



CUNA & Affiliates

Credit Union National Association, Inc.

601 Pennsylvania Avenue NW
South Building, Suite 600
Washington, D.C. 20004
(202) 638-5777

WRITTEN STATEMENT

OF

HARRIET MAY

PRESIDENT & CEO, GECU OF EL PASO, TX

ON BEHALF OF THE

CREDIT UNION NATIONAL ASSOCIATION (CUNA)

ON

“A REVIEW OF THE CREDIT UNION TAX EXEMPTION”

BEFORE THE

HOUSE COMMITTEE ON WAYS & MEANS

NOVEMBER 3, 2005

EXECUTIVE SUMMARY

INTRODUCTION (Pages 1-4)

Although GECU is a relatively large credit union (by credit union standards), and provides a wide range of services to meet the particular and unique needs of its membership, it is important to understand that it operates under the same philosophy, serves the same function and is organized under the same structural make-up as all other credit unions. It is this fact, repeated by credit unions of all types and sizes across the nation who remain true to their historic purpose and continue to provide the public need, that justifies maintaining the tax-exempt status of credit unions.

This testimony addresses the issues laid out by the Committee for review, including making a strong case that credit unions continue to meet the needs of their members, as envisioned when credit unions were created in the last century. The testimony also refutes many false and misleading statements of the banking industry in its effort to eliminate credit unions as a choice for America's consumers.

HISTORY OF THE TAX-EXEMPT STATUS (Pages 4-12)

The original reason for the credit union tax exemption was based on the cooperative nature of credit unions. Today, credit unions continue to exist as financial cooperatives, and their not-for-profit, tax-exempt status helps to assure that credit unions fulfill their role in the U.S. financial sector.

In fact, this credit union role, as a basis of the tax exemption, dates at least from as early as 1917 in Massachusetts. Since then, the tax exemption has been reaffirmed a number of times, including in 1935, 1936, 1937, 1951 and, most recently, in 1998. The 1951 reaffirmation is significant because in that year Congress repealed the tax exemption for mutual savings banks, specifically because these institutions had strayed from their commitment to mutuality.

However, in 1969, Congress extended the unrelated business income tax (UBIT) requirements of the Internal Revenue Code to cover a broad array of otherwise tax-exempt organizations. State chartered credit unions potentially became subject to UBIT under this action. (Federally chartered credit unions (as federal instrumentalities) were specifically exempt from UBIT.) From the start, this requirement has raised some difficult issues that have yet to be addressed satisfactorily by the IRS, particularly since IRS has never offered its own articulation of the purpose of state-chartered credit unions' federal tax exemption (which we believe is to enable these credit unions to function as not-for-profit cooperatives offering financial services that promote thrift). CUNA continues to work with the Service to clarify this situation.

Contrary to banker rhetoric, credit unions were established to serve the needs of working Americans, allowing them to pool their resources in self-help financial organizations.

This view is rooted in the legislative history of the development of credit unions. In fact, in 1934, a Senate report noted that there was a pressing need “to eliminate the loss of buying power which now results from the fact that the masses of the people are obliged to look to high-rate money lenders in time of credit necessity.” Credit unions were formed to serve these “masses,” and are proud to have 87 million members today.

Never has the asset size of credit unions (which is often a reflection of the number of members a credit union serves) been the basis for considering the imposition of federal income taxation.

Additionally, while credit unions are specifically chartered to serve the needs of individual members, since their earliest days credit unions have provided business loans to those members. In fact, the first federal statute *limiting* federal credit union business lending was enacted in 1998 with the passage of the Credit Union Membership Access Act (CUMAA).

Finally, credit union earnings are the only pot of money that would be taxed at the end of the year. However, these earnings also stand as a cushion to absorb any losses a credit union might incur through changing economic conditions. Taxation would erode what credit unions could build as this cushion and, depending on economic conditions, could even undermine maintaining the net worth required by statute. This cushion not only protects the credit union itself from future challenges, but also protects the National Credit Union Share Insurance Fund.

SERVING THEIR INTENDED GOALS (Pages 12-20)

Recent U.S. Treasury and congressional studies have found that credit unions are, indeed, fulfilling their purpose. The U.S. Department of the Treasury has conducted several detailed studies of credit unions in the last eight years. These objective studies, which were requested by Congress, are exhaustive and present detailed analyses of the credit union system. The studies portray credit unions generally as robust institutions with a specialized structure serving identifiable groups of members.

Meanwhile, in 1998, the Congress wrote in the CUMAA “findings” that there are five characteristics that distinguish credit unions: member ownership, net worth created by retaining earnings, dependence on volunteers, not-for-profit basis of operations, and service only to members.

The CUMAA congressional findings also concluded that credit unions are exempt from taxation because of these characteristics and because credit unions have “the specified

mission of meeting the credit and savings needs of consumers, especially (but not only) (parenthesis added) persons of modest means.”

Credit unions put these characteristics to work every day by serving all of their members, including those of modest means. In fact, recent studies have shown that households using a bank and not a credit union have higher incomes and wealth than do households using only a credit union. Other studies, specifically of data collected under the Home Mortgage Disclosure Act (HMDA), reveal that credit unions are taking advantage of greater opportunities to serve low- to moderate-income members (something they only attained the ability to do broadly within the last 10 years) and disproportionately serve LMI borrowers.

Finally, credit unions of all types remain restricted in who can join – either by community, occupation, association or some other “common bond,” despite rhetoric to the contrary by America’s bankers.

USE OF THE TAX BENEFIT (Pages 21-23)

Credit unions employ the tax benefit by passing it through to their members, primarily in lower rates on loans, lower fees (or none at all) and higher returns on savings. The nation’s 87 million credit union members benefit by \$6.3 billion a year as a result of paying fewer and lower fees and lower loan rates and earning higher rates on deposits compared to banking institutions. This \$6.3 billion is not retained by just a few large stockholders. Instead it is distributed across all 87 million members based on their usage of the credit union. In fact, relatively more of the benefit accrues to lower income members than would be explained by their volume of business at the credit union because credit union pricing tends to be friendlier to lower balance accounts than at banks and alternative financial institutions.

Additionally, there are also significant financial benefits to consumers that are not members of credit unions. Recent studies have shown that bank customers benefit in the aggregate by \$4.3 billion a year as a result of lower loan rates and higher deposit rates at banks as a result of the existence of credit unions. In total then, bank customers and credit union members benefit to the tune of at least \$10.6 billion a year merely because credit unions exist.

CHANGES IN THE INDUSTRY HAVE NOT COMPROMISED JUSTIFICATION OF RETAINING THE TAX EXEMPT STATUS (Pages 23-28)

As member owned institutions, credit unions endeavor to offer products and services that their members need and want. And as technology results in more and better offerings, credit unions must respond to meet their members’ demands, so long as they are permissible by law and regulation. In fact, over the years the National Credit Union

Administration, like the bank and thrift regulators, has on occasion amended its regulations to permit credit unions more flexibility to serve their members better.

However, there is no question that while credit unions may offer products and services provided by banks and thrifts in response to their members' needs, credit unions operate under serious constraints. As concluded by the Treasury in a recent report:

Federal credit unions generally operate within the same legal framework as other federally insured depository institutions. Most differences between credit unions and other depository institutions derive from the structure of credit unions. Credit unions have fewer powers available to them than do banks and thrifts.

Further, the relative size of a credit union, or the products and services it offers, does not affect its mission. Because of their size and efficiency, large credit unions are often more able to provide the benefits of the cooperative to members, such as lower loan rates and fees and higher dividend rates. Larger credit unions are also more able to offer special programs benefiting low- and moderate-income households.

However, none of the core characteristics of credit unions or rationales for credit unions' tax exemption has anything to do with credit union size, field of membership restrictions, the range of services offered, or the extent to which credit unions might not compete with other financial institutions. Instead, they have everything to do with the cooperative structure of credit unions and their mission of providing affordable services to American households, especially those of modest means.

CONCLUSION (Page 29)

It is clear that credit unions play a powerful role in our economy. Credit unions serve people of all walks of life at all economic levels. Credit unions provide the public with a not-for-profit, cooperative alternative to the for-profit sector. Consumers benefit by having access to lower cost services that might not otherwise be available to them, especially those of modest means. And the facts show that the banking industry, which is engaged in an effort to put credit unions out of business, continues to mislead Congress into thinking that their very existence is threatened because of credit unions and their tax status. But banks continue to earn record profits.

Recent oil industry ads in the *Washington Post* illustrate this fact. The ads point out that in fact the banking industry recorded the highest profits of all U.S. industries during the second quarter of 2005—even more than the pharmaceutical industry. While the banking industry continues earning record profits, credit unions provide a nearly 7-to-1 return to consumers on the dollar, benefiting them by over \$10 billion dollars in yearly savings.

Credit unions are an important part of the financial life of American consumers. And the tax-exempt status of credit unions is the glue that holds credit unions and their not-for-profit approach to cooperative financing together. If the tax exemption were removed—if 87 million Americans were forced to pay taxes solely because of their membership in a credit union—it would lead to the end of the movement that we know. Credit unions would become banks, and the consumers would pay dearly, not only in higher taxes, but in higher fees, less return on their savings and borrowings and the loss of a cooperatively owned, not-for-profit alternative in the financial services marketplace.

