level of confidence (i.e. if this study were repeated 100 times, in 95 of those times the percentage giving a particular answer would be within 3.5 percentage points of the percentage who gave that answer in this study).

Table 8. Virginia Credit Union and Bank Customer Mix

	Banks	Credit Unions	Explanation
Income			
Under $20,000	17%	6%	Banks Serve More
$20,000 - $34,000	16%	17%	Not Statistically Different
$35,000 - $49,000	15%	16%	Not Statistically Different
$50,000 - $69,000	13%	16%	Not Statistically Different
Greater than $70,000	21%	31%	Credit Unions Serve More
Refused to Answer	19%	15%	Not Statistically Different
Education			
Some High School or Less	9%	3%	Banks Serve More
High School Graduate	28%	18%	Banks Serve More
Some College	24%	34%	Credit Unions Serve More
College Graduate	36%	42%	Not Statistically Different
Refused to Answer	3%	2%	Not Statistically Different

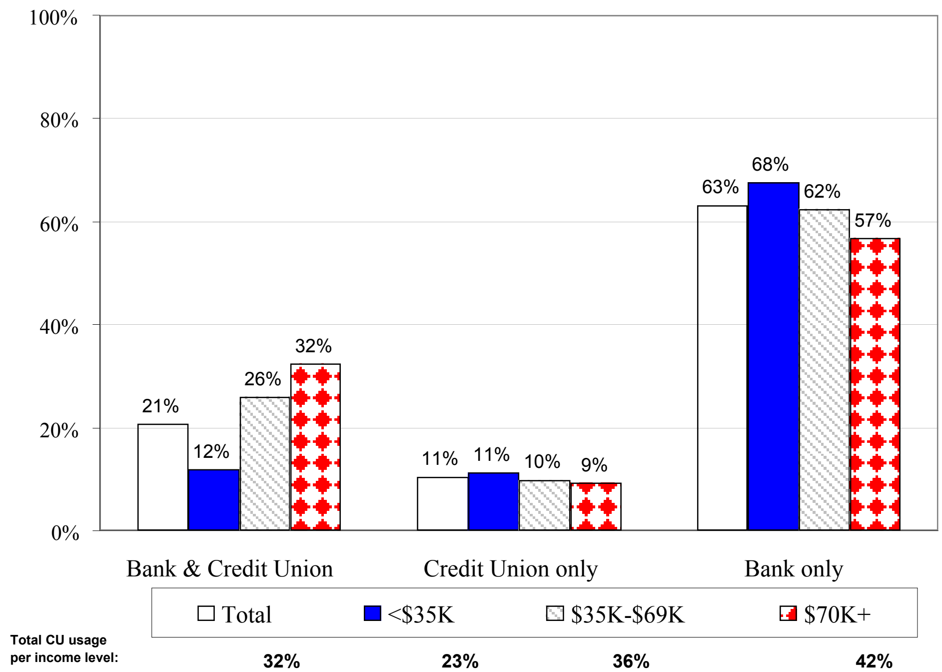
Source: Brooks Adams Research.

The updated survey also found credit union members in Virginia are more likely to fall into the highest income category ($70,000 or more) compared with the lowest category ($35,000 or less) and are more likely to possess a college degree rather than a high school degree.

As shown in the chart below, respondents with higher income and an annual household income of $70,000 or more are most likely to use both a bank and credit union (32%), while those earning less than $35,000 are least likely (12%). Similarly, 42% of those with an annual household income level of $70,000 or more use a credit union, compared to only 23% of those with an annual household income below $35,000.

