Financially Taxing Topic

Credit Union Exemption Dominates Discussion

By Tom Schuman

In many Indiana towns, a person can drive his or her car down the street and see two financial institutions – one a bank and the other a credit union.

They're likely to look very similar, not only in appearance but in the services they offer. Many of the internal differences are based on the charter – who regulates the business – of the institution.

Gather any number of bankers in a room, however, and the only difference they're likely interested in is the federal tax exemption that they say makes credit unions a competitor with an unfair advantage. Bring the credit union representatives together and they'll be sure to tell you that banks are still the 800-pound gorillas, while credit unions offer an important societal alternative.

We brought one representative of each industry, a lawyer who specializes in financial institutions and a finance professor together to discuss a variety of bank and credit union issues. More often than not, however, the topic turned back to that federal tax exemption.

Participants

- **Ken Carow, professor, Indiana University Kelley School of Business-Indianapolis**
- **John McKenzie, president, Indiana Credit Union League**
- **Mike Messaglia, attorney, Krieg DeVault**
- **Beth Neese, vice president-government relations, Indiana Bankers Association**

By the numbers

At the midway point of 2005, according to McKenzie, there were 226 credit unions in the state with a combined total of $14.8 billion in assets. He adds that approximately 2.2 million Indiana residents belong to credit unions. In the banking industry, 193 Indiana institutions (not including major banks with an Indiana presence that are chartered outside the state) total more than $103 billion in assets.

Some banks and credit unions have state charters, while other charters are federal. There also are thrift, mutual and other banking charters.

The primary difference in charters, Messaglia explains, is "who you are regulated by, who comes in and reviews your bank from a safety and soundness standpoint – making sure you are complying with regulations."

The major change in recent years, Carow notes, is a result of the Gramm-Leach-Bliley Act of 1999. That federal legislation allows one institution to offer more extensive services in the areas of banking, insurance and investment banking. Thus, many of the largest banks have formed financial holding companies to allow them to broaden their reach.

Another industry trend, moreso in banks than credit unions, is consolidation. Again, it's primarily the big players becoming bigger. And, while residents may bemoan the loss of local control that sometimes occurs in those mergers, each such occurrence also brings the potential for positive developments.

"When you have that consolidation, it always opens up an opportunity for a community bank to either increase its role or to start new – to do a de novo bank," Messaglia offers. "That activity in Indiana has been fairly strong over the past 10 years."

Carow adds that mergers often result in displaced professionals, allowing them to move into another local role in the industry or ignite that entrepreneurial flame that results in a new community bank.

Neese says not all the mergers are on the regional or national scale. "It's two community

banks going together. They may be slightly larger, but they're getting the economies of scale in trying to keep up with the compliance requirements that are out there."

The same holds true with credit unions, Carow notes, with the number of institutions declining slightly. The option is available to switch from a credit union charter to a bank charter, and vice versa. Approximately 26 of the nearly 9,200 national credit unions have made that choice (no banks have gone the other route to adopt credit union status), with the credit union typically switching to a mutual organization, then possibly taking the next step and becoming publicly owned by stockholders in a demutualization process.

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Credit union evolution

Congress established credit unions in the 1930s to help drive economic development. During the Depression, banks were sometimes reluctant to make personal loans in a time of fiscal instability.

Economic changes were a primary factor in altering that original scope.

"Credit unions, as they evolved, just couldn't go out and start serving anyone," McKenzie recalls. "They were formed primarily around either communities or employee groups – working people. With more of the jobs in our economy based on smaller-sized companies, our regulator (starting in 1982) began allowing credit unions to serve multiple employee or association groups."

Carow categorizes the single company/credit union bond as somewhat risky in the struggling economy of the early 1980s. If the company went bankrupt, then the credit union would have had to been bailed out. The regulatory diversification to remedy that brought "increased competition" in the form of a "greater group of consumers" and "broader niche" of services.

Despite any changes in size or services, McKenzie says credit unions' criteria for the federal tax exemption have not changed. He lists those as "member-owned, not-for-profit cooperative, operating for mutual purposes without access to capital stock and with a defined field of membership." Size, he says, is not a factor.

He adds that, on a national level, credit unions continue to represent about 6% of the assets of all depository financial institutions. That has not changed, he points out, more than a half-percent in the last decade.

The banking argument, however, is that the federal tax exemption allows credit unions to offer lower rates on loans, higher interest percentages on savings accounts and more. As credit unions expand their field of membership, bankers contend, the competition increases at the local level.

"The community banks out there around the state do see credit unions as a direct competitor," Neese states. "When you have credit unions expanding to take anybody who walks in the door, or (at least resides in) a specific county, it does change the type of competition. I think things have changed since the credit unions were first created in that people with low or moderate income have more choices about where they can bank today."

McKenzie acknowledges the options, but says they come at a higher cost to the consumer. Credit union members, he reports, saved their members $160 million in 2003 through lower fees and better rates. The banking industry response is that's only possible because of the federal tax exemption.

Congressional view

The House Ways and Means Committee in Congress engaged in a debate on credit unions and the tax exemption in early November. The stated purpose was a normal oversight review.

The key question in Congress, according to Messaglia, is whether credit unions are meeting the mission of "serving persons of modest means."