**WRITTEN STATEMENT
OF
HARRIET MAY
PRESIDENT & CEO, GECU OF EL PASO, TX
ON BEHALF OF THE
CREDIT UNION NATIONAL ASSOCIATION (CUNA)
ON
“A REVIEW OF THE CREDIT UNION TAX EXEMPTION”
BEFORE THE
HOUSE COMMITTEE ON WAYS & MEANS**

NOVEMBER 3, 2005

Good morning, Mr. Chairman, Ranking Member Rangel, and members of the Committee. On behalf of America’s Credit Unions and their 87 million members, thank you for inviting me to testify today on “A Review of the Credit Union Tax Exemption.” I am Harriet May, President and CEO of GECU in El Paso, Texas. I am testifying on behalf of the Credit Union National Association (CUNA), of which I am a member of its Board of Directors. CUNA is the largest of the credit union trade associations, representing over 90 percent of the nation’s approximately 9,000 state and federally chartered credit unions.

GECU (formerly know as Government Employees Credit Union) has served the families of El Paso (TX) County since 1932, when 11 men pooled \$5 each to serve fellow postal workers. Over the years, the credit union’s reputation for providing caring, proactive service to its members has made it the largest locally owned financial institution in El Paso. Today, we serve the needs of over 247,000 members with just over \$1 billion in assets. That equates to just over \$4,000 per member, a rather low number that can be explained by El Paso’s demographic composition.

El Paso’s population is 82% Hispanic with a median household income of just under \$30,000. Nearly 25% of the families live below the poverty level. GECU’s membership demographics mirror that of the community. The credit union serves 247,000 members – a third of every El Pasoan. Just over 43% of our members have household incomes of \$29,000 or below.

With these demographics, GECU has not developed “special” programs to reach the underserved or low income. Rather, we recognize that because the majority of our community and the members we serve are low-income, our day-to-day products and services must be tailored to meet their unique financial needs.

We serve our members’ lending needs with non-traditional products and services:

Consumer Loans

- Ready Credit line of credit – low-balance line of credit for member emergencies and other small-dollar needs. Typical loans range from \$200 to \$800 with the average being about \$500.
- Small dollar loans – GECU continues to make loans to members to meet their needs even if the amount is only \$200. This type of loan would not be considered extraordinary, but rather

“normal” for our membership. It is not atypical to provide a loan for a member to purchase dentures or eyeglasses. For the year 2004, GECU funded 1,329 small-dollar loans for \$518,948, an average balance of only \$390.48. As one member responded in a recent member satisfaction survey, *“Doy gracias porque es el único banco que nos presta dinero en caso de emergencia con bajo interés. Gracias por todo.”* L. Ramirez. (“I give thanks because you are the only “bank” that loans us money in emergencies with low interest. Thank you for everything.”)

- MasterCard First – designed particularly for those needing to rebuild their credit and for individuals desiring to establish credit
- FamilyAccount MasterCard – GECU piloted this product for MasterCard. The card enables the cardholder to allocate spending limits for family members who in turn receive their own card and unique account number which they can use to make purchases up to their spending limit. Primarily designed for college-bound students in El Paso, the product serves another segment of our population--parents and other older relatives. With the Family Account MasterCard, the cardholder is able to provide financial assistance for his or her parents without stripping them of their independence.
- Through July of this year, GECU has funded nearly \$38 million in mortgage loans to El Paso families; 83% of all first lien mortgage loans have been made to Hispanics; 40% of those loans were to households with income less than \$38,400.
- Additionally, through July of this year, GECU has funded nearly \$11 million in mortgage loans through Fannie Mae special programs, “Expanded Approval” and “My Community”, both of which provide additional financing opportunities for low-income families who would not otherwise be eligible.
- GECU has been very active in El Paso City Bond Money programs, providing members with down payment assistance and lower interest rates for homes purchased in targeted areas of town. The credit union won another \$3 million in September of this year and as of October 21 there is already \$1.3 million in the pipeline. The entire allotment would have already been claimed if there weren’t a current shortage of dwellings from which to choose in our community.
- GECU is the predominant provider of vehicle loans in El Paso, having earned a reputation for lower interest rates and finding ways to put members in new vehicles without putting unnecessary burdens on their monthly obligations.

Small Business Loans

- In response to member requests, GECU began offering small business loans to our members two years ago. Based out of the One Stop Business Resource Center in El Paso, staff works with small businesses to provide loans for working capital, expansion and inventory. We work closely with Accion, the Hispanic and Greater Chambers of Commerce, and other not-for-profit organizations dedicated to the success of small business in El Paso.

Deposit Products

- GECU offers Free Checking (no monthly service fee; no fee for excessive check writing).
- We also offer “The No Excuses Savers Club”. This product enables beginning savers to open a 12-month CD with just \$50. The product earns the prevailing 12-month CD rate and allows multiple deposits during the term of the CD (minimum \$10). As of July, we have over 5,362 accounts totaling over \$6 million with an average balance of \$1,129--quite an accomplishment for our typical member, nearly all of which are of modest means.

- We offer a Christmas Club Account that enables members to save for the holidays in a 9-month CD that they appreciate because the money is “off-limits” until it matures. This helps members develop savings discipline.
- IRNet Vigo--GECU was the first credit union in Texas to offer this low-cost alternative for wiring of money, designed especially for credit unions, to foreign countries. Our members especially appreciate being able to send money to their families in Mexico for a fraction of the cost of other wire transfer services.

Financial Education

- GECU offers monthly financial education classes in English and Spanish through the El Paso Affordable Housing Credit Union Services Organization (CUSO). Participants learn the basics about credit and how to apply for a mortgage loan. The CUSO was formed in 2001 by 8 local credit unions to provide education to credit-challenged individuals with the goal of eventually preparing them for home-ownership.
- The credit union also hosts quarterly seminars for first-time homebuyers hosted by our own mortgage loan officers. These seminars are offered in English and Spanish.
 - GECU’s Financial Counseling experts, full-time employees of GECU, educate members about developing realistic budgets and strategies for debt-free living.
- Through year-end 2004, Financial Counselors served 637 members with \$2.8 million in the program.
- GECU also partners with the YMCA with their Consumer Credit Counseling program; YMCA staff works out of one of GECU’s branches to serve families with credit counseling needs.
- GECU works to begin the financial education process early and is active with local Partners in Education programs, Junior Achievement and the CTAC (Career Technology Advisory Committee)
- GECU staff takes the message of financial education to the airwaves as well. Two of our senior managers are frequently asked to appear on a local morning Spanish-language talk show where they provide educational information about financial products and services to listeners.

Being a locally-owned, locally-managed financial institution benefits the community in many ways. The credit union philosophy of “people helping people” is more than a notion, it is our commitment to GECU’s membership and it is evidenced by the credit union’s current loan to deposit ratio of over 98%. Nearly every dollar deposited by a GECU member has been loaned out to another GECU member; the money stays in El Paso and is put back to work for El Pasoans – their families and their businesses.

Mr. Chairman, as the Committee conducts its important oversight function, I wanted to make sure I provided you with the backdrop for my credit union, which, although large by credit union standards, operates under the same philosophy, serves the same function, and is organized under the same structural make-up as all other credit unions.

In that spirit, Mr. Chairman, I welcome the opportunity to assist the Committee in its review of the history and purpose of the credit union tax exemption. The fact is that the credit union tax exemption is one of the best investments Congress has ever made on behalf of the American consumer. Credit unions of all types and sizes remain true to their historic purpose and continue to provide the public need that justifies maintaining the tax-exempt status of credit unions.

My testimony today will address the specific issues you laid out in the Committee Advisory notice. In addressing these issues, I will clearly review the history of why credit unions are tax exempt, as well as make the case that while the nation has undergone many changes in the century or so that credit unions have existed, the need for them continues today and credit unions continue to meet that need. I also will refute the many false and misleading statements of the banking industry in its effort to eliminate credit unions as a choice for America's consumers.

HISTORY OF THE CREDIT UNION TAX-EXEMPT STATUS

The Cooperative Structure of Credit Unions

At the outset, it is important to establish that the original reason for the credit union tax exemption was based on the cooperative nature of credit unions. Credit unions today continue to exist as financial cooperatives, and their not-for-profit, tax-exempt status helps to assure that credit unions fulfill their role in the U.S. financial sector.

The Federal Credit Union Act defines a federal credit union as a cooperative association chartered "for the purpose of promoting thrift among its members and creating a source of credit for provident or productive purposes," language that has not changed since 1934. Cooperative banking was needed because consumers in the 1930's were not typically served by the commercial banking industry but rather by loan sharks. Senator Morris Sheppard, the key Senate proponent of credit union legislation in the 1930's, said in his remarks when introducing the bill that would eventually become the Federal Credit Union Act of 1934:

"A credit union is a cooperative bank...supplying its members with (1) an excellent system for accumulating savings which enables them (2) with their own money and under their own management to care for their own short-term credit problems at normal interest rates with all the resultant earnings reverting to the members as dividends on their savings in the credit union and as surplus."

These words could just as accurately be said today about the nation's 9,000 federal and state credit unions.

The 1934 Senate report on the federal credit union bill stated: "Credit unions also have vast educational values. The fact that credit unions of working men and women, managed by fellow workers have come through the depression without failures, when banks have failed so notably, is a tribute to the worth of cooperative credit and indicates clearly the great potential value of rapid national credit union extension."

Credit unions continue to operate as democratically controlled mutual institutions, serving their members on a non-profit basis. Credit unions do not have separate groups of customers and stockholders with competing interests – obtaining reasonably priced financial services versus assuring good stock prices and returns. Rather than distributing net income among stockholders, most of a credit union's income is returned to members in the form of lower loan rates and fees, or higher yields on savings (and credit union dividends paid to members are, of course, taxed). Some earnings are retained by the credit union to comply with statutorily mandated net worth requirements and as a cushion to anticipate future needs.

So, in spite of revisionist attempts to rewrite history, since its inception, the credit union tax exemption has had nothing to do with the size of a credit union, field of membership restrictions, or the types of services a credit union offers.