Type of Financial Institutions Used

By income level

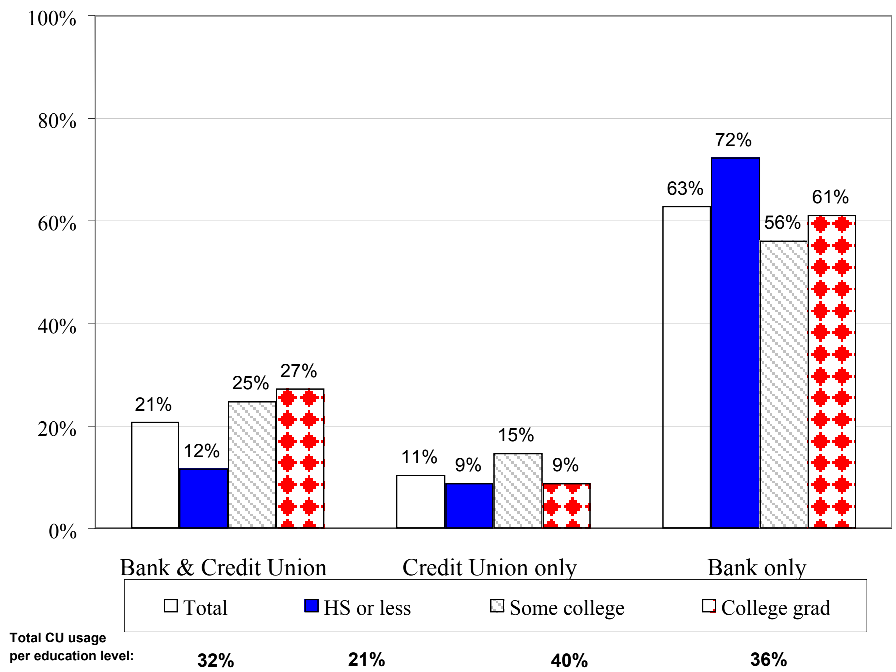


Source: Brooks Adams Research.

Bank and credit union usage also varies by education level. Having less education increases the likelihood of using a bank only, with 72% of those with a high school education or less using banks. On the other hand, 36% to 40% of those with some college education or college graduates use a credit union as their only financial institution or in addition to using a bank, compared to 21% of those with a high school education or less.

Type of Financial Institutions Used

By education level



Source: Brooks Adams Research.

The survey also indicated that the satisfaction level with financial institutions is high, with nine out of ten Virginians being satisfied. This figure does not vary between credit unions and banks. However, females are more likely to be satisfied, while younger residents are inclined to be dissatisfied.

There is a strong ongoing debate regarding the tax exemption status of credit unions. For example, the 1991 GAO report on credit unions devotes a twenty-page appendix to analyzing the credit union tax exemption.[77] In this section, Chmura Economics & Analytics (CEA) identifies the differences between taxes paid by both institutions, explains the basis for the differences, estimates the taxes that would be collected if credit unions paid the same taxes as banks, and considers the argument that small credit unions should be treated differently than large credit unions.

Tax Comparisons

Credit unions pay fewer taxes than banks, and federally chartered credit unions pay even less taxes than state-charted credit unions. As shown in Table 9, credit unions are exempt from federal income taxes as well as franchise taxes imposed by Virginia. Federally chartered credit unions are also exempt from state sales and use taxes, but state credit unions are obligated to pay them. Any unrelated business income[78] collected by a credit union is taxable, however. In addition, credit unions must pay payroll taxes and property taxes.

Table 9. A Comparison of Taxes Faced by Credit Unions vs. Banks

Tax	Federally Chartered Credit Unions	State Chartered Credit Unions	Banks
Federal Income Tax			√
Unrelated Business Income Taxes	√	√	√
Virginia Franchise Tax			√
County Franchise Tax			√
Payroll Tax	√	√	√
Property Tax	√	√	√
State Sales and Use Tax		√	√
Dividend Tax	√	√	√

Banks are taxed more heavily than credit unions. Most banks are Subchapter C corporations, which obligates them to pay a 35% top federal tax rate on income. In addition, the dividends distributed to shareholders are taxed. Based on a 1997 change in law, banks can also incorporate as Subchapter S corporations,[79] which are only taxed once on income (at the individual level). However, there can be no more than 75 stockholders in a Subchapter S corporation.[80] This requirement precludes the majority of Virginia banks from incorporating as Subchapter S corporations In fact, no Virginia bank is a Subchapter S.

Banks are also subject to state taxes, which differ dramatically across the country. Delaware, for example, imposes a regressive income tax structure on banks, with the highest tax rate (8.7%) on banks with net incomes of less than $20 million and the lowest tax rate (1.7%) on banks with net incomes of greater than $650 million.

In Virginia, banks must pay a franchise tax in lieu of a state tax on income. This franchise fee is 1% of a bank's net capital. Localities can also place a franchise fee of 0.8% on banks locating within their jurisdictions. Savings banks, on the other hand, are subject to the state income tax.

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[77] General Accounting Office (1991), pp. 289-309.