He offers, "I think it's still an open issue. Tax exemption is just a policy consideration because we're trying to promote a specific means. Is that still needed, or are we still getting that benefit (are) the question(s) that will always be asked whenever you have a tax-exempt status. Are we serving those persons with modest means that are not otherwise being served?"

Neese refers to several past studies and one mentioned at the congressional hearing that indicates "banks are doing a better job of serving low income people than the credit unions." She attributes part of that to community reinvestment requirements for banks that do not apply to credit unions.

McKenzie counters with numbers that show the average income level for individuals or households that use only banks ($76,000) compared to those same people that use only credit unions ($42,000). "Also, in data on the likelihood of having a mortgage approved, and on minority and lower income mortgage applicants, credit unions approve a higher percentage of those mortgages than any other type of financial institution."

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– John McKenzie
Indiana Credit Union League

Lending a hand

The ability of credit unions to participate in commercial lending is another contentious issue. Federally insured credit unions are currently limited to lending 12.25% of their assets, according to McKenzie, with the goal of increasing that to 20%. He contends that small business owners will be the winners. (Overall, he says, credit unions have just 1% of the national market share of business lending).

"The reason for an increase is because we're here to serve our members." With more and more involved as small business owners, "they are increasingly looking for the best possible terms they can get on small business loans. It's a need of membership, a need for small business loans in local communities."

There are two bills in Congress. One focuses on regulatory relief for all financial institutions – a morsel of agreement in a sea of dispute. The other, being pushed by the credit unions, also includes the increase in the lending cap and a move to a more risk-based capital ratio because, according to McKenzie, "The fact that we can't raise capital through issuing stock puts us in a position where we can't respond to the growth expectations of the members as much as we'd like."

Neese: "We support the reg relief bill. We might have to re-evaluate that if somebody offers an amendment increasing the commercial lending. That lets credit unions gets further and further into a field from their primary focus, without paying taxes, so we do see that as a competitive issue."

There may be several issues at play, but the topic of the day, in Messaglia's opinion, is the lending authority increase. "I don't have a feel for which way that's going to go, but that's probably the most pressing (issue) at the moment."

Consumer viewpoint

Do consumers know the difference between banks and credit unions? Neese says she's not sure about the average consumer on the street. Messaglia believes the distinction becomes clear once people are in the doors as credit unions "explain very well in terms of 'we are a credit union, we are a cooperative, you are a member, you have one vote.' "

With similar services being offered at banks and credit unions, Carow states that advertisements and convenience are among the factors that bring people to different institutions. It is then in their best interest to do some comparisons.

"I think most consumers don't, at first, see the difference. One of the reasons I chose the institution I've chosen is because I drive by it on the way to work every day," he reveals. "The consumer is going to look at those issues – who provides the best rates, who can give them the best service. In some communities, that may be a credit union, in some communities that may be the community bank; it might be the savings and loan. But I encourage consumers to check it out."

At the collegiate level, students study the various niche markets that each institution serves, Carow reports, with a

focus on increasing understanding of credit risk and related factors. Despite the traditional niches, there is recognition of the variety of products and services each type of institution offers.

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Cooperative measures

Asked to compare the bank/credit union situation to another industry, McKenzie listed rural electric cooperatives and not-for-profit hospitals as exempt from federal taxation due to their "specific role in those industries." Carow adds farming cooperatives to the mix.

All participants also point out that banks and credit unions do work together at times. The goal of regulatory relief is a shared one. In communities, particularly ones that are struggling, all financial institutions have an incentive to do what they can (individually as volunteer leaders and cooperatively).

In South Bend, for example, McKenzie says there is a Community Home Buyers Corporation. The program between the city, banks and credit unions helps low and moderate income residents secure mortgages at better terms. There is no doubt that similar partnerships exist in other communities.

Carow: "If they have an operation there, they have an investment in the community. Anyone with an investment has a desire to bring that community back to profitability. It's good for the financial institutions; it's good for the restaurants; it's good for the people living there."

Taxing topic

But in the end, it's the tax exemption debate that returns to the forefront. Both Neese and McKenzie go out of their way to point out the good that all financial institutions offer, but also slip in the following during the course of the discussion:

Neese: "I would say that credit unions are not exactly not-for-profit because they have substantial retained earnings. They do have profits. They just use them differently, and they don't necessarily distribute all those profits to their members. It's how they build buildings."

McKenzie: "There's no personal enrichment incentive in the credit union cooperative structure. Some of the problems that have crept into corporate America as far as personal enrichment and how that has manifested itself, that isn't anywhere to be found because the credit union structure in and of itself protects from it."

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Messaglia, outside of the direct fire, admits, "We wouldn't be here at this roundtable discussion if it wasn't for that (tax exemption) issue. That isn't going to be answered by me or anybody here. It's going to be answered by the people in Congress.

"But my expectation is that you're probably not going to see much of change in that anytime soon. I think it's something that is here to stay for awhile and hopefully the two organizations can co-exist and continue to serve their customers and communities."

If the tax exemption is changed, Carow ponders the results. "I would expect many of them (credit unions) might choose to go the mutual structure and then demutualize. They would have new access to capital, significantly increasing the ability of those institutions to grow and expand their operations in the community. In the long run, many credit unions will choose to be more like a bank and will be a bigger competitor."

INFORMATION LINK

Resources: Ken Carow at (317) 274-2783

John McKenzie at (317) 594-5320

Mike Messaglia at (317) 238-6249

Beth Neese at (317) 921-3135