Chronology of Credit Unions' Federal Tax-Exemption

The first credit union law was passed by Massachusetts in 1909. Federal revenue laws in 1913 and 1916 contained exemptions for some mutual and cooperative entities, but did not mention these new state chartered "credit unions" by name. Therefore, in 1917 the U.S. Attorney General ruled that Massachusetts credit unions were exempt from federal income tax because:

[O]n examination of the purpose and object of such associations, it appears that they are substantially identical with domestic building and loan associations or cooperative banks 'organized and operated for mutual purpose and without profit' [the Attorney General quoting from the 1916 statute]. It is to be presumed that the Congress intended that the general terms used in Section 11 should be construed as not to lead to injustice, oppression, or an absurd consequence.

The 1917 Attorney General ruling served as the basis for the exemption of state chartered credit unions from federal income taxes until 1951. By 1934 there were over 2,000 credit unions operating in the United States, chartered by 35 states and the District of Columbia.

The Federal Credit Union Act of 1934 allowed the states to tax federal credit unions only up to the maximum rates levied on similar domestic banking institutions.

In June 1935, in response to an inquiry from the Farm Credit Administration, which regulated federal credit unions at that time, the Internal Revenue Commissioner ruled that federal credit unions would be granted exemption from federal income tax.

In 1936 legislation was introduced to prohibit state and local taxation of federal credit unions not based on real or tangible property, and to provide credit unions an exemption from federal taxation. The tax provision that passed in 1937 remains unchanged since that time. Section 122 of the Federal Credit Union Act (12 USC Section 1768) reads as follows:

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...

The arguments in support of the tax exemption were summed up in the 1937 House Committee Report:

Experience with Federal credit unions since the passage of the original [1934] act indicates that the taxation of these organizations in a manner similar to the taxation of domestic banks places a disproportionate and excessive burden on the credit unions...As Federal credit unions are mutual or cooperative organizations operated entirely by and for

their members, it appears appropriate that local taxation should be levied on the members rather than on the organization itself.

At the same time that Congress provided for the federal credit union tax exemption, it designated federal credit unions as fiscal agents of the United States, required to perform whatever services the Secretary of the Treasury required in connection with the collection of taxes and the lending and repayment of money to the U.S. government (Section 121 of the Federal Credit Union Act, 12 USC Section 1767). When designated, federal credit unions can be depositories of public money, and some credit unions today hold federal tax and loan accounts, typically used by employers to deposit periodic payroll taxes due to the U.S. Treasury. This provision of the Federal Credit Union Act led to the formal designation of federal credit unions as instrumentalities of the United States government. This designation as a federal instrumentality is significant in determining which section of the Code governs federal credit unions' tax-exemption and in exempting federal credit unions from the application of the unrelated business income provisions of the Code.

Federal credit unions are exempt under Section 501(c)(1) of the Internal Revenue Code because they meet the three requirements of that subsection of the Code: They are chartered by Congress (through the authority granted to the National Credit Union Administration); they are federal instrumentalities; and the law they operate under (the Federal Credit Union Act) specifically grants an exemption. National banks are also federal instrumentalities, but they are for-profit institutions and Congress has not included in the National Bank Act a tax exemption for national banks.

Mutual Thrifts' Loss of Tax-Exemption

In 1951, the tax treatment of mutual thrifts and credit unions diverged for a very good reason: mutual thrifts had strayed from their commitment to mutuality, whereas credit unions have remained true to that commitment. The Attorney General's 1917 ruling had continued to provide the tax-exemption for state chartered credit unions until 1951. In 1951 Congress repealed the income tax exemption of mutual savings banks because they competed with taxed institutions and because they engaged in widespread proxy voting schemes to control boards. Voting is based on the amount a person has on deposit, not on the basis of one-member-one-vote as is the case with credit unions. This voting system allows a group to control the mutual thrift, and therefore to make business decisions for their own personal pecuniary rewards, not as a not-for-profit organization. The U.S. Treasury stated the following in its 2001 comprehensive report on credit unions:

In 1951, however, Congress removed the thrift tax exemption because these institutions had evolved into commercial bank competitors, and had lost their mutuality, in the sense that the institutions' borrowers and depositors were not necessarily the same individuals.

Although deciding to eliminate the tax-exemption for other mutual financial institutions in 1951, Congress specifically retained the tax-exemption for state chartered credit unions by adding to the list of exempt organizations Section 501(c)(14)(A): "Credit unions without capital stock organized and operated for mutual purposes and without profit." While this Code provision does not specifically reference state chartered credit unions, federal credit unions were exempt from federal income tax since 1937 under Section 501(c)(1), so this subsection only applies to state chartered credit unions.

No credit union issues stock, and therefore no credit union has stockholders. Credit unions have members, called shareholders because of the requirement to purchase a share in the credit union as the indicia of membership *and* ownership. No one can borrow directly from the credit union without becoming a member. Credit unions can only build up capital (“net worth”) through earnings retained after covering expenses, including paying members for their savings through dividends. (Credit union dividends are treated by the Internal Revenue Service for reporting and taxing purposes as identical to interest paid by bank customers on their savings.)

The Federal Credit Union Act assures that mutuality is maintained because the Act mandates the membership requirement and that each member of the federal credit union have one vote to elect the credit union’s unpaid board of directors, regardless of the amount of savings at the credit union. The standard federal credit union bylaws, issued by the National Credit Union Administration, dictate election procedures in conformance to the Act. In short, credit unions’ commitment to mutuality is firmly embedded in the laws governing them.

When, in 1951, Congress determined that mutual savings banks had become competitors with taxed institutions, the thrifts actually accounted for a greater share of household savings deposits than banks did. They were indeed significant competitors with banks. Today, in comparison, credit unions represent only a tiny fraction of the combined deposits of credit unions and banking institutions.

Unrelated Business Income Taxes

Not all credit unions are exempt from all federal income taxes. In 1969 Congress extended the unrelated business income tax (UBIT) requirements of Sections 511-514 of the Internal Revenue Code to cover a broad array of otherwise tax-exempt organizations. State chartered credit unions *potentially* became subject to UBIT. Federal credit unions are not subject to UBIT because federal instrumentalities are specifically exempt from Sections 511-514. It is totally logical that federally chartered credit unions are exempt from UBIT because Congress establishes the powers of a federal credit union in the Federal Credit Union Act and has not authorized any activity that it believes is unrelated to the purpose of a credit union. Federal credit unions are not required by the IRS to file the Form 990 that other tax-exempt organizations are required to file. In response to the banking industry’s call for 990 filings by all credit unions, we wrote to the Ways and Means Committee in July 2004, explaining why such a filing is not required and not necessary for federal credit unions. State chartered credit unions do file 990 forms, either individually or as part of a group 990 form filed by their state regulator or trade association, as permitted by the Service.

From the start, the application of UBIT to state-chartered credit unions raised some difficult issues that have yet to be addressed satisfactorily by the IRS.

UBIT applies to a trade or business regularly carried on by a state-chartered credit union, where that trade or business is not substantially related to the purpose of the credit union’s tax exemption. We believe that the purpose of state-chartered credit unions’ federal tax exemption is to enable them to function as not-for-profit cooperatives offering financial services that promote thrift. However, the IRS has never offered its own articulation of the purpose of the exemption. Without that piece of the puzzle, it is very difficult for credit unions to know what products and services are unrelated to their tax- exempt purpose.

To make matters worse, what little guidance the IRS has issued on this subject over the years has been sporadic, isolated, and contradictory. In the 1970s, for instance, the Service issued a small number of private letter rulings indicating that various insurance products were not subject to UBIT. In 1995, however, the IRS issued another private letter ruling that seems to contradict the earlier ones. Of course, even private letter rulings are of limited utility, as they are regarded as applying only to the organization to which the letter is addressed. Credit unions have been left wondering what to do.

We have tried diligently to address the problem with the IRS. In 1997, CUNA and other credit union organizations formally wrote to the IRS, challenging the conclusion of the 1995 private letter ruling and requesting guidance applicable to all credit unions.

The IRS has yet to respond to our 1997 request for guidance. Several years ago, the Service started to audit dozens of credit unions, questioning if they should be filing a Form 990-T, which is required for any tax-exempt organization with more than \$1,000 of gross income from unrelated business activities. Numerous activities were cited by the field staff as being *possibly* subject to UBIT; the IRS field staff turned to the central IRS office for guidance. We have been discussing this issue with the Service for some time, and we understand that the IRS hopes to provide some guidance to its *own* staff next year.

UBIT is a complicated area, and we think it is unreasonable to expect any credit union to be filing 990-T forms until adequate, public guidance is issued. The IRS Exempt Organization division recently released a listing of its FY2006 plans, which implies that it has possible problems with some state chartered credit unions complying with the UBIT requirements. We are concerned that the IRS may now be planning to hold credit unions responsible for taxes that they could not have known they owed—and that the IRS has yet to articulate a coherent theory of what is and is not subject to UBIT.

Recent Congressional Reaffirmation of Credit Unions' Tax-Exempt Status

In 1998, Congress overwhelmingly approved the Credit Union Membership Access Act, which reaffirmed the tax treatment of credit unions. CUMAA stated:

The Congress finds the following: . . . (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.

Serving Working America

The Federal Credit Union Act was enacted by Congress during the depths of the Great Depression. The law's preamble said the purpose of the legislation was "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."

That fleeting reference to "people of small means" was the only mention of that term in the entire statute. (Many state credit union laws do not mention this term at all.) Bankers cite these few

cryptic words to say that credit unions were chartered to serve only people at the low end of the income scale. As the legislative history indicates, however, **Congress created a national system of credit unions to address the credit and savings needs of working Americans**, allowing them to pool their resources in self-help financial organizations.