[78] If the credit union received a shipment of DVD players that it then sold to its customers, the net income from the sale of the DVD players would be taxable as non-business related income.

[79] McCarthy, Elizabeth. "Banks taking advantage of subchapter S status." *Sacramento Business Journal.* October 26, 1998 http://www.bizjournals.com/sacramento/stories/1998/10/26/focus5.html.

[80] House Bill H.R.2896, The American Jobs Creation Act of 2003, as passed by the Ways and Means Committee will increase the maximum number of S corporation shareholders from 75 to 100 if it becomes law.

Basis for the Difference in Tax Treatment

The most often stated reason that the tax treatment of credit unions and banks differ is because of the fundamental nature of each organization. A study prepared by the U.S. Treasury in 2001, noted two predominant reasons for granting tax-exempt status to federal credit unions in 1937 (Op. cit, p. 17):

1) that taxing credit unions on their shares, much as banks are taxed on their capital shares, "places a disproportionate and excessive burden on the credit unions" because credit union shares function as deposits; and
2) that "credit unions are mutual or cooperative organizations operated entirely by and for their members…[81]

In addition, GAO has pointed out that the tax-exempt status of state credit unions originally occurred because of their similarity to mutual financial institutions, which were tax exempt at the time but now must pay taxes.[82]

Notwithstanding the cited reasons behind the tax exemption, in 1978 (under President Carter) and 1985 (under President Reagan), the executive branch proposed taxing credit unions on the basis that the tax-exempt status gave them an unwarranted competitive advantage over other financial institutions. Supporters of credit unions successfully argued that the tax-exempt status should continue because of the unique services offered by credit unions, the benefits of mutual and nonprofit organization, and the potential harm that taxation would have on undercapitalized credit unions. Even if taxes were levied, the GAO report points out that credit unions could reduce their taxable incomes by reducing loan rates and/or increasing deposit rates.[83]

From a bank's perspective, a tax on credit unions seems to be fair. Most credit unions offer lower rates on loans and higher rates on deposits than banks.[84] Credit unions do not have to charge as large of a spread to earn the same amount of net income that a bank would. Credit unions are exempt from regulations such as the Community Reinvestment Act, which places a costly regulatory burden on banks. The growth of credit unions has been strong, particularly with the recent CUMAA's affirmation of multiple and community common bond membership practices. Banks argue that allowing credit unions to use such approaches to serve the general public, thereby competing in the open market, should cause those credit unions to be taxed, as occurred with thrifts some years ago.

Credit unions present several arguments for their continued tax exemption. Credit unions are member-owned not-for-profit cooperatives while banks are for profit institutions. Credit unions don't have the same access to equity markets as banks. Without similar access to equity markets, credit unions must keep higher equity to capital ratios than similarly situated banks. For these reasons, credit unions would argue that they are fundamentally different from banks and therefore deserve the continued income tax exemption.

Fiscal Impacts of Credit Union Taxation

Some observers have argued that Congress and state legislatures should identify the potential taxes that would be paid by credit unions to prompt them to consider whether those funds could be better utilized by supporting another sector of the economy. We present the complicated issues of such a notion by considering the implications of taxing state chartered credit unions and estimating the federal income tax received from a tax placed on federal credit unions.

Cook examines the tax implications of Virginia imposing a 1% franchise tax on the net capital of state chartered credit unions, which is equal to that for banks.[85] He demonstrates that a 1% tax rate applied to the net capital of credit unions in Virginia in 1999 leads to an effective tax rate on capital of 0.74%. Using the capital-to-asset ratio for banks in Virginia, a 1% franchise tax equals an effective tax rate of 0.28%. Consequently, Cook argues a franchise tax would place an unfair burden on credit unions compared to banks.

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[81] Summers, Lawrence H. *Comparing Credit Unions with Other Depository Institutions.* United States Department of the Treasury. January 2001. p. 28.
[82] General Accounting Office (1991), p. 289.
[83] General Accounting Office (1991), p. 290.
[84] One exception may be mortgage rates. Since these are sold in a secondary market, the rates offered by credit unions and banks seem to be little different.
[85] Cook, pp. 32-33.

