



CUNA & Affiliates

Credit Union National Association, Inc.

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

STATEMENT FOR THE RECORD
TO THE HOUSE WAYS AND MEANS COMMITTEE'S
OVERVIEW OF THE TAX-EXEMPT SECTOR

Credit Union National Association

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Washington, DC

**STATEMENT FOR THE RECORD
OF THE
CREDIT UNION NATIONAL ASSOCIATION
TO THE OVERVIEW OF THE HOUSE WAYS AND MEANS COMMITTEE
OF THE TAX-EXEMPT SECTOR**

Wednesday, April 20, 2005

Credit unions are exempt from federal and most state taxes because – unlike many other insured financial institutions – credit unions 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.

Congress itself came to the above conclusion just seven years ago, when it passed the Credit Union Membership Access Act (PL 105-219). Since 1998, nothing has changed in the structure and focus of credit unions.

The Credit Union National Association (CUNA), and the 86 million members of the credit unions in the United States, urges you to leave the tax status of credit unions unchanged, recognizing that the tax exemption is sound public policy, based on the following:

- The original justification for the tax exemption still holds;
- Credit unions serve those of modest means at reasonable costs;
- Over 86 million credit union members receive substantial benefits;
- The tax exemption ensures the cooperative alternative is available;
- Credit unions of all sizes benefit their members; and,
- There is no evidence of market disruption from the tax exemption.

The following pages detail each of these six points:

Original justification for the credit union tax exemption still holds

Since inception, the credit unions tax exemption has had absolutely nothing to do with either field of membership restrictions or the extent to which credit union service offerings were limited. Rather, the original reason for the tax exemption was based solely on the cooperative structure

of credit unions. The U.S. Treasury Department underlined this fact in its most recent comprehensive report on credit unions outlining the rationale for the tax exemption for federal credit unions:

Two reasons were given for granting this exemption (in 1937): (1) that taxing credit unions on their shares, much as banks are taxed on their capital shares, “places a disproportionate and excessive burden on the credit unions” because credit union shares function as deposits; and (2) that “credit unions are mutual or cooperative organizations operated entirely by and for their members . . .” Thus, the tax exemption was based primarily on the organizational form of credit unions. . . (Quotes within this excerpt are from H.R. REP. NO. 1579, 75th Cong., 1st Sess. P. 2.)¹

Similarly, the rationale for the tax exemption for state chartered credit unions hinges on their cooperative structure. In a 1991 report, the GAO found:

Under current law, state credit unions are exempt from tax under Internal Revenue Code section 501(c)(14)(A). This section states that credit unions that are (1) operating on a nonprofit basis, (2) organized without capital stock, and (3) operating for mutual purposes can qualify for exemption.²

Today, credit unions continue to operate as democratically controlled mutual institutions, serving their members on a non-profit basis. Rather than distributing net income among stockholders (as do banks), the bulk of it is returned to members in lower loan rates and fees, or higher yields on savings. The balance is retained by the credit union to comply with statutorily mandated net worth requirements that protect the federal share insurance fund and the taxpayer from loss. These retained earnings are not accumulated for the benefit of management or stockholders. They exist only for the benefit of members in the future by providing for the stability of the credit union.

As indicated at the outset, Congress recently reaffirmed the tax treatment of credit unions in the findings to the Credit Union Membership Access Act of 1998. Specifically, the findings read:

¹ U.S. Department of the Treasury “*Comparing Credit Unions and Other Depository Institutions*”, January 2001. Page 28.

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.³

By way of contrast, mutual savings banks lost their tax exemption because they competed with taxed institutions AND because they engaged in widespread proxy voting schemes and were not democratically controlled (voting was based on the size of each member's deposit not on the basis of one-member-one-vote as is the case with credit unions). The U.S. Treasury underlined this fact in its recent comprehensive report on credit unions. The report states: "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."

The significance of the credit union tax exemption is well understood by public officials. Last year, both President Bush and Senator Kerry wrote letters affirming their appreciation for the important service that credit unions provide to their 86 million members, and indicating their support for the continuation of credit unions' tax exemption. Their support was added to that of a number of members of Congress, including: Senate Banking Committee Chairman Richard Shelby, House Majority Leader Tom DeLay; House Majority Whip Roy Blunt; House Minority Whip Steny Hoyer; and nearly 200 other members of Congress.

Credit unions serve those of modest means at reasonable costs

A recently published study found that: "Households that use a bank only have higher median incomes than those who use a credit union only" and "Among households that use both a bank

² GAO, July 1991. Page 292.

³ Pub. L. No. 105-219. August 7, 1998.

and a credit union, those that use a bank primarily have higher median incomes than those that use a credit union primarily.”⁴

A significant way credit unions provide value to America’s working class and modest income consumers is through the pricing of their services. Numerous studies and reports show that credit unions charge fewer and lower fees than do banks for the same kinds of services.⁵ In particular, minimum balances to avoid fees are typically much lower at credit unions than at banks. Lower rates on loans, especially on used cars and small loans are another way credit unions serve those of modest means. Credit unions also serve America’s low and moderate-income households with member business loans. The Treasury reported in 1999 that 45% of credit union member business loans were to borrowers with household incomes below \$50,000.⁶ In addition, Home Mortgage Disclosure Act (HMDA) data consistently shows that low income or minority applicants are significantly more likely to have their loans approved at a credit union than at any other type of lender.