In 1934 basically there were rich people, served by the banks that survived in the 1930's, and everyone else who were at the mercy of loan sharks. As the 1934 Senate report on the federal credit union bill stated, there was a pressing need "to eliminate the loss of buying power which now results from the fact that the masses of the people are obliged to look to high-rate money lenders in time of credit necessity." Credit unions were formed to serve these "masses," and are proud to have 87 million members today. The commercial banking industry didn't seem to decide until the 1960's that it could make a profit off of the everyday financial needs of the typical American consumer.

When he introduced his credit union bill in 1934, Senator Sheppard cited the success of the 2,200 state chartered credit unions: "While these credit unions...are managed by the working people and the farmers who compose them, they have come through 3 years of extreme depression with practically no failures, establishing the finest record ever established by any form of banking in times of similar stress....This bill is offered as a substantial contribution to a better banking system for average city workers and farmers. It would greatly stimulate the spread of a form of cooperative banking, which has met every test of the depression successfully."

Senator Sheppard in his introductory remarks cited the success of state chartered credit unions composed of: postal workers; railroad workers; city employees; telephone workers; members of the National Grange; and the American Legion. Looking at the largest credit unions today, they are based on similar memberships composed of: America's military services; federal, state and local government employees; airline transportation employees; utility company employees; and so forth. The common denominator of the credit union member of the 1930's and the credit union member of the 21st century is he or she is part of working America. Morris Sheppard, Wright Patman and the other members of Congress who advocated in the 1930's the development of a national credit union system would be very proud to see their handiwork today.

Credit union charters based on community, associations or employment existed prior to 1934, and the new Federal Credit Union Act also recognized these various types of charters. However, charters based on employee groups were by far the most viable because they consisted of people who were employed and were the easiest to organize into a critical mass of participation. Therefore, most credit union charters issued in the decades following 1934 were for employee groups. Obviously, the U.S. economy has changed in 70 years. In the 1930's, one in five U.S. workers was employed on farms; today, that ratio has fallen to one in forty. In the 1930's, the service sector accounted for only one-third of the workforce; today it represents more than 80% of all workers, many working for small businesses. It was not until the early 1980's -- faced with a serious recession, a changing workplace, and the threat to safety and soundness both to individual credit unions and the National Credit Union Share Insurance Fund (created in 1970) -- that many credit unions began to change to multiple employee group charters or community charters.

The asset size of a credit union, which is typically a reflection of the number of members a credit union serves, also has never been and should never be the basis for considering the imposition of federal income taxation. Interestingly, Roy Bergengren, a founding father of the U.S. credit

union movement, testified to the Senate Banking Committee in 1933 that in some states some credit unions “are now bigger than the average bank in the State.”

Serving Member Businesses

Some people are of the mistaken belief that credit unions did not get the authority to offer business loans until the passage of the Credit Union Membership Access Act in 1998. On the contrary, credit unions have offered what we now think of as business loans from their earliest days. In fact, CUMAA *limited* for the first time by statute how much business lending a federally insured credit union can do. Until NCUA issued a member business loan regulation in 1987, the only restriction on business lending by a federal credit union was found in its bylaws.

It was no secret to those involved in passage of the Federal Credit Union Act in 1934 that business loans were commonly made by certain credit unions, depending on their field of membership. Roy Bergengren said to the Senate Banking Committee in 1933 that credit unions promote: “...the public good by developing thrift through the credit unions, solving the short-term credit problems of the worker, *the small business man*, and the farmer, freeing them from the usurious money lenders and teaching sound economic lessons at a time when such teaching is very essential” (emphasis added).

In fact, **the 1934 law said that federal credit unions’ purpose was “creating a source of credit for provident or productive purposes.” This language anticipated that business loans would be made by federal credit unions, since state chartered credit unions had been making business loans since first chartered in 1909.** For instance, here is a Boston advertisement from around 1912:

The Industrial Credit Union encourages borrowing by its members, when it will enable them...(2) To become established in business. *Examples:* The purchase of tools for a mechanic. The giving of sufficient credit to a member to enable him to start a business where he must put out money for wages, bonds, running expenses, etc. The buying for cash of plant, good-will or stock in trade.

Roy Bergengren documented in 1923: A loan for a World War I veteran to start a junk business; a loan to another veteran to buy a truck to fix machines; a loan to a widow to buy stenography equipment; and a loan to a man to buy a variety store in his neighborhood with follow-up loans for improvements and goods. In 1924, in a meeting seeking to organize financial cooperatives, the keynoter said a basic need in obtaining federal legislation is to make loans for “thrifty or productive use; that is, primarily for purposes that will enable borrowers to repay their loans out of the increase of that for which money is spent.”

A 1927 study on “Why Workers Borrow: A Study of Four Thousand Credit Union Loans,” published by the federal government in its “Monthly Labor Review,” found that about 8% of the loans were to “small business men who needed help to tide them over a dull period or to expand when their business seemed to warrant it. Many of the shopkeepers also borrowed in order to make cash payments on stock when they could buy it more cheaply that way.”

In responding to NCUA’s 1986 proposal to impose restrictions on business lending by all federally insured credit, those credit unions making business loans provided many examples. (Of course, then as now, only certain credit unions engage in business lending, depending on their

fields of membership.) Here are a couple of examples from the mid-1980's of the types of business loans being made by credit unions at that time:

- Northeast Community Federal Credit Union in San Francisco: Loans to immigrants to open small businesses in the changing "Tenderloin" area of the city.
- Santa Cruz Community Credit Union in California: Between its founding in 1977 and in 1985, approximately \$12 million of its \$20 million in loans were made for business purposes (many for less than \$25,000). Example: A business loan to a small local newspaper for capital expansion.

So contrary to any belief that Congress intended that credit unions be precluded from making business loans to its members as a condition of being tax-exempt organizations, **the record clearly shows that for 25 years prior to the enactment of the Federal Credit Union Act in 1934 and for the 70 years after its enactment, certain federal and state chartered credit unions have been an important resource for member business loans.**

Credit Unions Are Unique Among Cooperatives

Credit unions' earnings are the pot of money that would be taxed at the end of the year. Taxation would erode what credit unions could build as a cushion and, depending on economic conditions, could even undermine maintaining the net worth required by statute. This cushion not only protects the credit union itself from future challenges, but also protects the National Credit Union Share Insurance Fund. Because the full faith and credit of the United States stands behind the NCUSIF, ultimately the American taxpayers pay if serious problems arise in the financial market place. This is what happened when the federal government had to spend billions of dollars to clean up the savings and loan industry debacle of the 1980's.

Although both the NCUSIF and the Federal Deposit Insurance Corporation (which insures bank deposits) are backed by the U.S. government, only the NCUSIF requires the institutions it insures to deposit an amount equal to 1% of their federally insured funds with the U.S. Treasury *and* to replenish the 1% from their retained earnings if financial troubles throughout the system require large NCUSIF payouts. As credit unions grow, they are required to contribute more to maintain their 1% deposit in the NCUSIF, and the added dollars count toward the federal government's deficit reduction. Therefore, the unique NCUSIF capitalization system relies on well-capitalized credit unions that can transfer funds to the NCUSIF in case of systemic problems. The FDIC insurance program has no such safety net before it turns to the Congress for appropriated funds.

Other cooperatives don't have the full faith and credit of the United States ultimately standing behind their ventures. Fortunately, credit unions by their very nature – volunteer-lead, non-stock cooperatives – are conservatively run because there is no personal pecuniary interest in taking risks with other people's money, a key credit union distinction from both stock and mutual banks. It would be counterproductive to tax credit unions, thereby encouraging them to run up expenses and otherwise reducing their net income subject to tax.

Although estimates of taxing credit union indicate that that about \$1.5 billion a year would be collected by the federal government, these estimates apparently don't take into account fundamental changes that inevitably would be made in credit union operations if taxed. For example, there are 150,000 people who volunteer their services by serving on credit union boards and committees to further the not-for-profit mission of their credit unions. The Federal Credit

Union Act prohibits all but one volunteer from being compensated, and for the few federal credit unions that provide any “compensation,” it is nominal. Some states allow board compensation, but again any compensation received by board members in those states typically is quite nominal, if provided at all.

Since any compensation paid by a taxable organization is a deductible expense, the question would quickly arise if a credit union were taxed, “Why not pay people who serve on boards of directors, supervisory committees, credit committees, and other committees of the credit union?” This would lower the taxes due, but also undermine a credit union’s fundamental philosophy, “People Helping People.” And anyone serving in any position for other than nominal compensation is certainly driven by different motives than those who are volunteering their services.

ARE CREDIT UNIONS SERVING THEIR INTENDED GOALS?

Treasury and Congressional Findings: CUs Fulfill Their Purpose

The U.S. Department of the Treasury has conducted several detailed studies of credit unions in the last eight years. These objective studies, which were requested by Congress, are exhaustive and present detailed analyses of the credit union system. The studies portray credit unions generally as robust institutions with a specialized structure serving identifiable groups of members.

One of the most comprehensive studies, “Comparing Credit Unions With Other Depository Institutions,” was issued in 2001. (The link to the study is: <http://www.treas.gov/press/releases/reports/report30702.doc>.)

In that study, the Treasury Department was asked to analyze, among other issues, the “potential effects” of imposing federal tax laws on credit unions in the same manner as they are applied to banks and other financial institutions.

As part of its review, the study examined the history of the tax treatment of credit unions, including Congress’ rationale for the credit union exemption. The Treasury Department concluded (on page 28 of the report):

Thus, the tax exemption was based primarily on the organizational form of credit unions....