Notwithstanding the burden a franchise tax places on credit unions, it is unlikely that such a tax would be levied in Virginia. By law, federally-chartered credit unions cannot be subject to state income taxes. However, the tax can be levied on state-chartered credit unions.[86] Faced with the possibility of such taxation, state chartered credit unions may switch to federal charters thereby avoiding the taxation. For that reason, any serious efforts to tax credit unions would more likely occur at the federal level through congressional legislation rather than at the state level.

Another potential problem with levying a franchise tax on credit unions is the potential for the tax to increase the riskiness of credit unions by lowering its net worth to asset ratio. As a tax-exempt entity, a credit union that retains $1 of its net income adds $1 to its net worth. However, if a credit union is taxed on its net worth, it may choose to distribute more dividends, lower loan rates, or increase deposit rates to avoid the franchise tax. Under such a scenario, credit unions might offer even higher deposit rates and lower loan rates than in the past.

To ensure that credit unions do not let their net worth to asset ratios get too low, the NCUA regulates federally insured credit unions. In fact, federally insured credit unions have had a larger capital ratio than banks and thrifts since 1992.[87] To remain "well capitalized" under the NCUA guidelines, a credit union must maintain a net worth ratio greater than 7.0%. If a credit union's net worth ratio drops below 7.0%, the credit union must take "prompt corrective action," or steps to increase it above 7.0%.[88] From this perspective, if a tax is placed on a credit union's net worth, a larger number of credit unions will likely be deemed in need of "prompt corrective action."

As noted earlier, any serious credit union tax reform will likely come from the federal level. The Treasury Department estimated the revenue effects of taxing credit unions in 2001 and found that between $13.7 billion and $16.2 billion could be collected over a ten-year period if all credit unions were taxed.[89]

Chmura Economics & Analytics uses an approach that differentiates taxes by asset size and estimates that $1.89 billion would have been collected in the nation from credit unions in 2002. The CEA approach assumes the net income of federally insured credit unions are subject to the same corporate income tax rates as banks. To estimate the federal taxes collected from credit unions, the total net income of credit unions is differentiated by asset size (see Table 10 below).[90] Based upon 2002 corporate income tax tables, the taxes paid for the average credit union in each asset range is calculated. The taxes paid per credit union are multiplied by the number of credit unions in each asset range to determine the total potential income taxes collected.[91]

Table 10. Estimating Federal Income Taxes Collected from Taxing Credit Unions as Subchapter C Corporations, 2002

	Asset Size						
	< $2M	**$2M to $10M**	**$10M to $50M**	**$50M to $100M**	**$100M to $500M**	**$500M +**	**Total**
Total Net Income	$3,000,000	$94,000,000	$504,000,000	$427,000,000	$1,809,000,000	$2,825,000,000	$5,662,000,000
Number of Credit Unions	1,947	3,022	2,922	751	842	204	9,688
Net Income per Credit Union	$1,541	$31,105	$172,485	$568,575	$2,148,456	$13,848,039	$16,770,201

[86] State taxation of state chartered institutions is the subject of much debate. For example, Utah created a tax force to study the possibility of taxing state credit unions. See Jenifer K Nii, "Credit Union Tax Proposal Called Dangerous Step." in *Deseret News*, March 15, 2003.
[87] U.S. General Accounting Office. *Credit Unions: Financial Condition Has Improved, but Opportunities Exist to Enhance Oversight and Share Insurance Management.* GAO-04-91. October 2003, p. 11.
[88] National Credit Union Administration. *Rules and Regulations*. Part 702.
[89] Summers, Lawrence H. *Comparing Credit Unions with Other Depository Institutions.* United States Department of the Treasury. January 2001. p. 2.
[90] For tax year 2002, marginal corporate income tax rates vary from 15% for taxable incomes less than $50,000 to 35% for taxable incomes over $18,333,333. Calculating taxes separately for each asset range of credit unions will result in a more accurate projection of potential income taxes.
[91] The analysis omits state income taxes collected because each state has its own income tax policy and rates.

Federal Income Taxes per Credit Union	$231	$4,666	$50,519	$193,316	$730,475	$4,746,814	$195,165
Total Federal Income Taxes	$450,000	$14,100,000	$147,616,500	$145,180,000	$615,060,000	$968,350,000	$1,890,756,500

Note: Net income and number of credit union data are from Consolidated Balance Sheet for Federally Insured Credit Unions, NCUA

The largest number (31%) of credit unions are in the asset size of $2 million to $10 million. If faced with the same taxes as banks, these credit unions would experience an average tax liability of $4,666 based on an average of $31,105 net income per credit union. However, the overwhelming majority of taxes collected (83.7%) would be obtained from credit unions with asset sizes greater than $500 million.