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. Four 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.)

86 million CU members receive substantial benefits

⁴ Jinkook Lee and William Kelly, *Who Uses Credit Unions, Third ed.* Filene Research Institute, 2004. Page 15.

⁵ *2004-2005 Credit Union Fees Survey*, Credit Union National Association. *Big Banks, Bigger Fees 2001*, US Public Interest Research Group. New Jersey Department of Banking and Insurance, various surveys. The Money Talks Personal Finance Advice website at www.moneytalks.org.

⁶ US Department of the Treasury. *Credit Union Member Business Lending*. January 2001.

Credit unions provide substantial, tangible benefits to members that far exceed the amount of the tax exemption. These benefits are realized in the form of lower fees, lower loan rates, and higher yields on savings. CUNA has estimated that these benefits total over \$6 billion a year.⁷ That is the additional amount that credit union members would pay if they were to conduct all the business they do at banks instead of credit unions. That is about four times the roughly \$1.5 billion that credit unions would pay in federal income tax.

The tax exemption is leveraged as it is for the benefit of credit union members 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 either do not compensate directors (as is the case with federal credit unions), or (in the case of state-chartered credit unions) generally compensate only the board Treasurer or reimburse incidental expenses incurred by other directors. The savings realized in not compensating all directors are then passed on to members. Finally, credit unions ratios for expenses and loan losses compare very favorably to similarly sized banks.

Tax exemption keeps the cooperative alternative available, and supports safety and soundness

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, higher capital requirements than other depository institutions, etc. The tax exemption is the incentive that encourages credit union CEOs and boards to continue to operate as credit unions rather than shedding those 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.

Because the tax exemption is an important part of the reason credit unions remain cooperatives, it 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

⁷ *The Benefits of Credit Union Membership*. CUNA Research and Policy Analysis White Paper, 2004.

retaining earnings, weakening protection for 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. In their 1996 study of the National Credit Union Share Insurance Fund, Edward Kane and Robert Hendershott show 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.

⁸ This is an especially useful trait for federally insured depository institutions.

Large credit unions stand out in providing credit union benefits

There is no relation between the size of an institution and the absence or presence of reasons to justify the tax exemption. Members of large credit unions relate to the institutions to which they belong in exactly the same way as do members of smaller credit unions. Regardless of the size of the credit union, each credit union member has one equal vote, and thus an equal say, in the direction of the credit union.

Large credit unions are democratically controlled, not-for-profit cooperatives in every way that are smaller credit unions. 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 market. But neither activity 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

⁸ 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.

moderate-income households. In a survey conducted in 2002, when asked how many of up to 18 services geared to low/moderate income households were 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/moderate income members, and to have added underserved areas to their fields of membership under NCUA's Access Across America program.⁹

No evidence of market disruptions from credit union tax exemption

There is no evidence that the credit union tax exemption adversely affects banks or thrifts; other financial institutions continue to thrive in the presence of credit unions. In fact, the FDIC recently reported that banks recorded record profits for the fourth year in a row.¹⁰ 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%. And, although some more credit unions have become more interested in recent years in business lending to their members, credit unions as a whole hold a very small portion of the market: Less than 1% of the business loan market in the U.S.

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 of record profits for the industry as a whole, and for community banks in particular" and "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."¹¹ Two Federal Reserve economists have recently described the strong performance of the nation's smaller

⁹ 2003 *Serving Members of Modest Means Survey Report*. CUNA.

¹⁰ Federal Deposit Insurance Corporation, *Quarterly Banking Profile, Fourth Quarter 2004*.

¹¹ Comments before the 2003 Chicago Federal Reserve Bank Conference: *Whither the Community Bank?*

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.”¹²

As Federal Deposit Insurance Corp. Chairman Donald E. Powell told the convention of the Independent Community Bankers of America March 12, “In the banking business, times are surely good.”

Summary.

America’s credit unions continue in their long tradition of providing members affordable financial services driven by their cooperative, not-for-profit structure. As a result, 86 million members receive significant benefits from their credit unions even while the rest of the financial services industry thrives. The public policy rationale for the credit union tax exemption is just as valid today as it was at credit unions’ inception.

The Credit Union National Association – the nation’s largest credit union trade association representing 90 percent of the nation’s 9,000 credit unions – is pleased to offer these comments and suggestions to the Ways and Means Committee as it conducts its overview of the tax-exempt sector. We look forward to working with the Chairman, Members and staff of the committee as it continues its overview, and stand ready to answer any questions or expand on or otherwise further explain our remarks.

¹² William F. Bassett and Thomas F. Brady. *The Economic Performance of Small Banks, 1985-2000.*_ Federal Reserve Bulletin, November 2001.