The study observed that credit unions have grown larger in recent years and have expanded the list of products and services they offer their members. Nonetheless, drawing on the Credit Union Membership Access Act (CUMAA, P.L. 105-219) and a 1997 Treasury report, “Credit Unions,” the study concluded, remain “clearly distinguishable from” banks and thrifts in their organizational and operational characteristics. Such characteristics are:

- Credit unions are member-owned and each is entitled to one vote in selecting the credit union’s board and in other decisions.
- Credit unions do not issue capital stock but create net worth by retaining earnings.

- While some credit unions have the legal authority to have paid employees or other paid directors serve on their boards, credit unions depend on volunteers elected by their members to serve as directors.
- Credit unions are not-for-profit and all earnings are either retained as net worth or returned to the members in the form of lower loan rates, dividends or interest on savings, bonus dividends or similar uses.
- Credit unions may “only accept as members those individuals identified in a credit union’s articulated field of membership.”

The study noted that while other types of institutions may exhibit one or more of these characteristics, only credit unions exhibit all five together.

Section Two of the congressional findings of CUMAA -- legislation enacted in 1998 to overturn the Supreme Court’s ruling on field of membership -- lists these same attributes as the distinguishing factors a credit union embodies.

The CUMAA congressional findings also concluded that credit unions are exempt from taxation because of these characteristics and because credit unions have “the specified mission of meeting the credit and savings needs of consumers, especially (but not only,) *(parenthesis added)* persons of modest means” .

Congress further found, after probing hearings in the House Financial Services Committee and Senate Banking Committee, that the credit union movement in the United States began as a “cooperative effort to serve the productive and provident credit needs of individuals of modest means.”

Congress further stated in its findings that “Credit unions continue to fulfill this public purpose....”

Service To All Members, Including Those of Modest Means, Is the Hallmark of Credit Unions

I began this statement by listing some of my own credit union’s services. Credit unions all across the country undertake considerable efforts to serve the financial needs of individuals of modest means. These programs include pro-consumer check cashing and other services that provide alternatives to payday lending; beneficial savings plans; financial counseling; financial management workshops; special home mortgage and other tailored lending programs; and partnerships with community organizations that serve low and moderate income families.

These initiatives are in addition to the favorable loan and savings programs credit unions routinely offer their members. Many credit unions will open a share certificate or savings account for \$100 or less and will grant a member a loan for a similar low amount – a practice that is virtually unheard of at other financial institutions. In addition, a number of credit unions provide technical support, training, equipment, financial or other assistance to credit unions that serve predominantly low and moderate income areas.

Throughout most of their history, credit unions have actually been hamstrung in their efforts to serve members of modest means because field of membership rules generally restricted eligibility to occupational groups. It is only in the past couple of decades that smaller employee groups became eligible for credit union service, and even more recently that community charters became relatively accessible for credit unions. Then just five years ago, the National Credit Union Administration adopted an expedited program known as Access Across America to permit federal credit unions to add underserved areas to their fields of membership. Since the beginning of 2001, over 92 million potential members from underserved areas have been added to credit union fields of membership. Credit unions acknowledge it will take some time to reach out to and serve members in these communities. However, in the three years ending December 2003, credit unions that added such underserved areas experienced membership growth over three times that of other credit unions (17.4% vs. 5.2% over the three year period.)

The study, "Who Uses Credit Unions," (Lee, Jinkook, University of Georgia and Kelly, Jr., William A., University of Wisconsin-Madison) which was updated in 2004, clearly shows that households of modest means, as well as households in other income categories, rely on credit unions to meet their financial needs. The study was based on the Survey of Consumer Finance that is sponsored every three years by the Federal Reserve Board.

Among other things, the study reviewed the median net financial wealth of households, which it defined as total financial wealth less credit card and other unsecured debt. This included deposit accounts, mutual funds, securities accounts, savings, insurance, cash and other financial assets.

The study found that households that use banks exclusively have a median net financial wealth 2.7 times as much as households that use a credit union exclusively. The median net financial wealth for a credit union household was \$7,900. The average annual income for households that use credit unions only for their financial needs was \$42,662 compared to \$76,923 for households using banks only. Income could include wages, salaries, interest income, unemployment compensation, child support, alimony, welfare assistance and pension income.

The study's findings squarely refute the charge that bank customers are less affluent than credit union members. "Households using a bank and not a credit union have higher incomes and wealth than households that use only a credit union," the study points out.

The methodology of the study is significant because unlike other studies, it reviewed consumer financial institution affiliations based on five categories: households that use banks only and are not members of a credit union (56% of the households); households that use both banks and credit unions, but primarily use a bank (16%); households that use both banks and credit unions but primarily use a credit union (12%); households that use a credit union only (8%); and those that use neither banks nor credit unions (6%).

The use of this model allowed the study to overcome the deficiencies in other studies on credit union membership that compare credit union members with non-members or compare credit union members with bank customers.

The study also found:

At the top income brackets, we see a very high use of banks only, which suggests that banks are particularly successful in gaining the entire business of these households. However, households in the top income brackets seldom use a credit union only. For example, in the \$100,000-\$200,000 income category, households are 23 times more likely to use only a bank than only a credit union and households with income over \$200,000 are 68 times more likely to use only a bank than only a credit union.... Further among those that use a bank only, median net financial wealth is higher than among households that use a credit union.

The latest report from the Federal Reserve Board on Home Mortgage Disclosure Act (HMDA) data (December 2004) also demonstrates credit unions' service to those of modest means.

The HMDA data set provides a wealth of information on mortgages by type of loan (such as refinancing and conventional loans) and the socioeconomic characteristics of the applicant. The data provides information on loan approvals and denials. It also shows the proportion of approved loans that were actually granted.

The HMDA data over the past three years, ending in 2004, shows:

- A rising proportion of mortgage loans originated by credit unions are to low-to-moderate income (LMI) borrowers (those whose household income is at 80% of median or less).
- As a result, in 2003 and 2004, a greater proportion of credit union mortgage loans were made to LMI borrowers than at other lenders.

PROPORTIONS OF MORTGAGES ORIGINATED TO LMI BORROWERS

	2002	2003	2004
Credit Unions	24.3%	25.4%	27.6%
All Other Lenders	26.2%	25.4%	26.6%
CU – Others	-1.9%	0.1%	1.0%

This is firm evidence that credit unions are taking advantage of greater opportunities to serve LMI members and disproportionately serve LMI borrowers.

In addition to the core fact that credit unions make a greater portion of their loans to LMI borrowers than other lenders do, there are a number of other indicators in the HMDA data that demonstrate greater credit union service to LMI borrowers. While credit unions serve a greater proportion of LMI borrowers than do other lenders, they also provide more favorable treatment to LMI borrowers compared to their treatment from other lenders.

Credit unions understand and appreciate that they have a special purpose in helping to meet the financial needs of individuals of modest means. Not only is the regulatory environment more conducive to outreach, but also CUMAA facilitates credit union expansions to serve the underserved. Key data already indicate credit unions provide important service to individuals ignored or shunned by other institutions and there is every indication that future data will reflect the ever growing efforts of credit unions to serve those of modest means.

In fact, just three days ago, here in Washington a group of credit unions announced a near billion-dollar new mortgage program targeted specifically at our lower income members. This program has been under development for the past year. Under the program, which we are calling Home Loan Payment Relief (HLPR, pronounced “helper”) credit unions will make loans to borrowers with incomes at or below the local area median at rates that are a full percentage point below market for the first three years of the loan. After that, the rates will adjust to market on an adjustable basis, with yearly limits on the increase of 1% and a lifetime cap of 5%.

With the initial rate discount, credit unions are essentially giving up their normal net income from these loans. The program will enable thousand of modest means credit members to buy their first house, without exposing them to the severe risks of such exotic loans as short-term adjustable interest only loans. We expect this program to grow to over \$10 billion over the next several years.

Field of Membership as a Defining Characteristic of Credit Unions

Since their inception, credit unions have had limitations on whom they could serve. Historically, these limitations had nothing to do with the tax exemption. But this is an appropriate occasion to address some issues raised by the banking industry about field of membership.

A credit union’s field of membership represents the persons, organizations and other entities to whom and which a credit union may legally provide its services. At the federal level, a credit union’s field of membership may be occupational -- based on employment by the same or related businesses; associational -- based on membership in the same association; multiple group -- comprised of more than one group; or based on one or more communities. Each group within a credit union must have a common bond, which is the characteristic that distinguishes the group from the general public. There are a number of other statutory and regulatory restrictions that apply, regardless of the type of field of membership a credit union chooses.

Some would have this Committee believe that field of memberships have become so broad that virtually anyone can join any credit union. That is far from the case. As a resident of El Paso, I cannot join a credit union with a community charter in New York, regardless of how large that community might be. As a credit union CEO, I cannot join Navy Federal Credit Union, and my colleague from Navy Federal cannot join GECU.

At the same time, comments from then NCUA Board Chairman Dennis Dollar help illustrate why reasonable field of membership expansions and the capability to add new groups is so essential to credit unions.

We have lost more credit unions, and particularly small credit unions, because of lack of diversification of field of membership than any other reason. If we are going to be effective with risk-management in our credit unions, if we are going to be effective enabling credit unions to diversify their risk to where the closing or downsizing of a sponsor does not take away what would otherwise be a strong and functioning credit union, we must have diversification in our field of membership within the bounds of what the law allows.

Consistent with the bankers' record of attack, several issues remain the subject of their criticism. One relates to the misconception that CUMAA only permits groups of 3,000 or less to be added to an existing credit union. This is inaccurate.