The analysis in Table 10 assumes that credit unions do not change their behavior in the face of taxation. However, credit unions will likely take steps to reduce their taxable income if they can do so without dropping their net worth to asset ratios below the NCUA's recommended 7.0%. Since credit unions are member-owned cooperatives, the implicit goal of the credit union is to improve the well-being of members. If a credit union's income is taxed, the payment represents money shifting from the credit union system to the government. Consequently, less money is available to grow the credit union or to provide dividends to current members. To maximize member benefits, credit unions will likely change their behavior to reduce taxes. They can do this by increasing dividends and deposit rates and or reducing loan rates.

Differentiating Credit Unions by Asset Size for Tax Purposes

In light of that fact that the largest credit unions are most similar to banks, an argument can be made that they should be taxed as banks. As noted in Table 2 on page 21, more than 90% of all credit unions with an asset size of $500 million or more offer direct deposit, PC banking, credit cards, ATM cards, IRAs, and home mortgages. These large credit unions are also efficient based on the employee compensation to asset ratio of credit unions and banks (see Chart below.) In addition, many of these large credit unions possess multiple common bonds or community charters, which allows them to provide membership to many potential customers. The wide membership base makes the large credit unions more diversified than smaller credit unions, which helps them to withstand temporary shortfalls.

Table 11: Federally Insured Credit Union Statistics, 2002

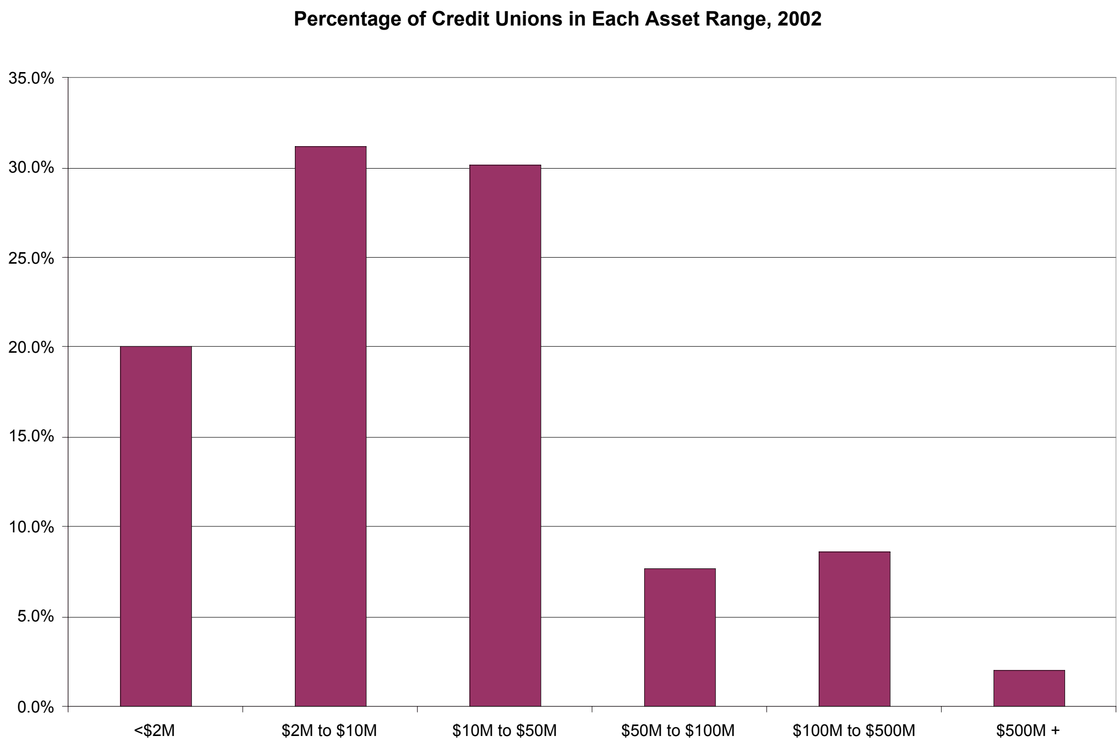
Number of Credit Unions	1,947	3,022	2,922	751	842	204	9,688
Employee Compensation	$32,000,000	$301,000,000	$1,215,000,000	$900,000,000	$2,996,000,000	$3,113,000,000	$8,557,000,000
Assets	$1,708,000,000	$16,181,000,000	$69,049,000,000	$52,762,000,000	$177,403,000,000	$239,971,000,000	$557,074,000,000
Loans	$935,000,000	$9,078,000,000	$40,248,000,000	$32,189,000,000	$112,581,000,000	$147,618,000,000	$342,649,000,000
Sum of Net Worth	$280,000,000	$2,188,000,000	$8,325,000,000	$5,919,000,000	$19,222,000,000	$24,551,000,000	$60,485,000,000
Net Worth/Assets	16.40%	13.53%	12.02%	11.13%	10.69%	10.05%	10.72%
Emp Comp/Assets	1.87%	1.86%	1.76%	1.71%	1.69%	1.30%	1.54%

Table 12: US Bank Statistics, 2002

Number of Banks	4,168	2,405	539	370	325	80	7,887
Full Time Employees	82,969	146,180	73,951	79,668	245,664	1,117,075	1,745,507
Employee Compensation	$3,615,339,000	$6,560,876,000	$3,651,160,000	$3,965,265,000	$13,054,957,000	$69,563,407,000	$100,411,004,000
Deposits	$178,351,739,000	$340,935,523,000	$167,140,511,000	$199,271,007,000	$639,607,803,000	$3,164,532,272,000	$4,689,838,855,000
Assets	$211,337,776,000	$409,498,007,000	$206,019,467,000	$254,312,111,000	$937,269,854,000	$5,058,505,367,000	$7,076,942,582,000
Loans	$127,132,801,000	$258,672,141,000	$133,379,693,000	$163,677,803,000	$558,244,337,000	$2,838,309,524,000	$4,079,416,299,000
Capital (Tier 1)	$22,163,241,000	$38,098,897,000	$18,223,872,000	$22,070,066,000	$82,294,131,000	$352,197,680,000	$535,047,887,000
Capital/Assets	10.49%	9.30%	8.85%	8.68%	8.78%	6.96%	7.56%
Emp Comp/Assets	1.71%	1.60%	1.77%	1.56%	1.39%	1.38%	1.42%

On the other hand, small credit unions do not 'look like banks' because they provide fewer bank-related services. For example, fewer than 25% of the credit unions with an asset size smaller than $5 million possess web sites or provide ATM cards and credit cards. Many small credit unions are single common bond credit unions with high participation amongst potential members. Given their small size, they tend to have high capital (net worth) to asset ratios as a buffer against potential shortfalls.

Given these factors, a tax only on larger credit unions may be considered. As noted earlier, credit unions with asset sizes greater than $500 million will likely pay 83.7% of the income taxes collected under a hypothetical income tax even though they make up only 2.1% of all credit unions (see chart below). Consequently, exempting smaller credit unions will not have much effect on tax collections. In fact, the Reagan administration proposed the taxation of credit unions with more than $5 million in gross assets in 1985 as part of a larger tax reform package.[92] This item was dropped from the final tax reform package passed in 1986.



There are several potential pitfalls with such a policy. A tax on credit unions of a certain size will result in actions to avoid the tax. The credit unions that would be subject to this tax may decide to split into smaller credit unions. While this may save these credit unions from tax liability, they may lose some of the economies of scale associated with large-scale operations. In addition, credit unions will be motivated to cap membership, causing the denial of membership to individuals who would otherwise qualify.

[92] *President's Tax Proposals to the Congress for Fairness, Growth, and Simplicity*, May 1985, pp. 247-248.