Groups with 3,000 or more members are eligible to join an existing credit union if the NCUA determines in writing in accordance with guidelines and regulations that the group would not be financially viable and is unlikely to succeed as a new single common bond credit union. (S. Rept. 105-193)

Another issue is how NCUA views "local" as the term applies to the area a community credit union may serve. The fact remains that Congress specifically authorized NCUA to prescribe a regulation defining "well-defined local community" for credit unions that seek to serve a community. NCUA was given this task because it has the relevant expertise developed over decades of implementing field of membership issues.

Community credit unions must meet all legal requirements, including being well-defined by specific geographic boundaries. Under NCUA's policies, "If NCUA does not find sufficient evidence of community interaction and common interests...additional documentation will be required" in order for NCUA to assess whether the community exists and may be rejected if all requirements are not met.

Additionally, community credit unions must develop a detailed and practical business plan. The plan must "focus on the accomplishment of the unique financial and operational factors of a community charter. Community credit unions will be expected to regularly review and to follow...the business plan" which is also subject to review by NCUA examiners.

As NCUA Board Chairman JoAnn Johnson stated, NCUA follows three standards when implementing policy: it must be thoroughly consistent with CUMAA; it must comply with recognized and historical safety and soundness standards; and it must be implemented with a minim amount of paperwork and unnecessary regulatory burden.

In responding to Congress's directive to prescribe requirements for "well-defined local communities" that is exactly what NCUA has done.

As stated by then NCUA board Member Debbie Matz when the changes to the agency's field of membership policy were adopted:

I am cognizant of the fact that the statute requires that a proposed community credit union must comprise "a local community, neighborhood, or rural district." I have given a great deal of thought to the concept of "local community" and what that really means in the year 2003. I have concluded that times have changed and so has the concept of local community. Years ago this might have been the neighborhood in which one lived and worked – perhaps a few city blocks or a town. In this age of advanced communications, accessible public transportation and highway systems and regional shopping malls and business centers, the larger community charters permitted in this regulation are not, in my opinion, inconsistent with the statutory requirements.

Further, I have concluded that size, in and of itself, should not be a factor in determining the validity of a field of membership. It is a commitment to the credit union philosophy of people helping people. This is what credit unions are all about. I believe that one of the distinguishing characteristics of credit unions is the wide array of affordable financial services they offer: \$200 loans to a family to prevent their electricity from being turned off; risk-based lending as an alternative to payday loans; branches in very-low-income neighborhoods; and world-class financial literacy programs. Under this rule, the size of a community is no longer the primary focus. Our attention would shift to the real issue – how the credit union would serve everyone in its field of membership.

Perhaps most importantly, larger fields of membership will permit more people to join a credit union and I think that is a really good thing. This (change) will permit credit unions to make their services available to some of the 56 million people who do not have accounts in insured financial institutions.

Despite rhetoric to the contrary, credit union membership has demonstrable limitations. Nonetheless, as recognized by GAO, the Treasury and others, CUMAA contains a number of provisions that authorize credit union membership growth and expansion. NCUA's obligation as the regulatory agency charged with implementing these provisions is to permit credit unions to utilize the full extent of the field of membership authority granted to them by Congress, which the agency seeks to do. Any less from NCUA would be abrogating the responsibilities bestowed on it by Congress.

None of this has the slightest bearing on the tax exemption issue.

Credit Union Member Business Lending Meets A Need that is Not Being Fulfilled Elsewhere

Based on data from the Small Business Administration (SBA) and elsewhere, credit unions that engage in member business lending often fulfill borrowing needs that are not being met by other institutions. Nonetheless, credit union opponents often focus their criticisms on member business lending activities.

Under CUMAA, the Department of the Treasury was requested to review a number of issues relating to credit unions' member business lending. This included examining the extent to which member business lending helps to meet the financial needs of low and moderate income individuals. The study also considered whether credit unions that engage in member business lending have a competitive advantage over other financial institutions.

In January 2001, the Treasury issued its report, which indicated then, as is the case now, that **member business lending is consistent with the purpose of credit unions; it does not represent the competitive concern that banks claim** it does; and it is an activity for credit unions that is **consistent with safety and soundness**.

Under NCUA rules and statutory requirements, a member business loan (MBL) is a loan, line of credit, or letter of credit under which the borrower uses the proceeds for commercial, corporate, business investment property or venture, or agricultural purposes. Loans fully secured by 1-4

family residences and loans the total of which to an individual are less than \$50,000 are excluded. As part of CUMAA, credit unions must limit their MBLs to the lesser of 1.75 times net worth or 12.25 percent of total assets. These limits were first imposed in 1998.

In its study, the Treasury found that 25 percent of the credit union member business loans were made to members with household incomes of less than \$30,000. Another 20 percent of credit union member business loans were to households with incomes between \$30,000 and \$50,000. The study also indicated that member business lending does not pose a material risk to the National Credit Union Share Insurance Fund.

The Treasury added:

“Business lending is a niche market for credit unions. Overall, credit unions are not a threat to the viability and profitability of other insured depository institutions.”

A major reason for the Treasury’s conclusion is that credit unions share of business loans is less than 1 percent of the market. Only about 1,780 credit unions make member business loans, an increase of about 170 credit unions from 1995. Also, the average size member business loan at a credit union is around \$155,000. A 2002 survey conducted by the American Bankers Association showed that only 4% of commercial banks viewed credit unions as their primary competitors in business lending or other business financial services.

“Banks still dominate SBA lending,” the *American Banker* newspaper reported on October 27, 2005. “More than a dozen banking companies make more loans on their own than all credit unions combined in fiscal 2005. Bank of America Corp., for example, made nearly 12,000 worth \$413 million.”

Citing the need for lenders to make more, small business loans, the SBA has encouraged credit unions to participate in its 7(a) lending program. Currently 103 credit unions make loans through that program; the average loan size is around \$109,000.

Treasury Secretary John Snow has also encouraged credit unions to provide member business loans. In February 2004, the Secretary appeared before the CUNA Governmental Affairs Conference and commended credit unions:

Small business is at the foundation of this great economy, and credit unions have been there for entrepreneurs when they needed you the most. As of last year, credit unions were welcomed into the SBA lending programs, and I hope that has helped out both you and America’s entrepreneurs as much as this Administration hoped it would. You know as well as I do: small business is where the jobs come from. We estimate that between two-thirds and three-quarters of recent net new jobs are coming from that sector. That’s why we want to make small business tax cuts permanent, and that’s why I want to commend the credit union community for financing America’s hard-working small-business owners!

In February of this year, the Secretary reiterated his support:

You do good work. Loans to small business, home mortgages, financial education and fighting the financial war on terror... each one of these efforts is critical to

our country's economic health and strength, and I applaud you for doing good while you do business. We don't want less small business lending.

Yet, that is exactly what banker groups envision for credit unions, making fewer member business loans. If that happens, it won't just be credit unions and their members that are harmed, but the small business community and the economy.

USE OF THE TAX BENEFIT

There are significant financial benefits to members. The nation's 87 million credit union members benefit by \$6.3 billion a year as a result of paying fewer and lower fees and lower loan rates and earning higher rates on deposits compared to banking institutions. This \$6.3 billion is not retained by just a few large stockholders. Instead it is distributed across all 87 million members based on their usage of the credit union. In fact, relatively more of the benefit accrues to lower income members than would be explained by their volume of business at the credit union because credit union pricing tends to be friendlier to lower balance accounts than at banks and alternative financial institutions. For example, in 2004, considering a basic checking account, 79% of credit unions had a no fee account compared to only 32% of banks. Further, at those credit unions charging a fee, the monthly average was less than half the average fee charged by banks, \$4.21 compared to \$8.56. Finally, the average minimum balance required to avoid the fee at a credit union was \$486, less than a third of the average fee-avoiding minimum at banks of \$1,645. Clearly, lower income members receive significant benefits from their access to credit union service.

There are also significant financial benefits to consumers that are not members of credit unions. Based on the work of Professors Robert Tokle of Idaho State University and Robert Feinberg of American University, and also based on research from the Board of Governors of the Federal Reserve, bank customers benefit to the tune of at about \$4.3 billion a year. This is the result of lower loan rates and higher deposit rates at banks as a result of the existence of credit unions. The effect of credit union presence on bank fees has not been estimated, but undoubtedly would add to the \$4.3 billion annual benefit to bank customers.

Although bank customers benefit because of the existence of credit unions, other financial institutions continue to thrive in the presence of credit unions. The FDIC recently reported that banks recorded record profits for the fourth year in a row.¹ Aggregate bank return on assets (ROA) has exceeded 1% for the past 12 years, averaging 1.23%. And credit unions are only growing marginally faster than banks. In the decade ending in 2004, total banking institution assets grew at a compound annual rate of 7.25% compared to 8.4% for credit unions. Credit unions now account for 6.2% of the combined assets of all depository institutions. At the growth rates of the past decade, it will take until the year 2053 for the credit union share to climb to just 10%.

The health of the banking industry over the past decade has not been confined to just large banks. In a 2003 conference, Federal Reserve Gov. Mark Olson said: "The year that just ended was one

¹ Federal Deposit Insurance Corporation, *Quarterly Banking Profile, Fourth Quarter 2004*.

of record profits for the industry as a whole, and for community banks in particular...Community banking has a long history of strength and success and a bright future. The past year was a good one for community banks. Once again the vitality and adaptability of the community banking franchise were amply demonstrated."² Two Federal Reserve economists have recently described the strong performance of the nation's smaller banks. They

found that "small banks have grown considerably more rapidly than large banks and have tended to meet or exceed them in some measures of profitability."³

In total then, bank customers and credit union members benefit to the tune of at least \$10.6 billion a year. That is seven times the amount of revenue that would result from the taxation of credit unions. The tax exemption is leveraged in this way because of the cooperative structure of credit unions. When comparing banks to credit unions, the amount that banks pay in dividends to stockholders is more significant than is the tax exemption. Further, credit unions pay very little compensation to directors, with the savings passed on to members. Finally, credit unions' ratios for expenses and loan losses compare very favorably to similarly sized banks.

Society benefits in a number of ways from the tax exemption of the nation's not-for profit credit unions. Both members and nonmembers benefit from the existence of credit unions. Part of that benefit stems from having a sector of the financial services industry with the provision of service to the less fortunate in our society as an integral part of their strategic mission. This benefits the nation's modest means households both directly through credit union services and indirectly by serving as an example to other financial service providers. In addition, the taxpayer is provided considerable protection from risk of loss to the National Credit Union Share Insurance Fund by virtue of the tax exemption. Credit unions also provide an important source of loans to America's small businesses at a time when credit from other sources is becoming less available.

Removing the tax exemption of credit unions would so change the structure of the industry that within a few years, most credit unions would either have become banks or would be operating very much like banks. That would result in a significant loss of benefits to the nation's 87 million credit union members.

Credit union members benefit both financially and non-financially by virtue of their membership in a credit union. In terms of non-financial benefits, they have the opportunity to belong to and participate in a democratically controlled financial cooperative. Further, they may volunteer to participate in the governance of their financial institution. Crucial to credit unions is the control exerted by the over 150,000 volunteers who serve on boards and committees. Credit unions are also known for offering consumer education and financial counseling services that would be threatened under taxation.

Evidence of the consistently strong level of member focus at credit unions is found in the results of the annual *American Banker* newspaper survey of financial institution customers. Credit union members have for 21 years in a row given credit unions higher satisfaction ratings than bank customers give banks. The cooperative structure really does make a difference.

² Comments before the 2003 Chicago Federal Reserve Bank Conference: Whither the Community Bank?

³ William F. Bassett and Thomas F. Brady. *The Economic Performance of Small Banks, 1985-2000*. Federal Reserve Bulletin, November 2001.

The tax exemption also serves to protect taxpayers from losses to the share insurance fund. There are two important connections between the stability of NCUSIF and credit unions' tax exemption. First, the primary buffer for a deposit insurance system is the capital or net worth maintained in insured institutions. Because credit unions have no access to capital markets, their only source of capital is the retention of earnings. A tax on net income would thus disincent credit unions from retaining earnings, weakening protection for the NCUSIF. In fact, the cost to the taxpayer of FSLIC's losses far exceeded the total taxes paid by FSLIC insured institutions prior to FSLIC's failure.

Second, as cooperatives, credit unions have a systemic inclination to avoid risky activities. Kane and Hendershott have shown that the cooperative structure of credit unions presents credit union decision makers with incentives that are strikingly different from those faced by a for-profit financial institution, making it less feasible for credit union managers to benefit from high-risk strategies.⁴ This is an especially useful trait for federally insured depository institutions.

Credit unions have a long history of providing business loans to their members, although such loans represent a small portion of the portfolio for most credit unions. However, at a time when research published by the Small Business Administration finds that consolidation in the banking industry is reducing credit access for small business, the credit access provided by credit unions is even more important.

Society benefits in a number of ways from the existence of cooperative, not-for-profit credit unions. These benefits would gradually disappear were credit unions subject to federal income tax. Credit union regulation, which is much more restrictive than that for other financial institutions, includes: limits on who the credit union can serve, limits on business lending, lack of access to capital markets, etc. The tax exemption is the incentive that encourages credit union CEOs and boards to continue to operate as credit unions rather than throwing off the restrictions by converting to a bank charter. Such conversions would only limit the range of choices available to America's consumers, especially those of modest means.

CHANGES IN THE INDUSTRY HAVE NOT COMPROMISED JUSTIFICATION OF RETAINING THE TAX EXEMPT STATUS

Credit unions have undergone changes similar to other industries over time. With new technology, the advent of new products and services, credit union members have demanded that their credit unions provide them with access to all the benefits of a modern financial service provider. Credit union membership trends have changed during this time as well. Historically, credit unions were employer based, but with changes in the economy and the closure of many plants, credit unions found ways to continue serving their members, most recently by converting to geographically based memberships that the Federal Credit Union Act has made possible since 1934. But one thing has remained constant—the structure of a credit union and its intense focus on providing its members a not-for-profit alternative with personal service.

⁴ Edward Kane and Robert Hendershott, *The Federal Deposit Insurance Fund that Didn't Put a Bite on U.S. Taxpayers* Journal of Banking and Finance, 20(September, 1996), pp.1305-1327.

Credit Union Products and Services Remain Comparatively Restricted

As member owned institutions, credit unions endeavor to offer products and services that their members need and want. And as technology results in more and better offerings, credit unions must respond to meet their members' demands, so long as they permissible by law and regulation.

Over the years, NCUA, like the bank and thrift regulators, has on occasion amended its regulations to permit credit unions more flexibility to serve their members better. For example, in 2001 NCUA included in its rules a list of activities that federal credit unions may engage in that are incidental to their authority to operate as a credit union. Such activities encompass electronic financial services and loan-related products. While some have sought to portray the rule change as too liberal, in essence the incidental powers rule codified activities that NCUA had already permitted credit unions to engage in through prior legal opinion letters.

While NCUA has made incremental changes to the list of permissible activities for credit unions, Congress has not considered any comprehensive modernization of the Federal Credit Union Act in over 70 years. (CUMAA, passed in 1998, as previously indicated, was a response to efforts to correct a field of membership problem and resulted in imposing new, burdensome regulations on credit unions.) By contrast, it is fair to note that the sweeping new authority Congress granted the banking system when it adopted the Gramm-Leach Bliley Act in 1999 does not apply to credit unions, with the exception of the privacy provisions. Under that Act, among other things, affiliations between banks, securities firms and insurance companies are facilitated. In addition, financial holding companies are authorized to engage in a range of activities, including any activity that the Federal Reserve Board determines is financial in nature or incidental to financial activities. Banks are permitted to own or control a financial subsidiary that engages in activities that banks may not engage in directly, and they may underwrite and deal in municipal revenue bonds. Further, the Act authorized a number of securities activities for banks including statutory exemptions from broker/dealer requirements and investment advisory requirements.

Even without Gramm-Leach-Bliley, credit unions lag far behind banks in the kinds of activities in which they can engage, notwithstanding the fact that credit unions may offer additional services to their membership through credit union service organizations (Credit unions may loan up to 1% of their assets to a CUSO or invest up to 1% of assets in such organizations.) The 2001 Treasury study comparing credit unions with banks makes it clear credit unions face more operational restrictions than other institutions.

In general, federal credit unions have more limited powers than national banks and federal savings associations. Most notably, federal credit unions face stricter limitations on their commercial lending and securities activities. In addition, a usury ceiling prevents them from charging more than 18 percent on any loan, and the term of many types of loans may not extend beyond 12 years.

The Treasury notes a number of activities that are not permissible for credit unions but are allowed for banks. These include the offering of trust accounts, the purchase or sale of derivatives, investments in corporate debt securities and other activities. (Unlike banks, credit unions' investments are very limited and include government and agency securities, along with certain insurances of government-sponsored enterprises. Credit unions with net worth of 9% have authority to invest in certain mortgage-related securities.)

One of the harshest limitations on credit unions is the ceiling on their member business lending, which is set at the lesser of 1.75 times net worth or 12.25 percent of total assets. National banks have no specific restrictions on commercial lending and thrifts may make commercial loans up to 20% of their total assets.

Credit unions also come under more stringent core net worth (capital) requirements than are placed on banks. As required by statute, credit unions must maintain net worth levels that are actually spelled out in the law. Banks also have core capital requirements, but they are set by regulation, which is easier to change than statutory requirements. In addition, credit unions sustain core net worth that is a full two percentage points higher than the core capital required of banks.

Indeed, the net worth, lending, and other significant restrictions under which credit unions operate are the impetus for the credit union provisions in the Financial Services Regulatory Relief Act, HR 3505, and the Credit Union Regulatory Improvements Act, HR 2317, which are currently pending in the House.

There is no question that while credit unions may offer products and services provided by banks and thrifts in response to their members' needs, credit unions operate under serious constraints. As concluded by the Treasury:

Federal credit unions generally operate within the same legal framework as other federally insured depository institutions. Most differences between credit unions and other depository institutions derive from the structure of credit unions. Credit unions have fewer powers available to them than do banks and thrifts.

A Credit Union's Size Does Not Affect Its Mission

Some have suggested that the nation's very largest credit unions are in some sense no longer true credit unions, that they no longer live up to what Congress originally intended credit unions to be. They go on to argue that therefore large credit unions should no longer be tax-exempt. Yet, these "large" credit unions continue to promote thrift and to provide a source of credit for provident or productive purposes. How many members a credit union has, or how many loans it provides does not affect the core characteristics of a credit union, or the real reasons for credit union's tax exemption. Further, large credit unions today fully live up to what Congress had in mind when it originally created the federal credit union charter and later granted the credit union tax exemption. It should also be remembered that a "large" credit union would still be modest sized by bank standards, and that the nation's three largest banking institutions each is larger than the entire credit union movement.

None of the core characteristics of credit unions or rationales for credit unions' tax exemption has anything to do with credit union size, field of membership restrictions, the range of services offered, or the extent to which credit unions might not compete with other financial institutions. Instead, they have everything to do with the cooperative structure of credit unions and their mission of providing affordable services to American households, especially those of modest means.