Conclusions and Policy Implications

When viewed in aggregate, credit unions and banks have clearly become more similar both in terms of services provided and regulations imposed. Although the single common bond structure of credit unions has expanded to multiple and community common bonds have extended since the original legislation in 1934, the Credit Union Membership Access Act (CUMAA) enacted in 1998 noted that credit unions continue to fulfill the public purpose that "began as a cooperative effort to serve the productive and provident credit needs of individuals of modest means."[93]

Analyzing key measures of change within the financial institutions industry and using 1998 as a point of demarcation, Chmura Economics & Analytics finds mixed evidence that growth in credit unions accelerated after the CUMAA was enacted. For that reason, Chmura Economics & Analytics concludes that the environment between banks and credit unions has not changed materially since 1998 when Congress indicated in the CUMAA that credit unions continued to fulfill the public purpose of serving individuals of modest means. Moreover, the U.S. Treasury report of 2001 assessed the differences between credit unions and banks and found no "particular safety and soundness competitive equity concerns."[94]

Despite these broad findings, there are two areas that deserve further attention for policy consideration:

1. Measuring the degree to which credit unions serve those of modest means
2. Taxing credit unions that are most similar to banks

Measuring Service to Individuals of Modest Means

In light of the National Community Reinvestment Coalition (NCRC) study and a lack of National Credit Union Administration (NCUA) regulations pertaining to the enforcement of low income community needs on the part of credit unions, it appears that the focus of credit union activity has strayed from its initial purpose of helping people of modest means meet their credit needs. The determination by the NCRC that banks better service the needs of low and moderate income (LMI) neighborhoods suggests that validating credit union growth because of their unique constituency of modest means individuals and households is justified. From this perspective, a Community Reinvestment Act (CRA)-like regulation that ensures credit unions are fulfilling the public purpose of serving individuals of modest means is an appropriate policy to measure credit union compliance.

Selective Taxation of Credit Unions

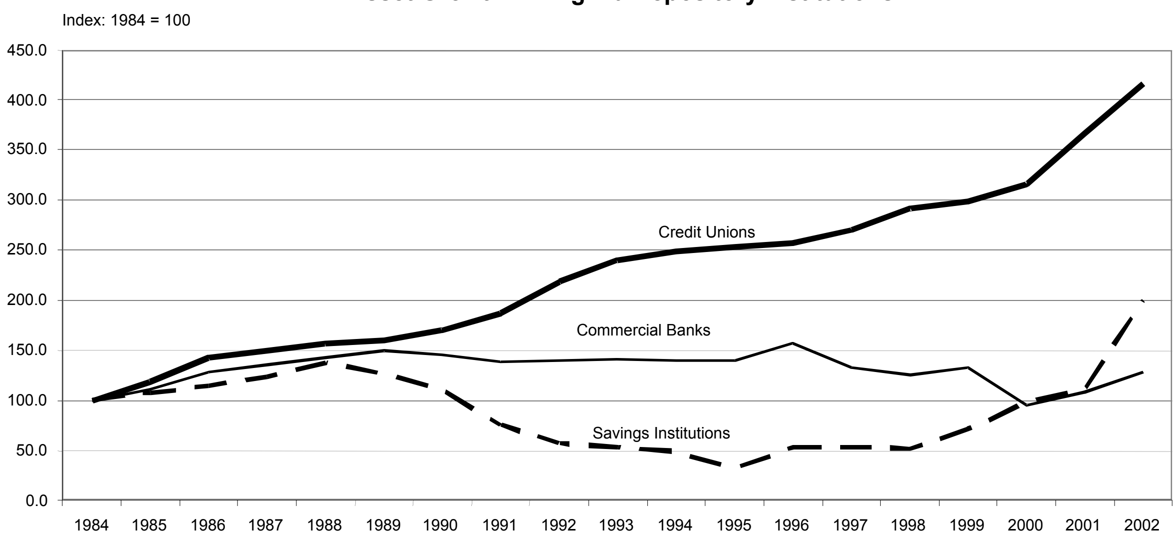
Banks and credit unions are fundamentally different organizations. From that perspective, taxing credit unions across the board is not warranted. However, a segment of credit unions, most notably some of the largest credit unions, and particularly those that have aggressively used multiple and community common bonds to grow, appear to have become indistinguishable from banks. Based on precedent, it appears that some credit unions can fall under the same classification of mutual savings banks: "the exemption of mutual savings banks was repealed in order to establish parity between competing financial institutions."[95] For that reason, CEA recommends further analysis of the largest credit unions to determine if there is "parity between competing financial institutions." If a change in policy causes some credit unions to become subject to taxation, however, they should also enjoy all benefits of banks.

[93] Credit Union Membership Access Act. Pub. L. No. 105-219 [H.R. 1151], Aug. 7, 1998.
[94] U.S. Department of Treasury (2001), p. 2.
[95] U.S. General Accounting Office (1991), p. 291.

Ideally, this study would identify trends in financial institutions in Virginia along with those in the nation. Unfortunately similar data for Virginia are clouded by issues that make comparisons between financial industries difficult, if not impossible. Unadjusted data indicate that credit unions located in Virginia[96] exhibited significantly higher rates of growth, in terms of total assets, than other financial institutions. Unlike the nation, however, savings institutions in Virginia fared better than commercial banks over the past few years. Assets in Virginia credit unions increased 316.2% from 1984 through 2002. Commercial bank assets only gained 28.1% over this period while savings institution assets advanced 100.4%.

Unadjusted Virginia-specific data do not reflect the true growth in financial institutions because of reporting issues that allow the institutions to report assets in states other than those attached to the depositors' residence. Specifically, the savings institution and credit union data each include several supra-regional entities that report their assets in Virginia. Within credit unions, 64% of all Virginia credit union assets are accounted for by the Navy Federal Credit Union and the Pentagon Federal Credit Union. Both of these institutions report statistics for their worldwide operations at their Virginia credit union, which serves as the headquarters. The Navy Federal Credit Union, which is located in Vienna Virginia, for example, lists 2,305,116 members in December 2001 under Virginia. Additional information collected by the CUNA, indicates that only about 380,000 of those members possess Virginia addresses.[97]

Asset Growth in Virginia Depository Institutions



Source: FDIC and CUNA.

In Virginia's savings institution industry, three firms account for the majority of assets. Seventy seven percent of all assets in Virginia-based savings institutions are in Citibank, Federal Savings Bank; E*Trade Bank; and Capital One, Federal Savings Bank. Similar to the credit union, E*Trade Bank and Capital One reflect deposits from around the nation rather than those that are Virginia specific.

Commercial bank data also cross state lines and have become even more difficult to track over time as large headquarters such as Crestar Bank and Signet Bank have been purchased by banks that are headquarter in other states. When these mergers occur, asset-liability operations often shift to the new headquarters along with some of the assets that would have previously been recorded in Virginia.

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96 In this review, credit unions in Virginia include both state and federally chartered credit unions that report headquarter locations within Virginia.

97 This discrepancy occurs because credit unions are not obligated to report data by state. For that reason, they typically report all membership at the 'headquarters' location.

Comparisons of the characteristics of financial institutions in the United States and Virginia in 2002 also underscore the reporting issues with state-specific data. Significant variations from national averages occur with the asset sizes of Virginia-based institutions. The average asset size for Virginia based credit unions is $145 million compared to a national average of $57 million.[98] Virginia's large savings institutions also boost the average asset size of these institutions when compared against the United States. Also, commercial banks in Virginia tend to be somewhat smaller-–$647 million in Virginia versus $890 million in the United States.

[98] Nation-wide credit unions that report assets from Virginia (Navy Federal Credit Union, Pentagon Federal Credit Union) will overstate actual Virginia credit union assets.

Table 12: Characteristics of Virginia Financial Institutions in 2002

	Commercial Banks	Savings Institutions	Credit Unions
Assets	$84.2 Billion	$67.2 Billion	$35.3 Billion
AAR Asset Growth	1.4%	3.9%	8.2%
# Institutions	130	16	243
Average Asset Size	$647,352,946	$4,197,910,625	$145,207,981

Source: FDIC and CUNA.
AAR = annual average rate.

In light of the inability to obtain data that reflect true state-specific trends, this report uses only national data to identify changes in trends between financial institutions.

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Chmura Economics & Analytics (CEA) is a consulting firm specializing in the areas of quantitative research, traditional economics, and workforce and economic development

- ✓ Quantitative research covers a broad range of statistical and econometric applications that help management in decision-making, planning, and realizing goals.
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- ✓ Workforce and economic development includes helping regions asses their current workforce and economic environments with a goal toward devising plans to improve the pace of growth and lift living standards.

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(*Mrs. Bowen is on a leave of absence during her tenure with Governor Warner.)

"… a wise and frugal government, which shall restrain men from injuring one another, shall leave them otherwise free to regulate their own pursuits of industry and improvement, and shall not take from the mouth of labor the bread it has earned. This is the sum of good government, and this is necessary to close the circle of our felicities."

Thomas Jefferson
1801

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