Credit unions are all about their members. Today credit unions serve 87 million members with affordable financial services. Twenty one million of those members belong to the one hundred credit unions with assets over \$1 billion. There is no relation between the size of an institution and the absence or presence of reasons to justify the tax exemption. Large credit unions are democratically controlled, not-for-profit cooperatives in every way that smaller credit unions are. The boards of directors of large credit unions are composed of volunteers just as they are at small credit unions. A large credit union may be more likely to offer a broader array of services, and to be a greater presence in a local community. However, neither factor makes it less a cooperative than a smaller credit union. No one suggests that as soon as the congregation of a church, synagogue or mosque exceeds a certain size, it should no longer be tax exempt. Likewise, it would be ludicrous to say the American Heart Association should lose its tax exemption simply because of its size, while a small local charity should not.

Because of their size and efficiency, large credit unions are often more able to provide the benefits of the cooperative to members, such as lower loan rates and fees and higher dividend rates. Larger credit unions are also more able to offer special programs benefiting low- and moderate-income households. In a survey conducted in 2002, when asked how many of up to 18 services geared to low/mod income households they offered, only 6% of credit unions with assets below \$20 million offered at least half of the services. Fully 42% of credit unions with assets over \$500 million offered that many of the services. Large credit unions are also more likely than small credit unions to participate in outreach activities to attract low/mod income members, and to have added underserved areas to their fields of membership under NCUA's Access Across America program.

I have already described how my own large credit union fulfills its mission. Here are some examples of what other large credit unions do today:

Navy Federal Credit Union, the nation's largest with two and a half million members and \$25 billion in assets, is the epitome of a not-for-profit financial cooperative organized to provide its members with low-cost financial services. It is guided by an unpaid, volunteer, member-elected Board or Directors (one member, one vote.) Navy Federal serves most military and civilian personnel of the Navy and Marine Corps and their families, including almost 400,000 young active duty military personnel of modest means. Members can open a share account with only \$5, and the account has no monthly fees, minimum balance requirement, and earns dividends. The credit union operates 108 field offices around the world, from Keflavik, Iceland to Guantanamo Bay, Cuba, to Diego Garcia in the Indian Ocean to Bahrain. Half of the overseas offices operate at a loss, but they are maintained in order to serve military personnel on overseas deployments.

San Antonio Federal Credit Union (230,000 members and \$1.8 billion in assets) is a pioneer in financing manufactured housing for members with limited incomes. For many Americans, high quality manufactured housing is a cost effect alternative to the escalating costs of traditional site built homes. Manufactured housing must meet manufacturing standards that meet or often exceed requirements of some local codes. Since entering the manufactured housing finance market in 2002, San Antonio Federal

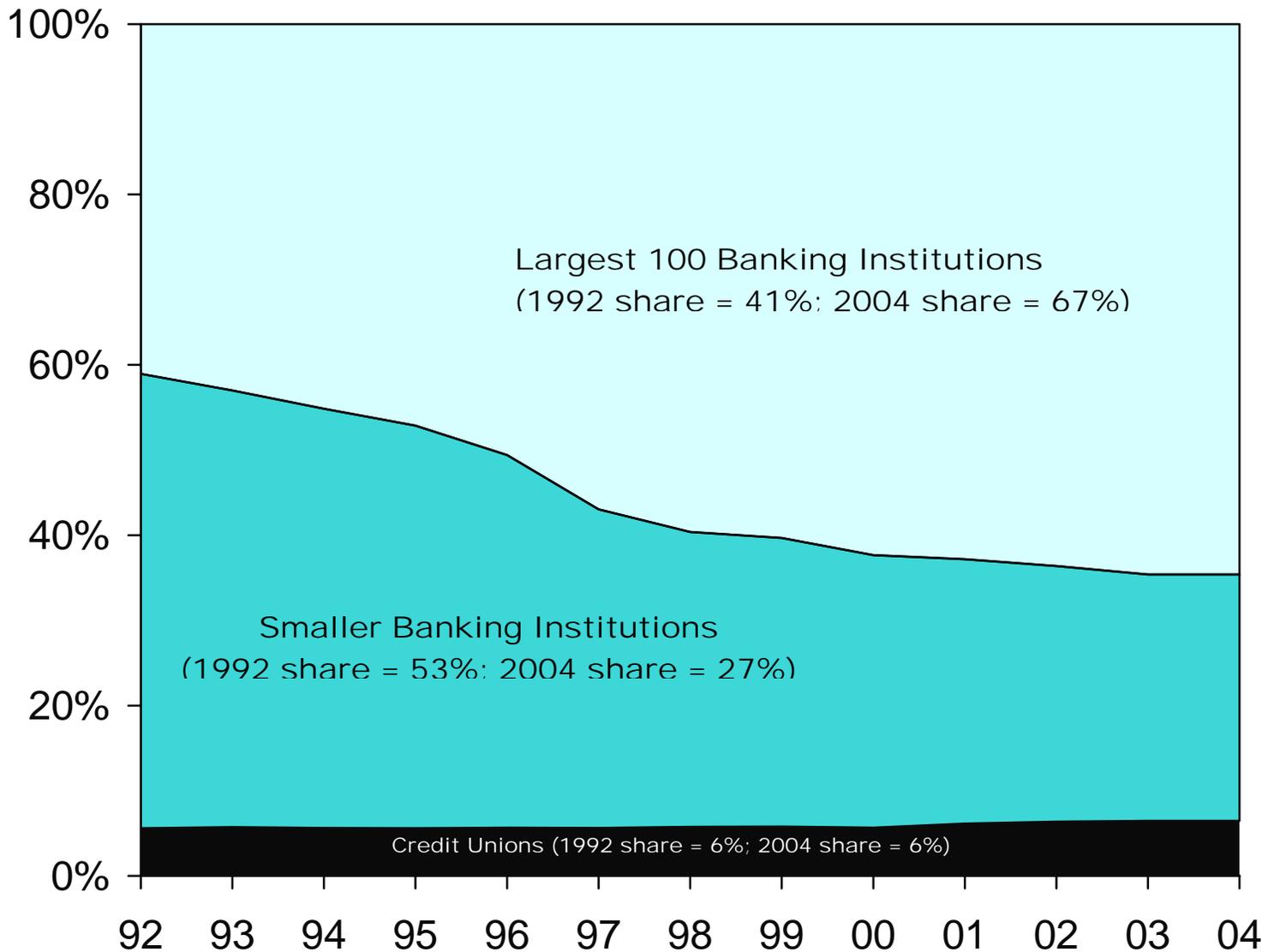
Credit Union has made over 3,000 high quality portfolio loans for this affordable housing. The average loan size is about \$50,000. The credit union is also developing the infrastructure to assist other credit unions around the country to serve this market.

Despite the protestations of community bankers, as described above, credit unions are not unfair competitors to banks, and credit unions are not eroding their market share. Further, the share of total depository institution assets held by community and smaller regional banks (all but the top 100 banking institutions in the US) has indeed plummeted from 53% in 1992 to 27% in 2004. However, over the same period, the share of credit unions has remained stable at about 6%. It is the largest 100 banks (larger regionals, super regionals, and money center banks) that have taken the market share, from 41% in 1992 to 67% in 2004. This is shown in the accompanying chart.

If credit unions had such an “unfair” advantage over banks, one can wonder rhetorically why we have not seen a wholesale conversion from bank to credit union charters. The reason no commercial bank has converted to a credit union is that doing so would expose them to democratic ownership and control, would likely cause banker salaries to decline dramatically, and would force the institutions to adhere to a much more restrictive regulatory regime.

Finally, it is disappointing but not surprising that in all their protestations about the tax treatment of credit unions the banking organizations fail to mention the growing role of Subchapter S banks. Over 2,100 banks have adopted the Sub S form of tax treatment since 1997. While Subchapter S status is not the same as a tax exemption, it results in significant loss of government revenue. The direct cost to the federal government from banking institution Sub S elections is estimated to be \$790 million in lost revenue in 2004, and the total will only grow as banks continue to try to expand Sub S eligibility. In fact, it is estimated that the total cost to the Treasury for Sub S election will exceed the estimated cost of the credit union tax exemption within a few years. We believe that the Committee may wish to investigate Subchapter S election, as there appears to be absolutely no functional difference between a Sub S and a Sub C corporation to justify different tax treatment.

Small Bank Asset Share Declines Are Due to The Increasing Dominance of Mega-Banks



Sources: FDIC, NCUA, CUNA E&S. "Banking Institutions" include commercial banks and savings & loans.
"Smaller Banking institutions" are defined as all banking institutions smaller than the Largest 100.

CONCLUSION

Mr. Chairman, it is clear that credit unions play a powerful role in our economy. Credit unions serve people of all walks of life at all economic levels. Credit unions provide the public with a not-for-profit, cooperative alternative to the for-profit sector. Consumers benefit by having access to lower cost services that might not otherwise be available to them, especially those of modest means. And the facts show that the banking industry, which is engaged in an effort to put credit unions out of business, continues to mislead Congress into thinking that their very existence is threatened because of credit unions and their tax status. But banks continue to earn record profits. And if you saw the oil industry ads in the *Washington Post* last week, you would have noticed that in fact the banking industry recorded the highest profits of all U.S. industries during the second quarter of 2005—even more than the pharmaceutical industry. While the banking industry continues earning record profits, credit unions provide a nearly 7-to-1 return to consumers on the dollar, benefiting them by over \$10 billion dollars in yearly savings.

Credit unions are an important part of the financial life of American consumers. And the tax-exempt status of credit unions is the glue that holds credit unions and their not-for-profit approach to cooperative financing together. If the tax exemption were removed—if 87 million Americans were forced to pay taxes solely because of their membership in a credit union—it would lead to the end of the movement that we know. Credit unions would become banks, and the consumers would pay dearly, not only in higher taxes, but in higher fees and less return on their savings and borrowings.

Thank you again, Mr. Chairman, for the opportunity to address the Committee in its effort to review the tax-exempt status of credit unions.