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Summary

Credit unions make loans to their members, to other credit unions, and to corporate credit unions that provide financial services to individual credit unions. There are statutory restrictions on their business lending activities, which the credit union industry has long advocated should be lifted. Specific restrictions on business lending include an aggregate limit on an individual credit union's member business loan balances and on the amount that can be loaned to one member. Industry spokespersons have argued that easing the restrictions on member business lending could increase the available pool of credit for small businesses. Credit unions also lack sources of capital beyond retained earnings, and alternative supplemental capital sources would allow them to increase their lending while remaining in compliance with safety and soundness regulatory requirements. Community bankers, who often compete with credit unions, argue that policies such as raising the business lending cap would allow credit unions to expand beyond their congressionally mandated mission and could pose a threat to financial stability.

Members of the 114th Congress have introduced legislation that would allow credit unions to expand their lending activities. H.R. 989, the Capital Access for Small Business and Jobs Act, was introduced and referred to the House Committee on Financial Services on February 13, 2015. H.R. 989 would redefine net worth for credit unions to include additional sources of supplemental capital. In addition, H.R. 1188 and its companion bill, S. 2028, the Credit Union Small Business Jobs Creation Act, would raise the current member business lending cap. H.R. 1422 and S. 1440, the Credit Union Residential Credit Union Loan Parity Act, would amend the FCU Act to revise the statutory definition of member business loans, further enhancing the capacity of credit unions (satisfying the net worth capitalization requirements) to make more member business and commercial loans. On April 13, 2015, the House-passed H.R. 299, the Capital Access for Small Community Financial Institutions Act of 2015, would amend the Federal Home Loan Bank (FHLB) Act to require the treatment of state-chartered credit unions as insured depository institutions, among other things; thus making it possible to harmonize FHLB-membership requirements for small banks and credit unions. The House included the language of H.R. 299 in an amendment to H.R. 22, the Surface Transportation Reauthorization and Reform Act of 2015, as passed on November 5, 2015. S. 1484, the Financial Regulatory Improvement Act of 2015, and S. 1910, the Financial Services and General Government Appropriations Act, 2016, also contain language similar to H.R. 299.

Small memberships limit the range of financial services that small credit unions can offer as well as their ability to accumulate enough retained earnings (capital) to substantially increase their commercial lending activities. Thus, the benefits to credit unions from legislative actions to enhance their lending ability may be greater for larger institutions. Larger credit unions, with the resources to offer a wide array of financial services to members, would also be expected to become more significant competitors with community banks operating in similar lending markets. Competition between credit unions and commercial banks, particularly those with over $1 billion in assets, would be expected to intensify.

Although total assets and membership in the credit union industry have risen over the past decade, the total number of credit unions has declined. The industry's assets are not evenly distributed. Some differences in credit union and bank regulation are unlikely to account for the competitive advantages that large credit unions enjoy relative to their smaller counterparts. These observations mirror the consolidation trends observed in the depository banking industry and are discussed in greater detail in the **Appendix**.

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Introduction

Credit unions engage in *financial intermediation*, or facilitating transfers of funds back and forth between savers (via accepting deposits) and borrowers (via loans). Although other institutions (e.g., depository banks, insurance companies, pension funds, hedge funds) also engage in the financial intermediation matching process, this report focuses on issues facing the credit union industry.[1]

The original concept of a credit union was of a membership-owned cooperative organization formed for the purpose of promoting thrift among its members and providing them with a low-cost source of credit. Congress passed the Federal Credit Union Act of 1934 (FCU Act; 48 Stat. 1216) to create a class of federally chartered financial institutions for the purpose of "promoting thrift among its members and creating a source of credit for provident or productive purposes."[2] Given the numerous bank failures and runs that occurred during the Great Depression, Congress wanted to enhance the ability of these cooperative organizations to meet the credit needs of their memberships, who were unable to obtain bank credit.[3] The credit union industry has evolved with marketplace changes so that many of the financial services that credit unions provide are similar to those offered by banks and savings associations.

Credit union charters are granted by federal or state governments on the basis of a "common bond." There are three types of charters: (1) a single common bond (occupation or association based); (2) multiple common bonds (more than one group each having a common bond of occupation or association); and (3) a community-based (geographically defined) common bond.[4] Individual credit unions are owned by their memberships. The members of a credit union elect a board of directors from their institution's membership (one member, one vote).[5] Given that credit unions are financial cooperatives that return profits to their memberships, members' savings are referred to as "shares" that earn "dividends" instead of interest. Credit union loan and investment powers are more restricted than those of commercial banks. Credit unions can only make loans to their members, to other credit unions, and to credit union organizations. The investment authority of federal credit unions is limited by statute to loans, government securities, deposits in other financial institutions, and certain other limited investments.

The National Credit Union Administration (NCUA), an independent federal agency, is the federal regulator and share deposit insurer for credit unions.[6] Typically, the Office of the Comptroller of the Currency (OCC) charters and supervises national depository (commercial) banks; the Federal

[1] For more information about depository banks, see CRS Report R43002, *Financial Condition of Depository Banks*, by Darryl E. Getter.

[2] See "NCUA: The Federal Credit Union Act," http://www.ncua.gov/Legal/Documents/fcu_act.pdf.

[3] William R. Emmons and Frank A. Schmid, "Credit Unions Make Friends—But Not with Bankers," Federal Reserve Bank of St. Louis, *The Regional Economist*, St. Louis, MO, October 2003, at http://www.stlouisfed.org/publications/re/articles/?id=406.

[4] The National Credit Union Administration (NCUA) updated the framework used to determine the field of membership in federal credit unions, allowing automatic qualification of 12 associational groups as valid associations. See NCUA, *Associational Common Bond Updates*, Supervisory Letter SL No. 15-02, July 6, 2015, at http://www.ncua.gov/Resources/Documents/LTCU2015-03Enclosure2.pdf; and NCUA, "Chartering and Field of Membership Manual Final Rule," 80 *Federal Register* 87, May 6, 2015.

[5] Credit union board member positions are voluntary and unpaid; the board of directors may appoint a president or chief operating officer, who is paid and would report directly to the credit union board.

[6] NCUA was created by the Federal Credit Union Act of 1934 (48 Stat. 1216). P.L. 91-468, 84 Stat. 994 made the NCUA an independent agency, which is governed by a three-member board.

Deposit Insurance Corporation (FDIC) provides deposit insurance and liquidates failed banks; and the Federal Reserve provides lender-of-last-resort liquidity to solvent banks via its discount window. The NCUA, by comparison, serves all three functions for federally regulated credit unions. The NCUA also manages the National Credit Union Share Insurance Fund (NCUSIF), which is the federal deposit insurance fund for credit unions.[7]

Numerous financial entities experienced distress during the 2007-2009 recession, including the credit union system. In response, the NCUA has adopted enhanced capital requirements for credit unions, which is intended to increase the resiliency of the credit union system to insolvency (failure) risk and to minimize possible losses to the NCUSIF and ultimately taxpayers. Some credit unions may need to curtail lending until they fully adjust to the increased requirements. In addition, Congress is considering legislation (e.g., H.R. 1188 and S. 2028, the Credit Union Small Business Jobs Creation Act; H.R. 989, the Capital Access for Small Business and Jobs Act) to enhance the lending ability of the credit union industry as part of its efforts to spur economic growth. H.R. 1422 and S. 1440, the Credit Union Residential Credit Union Loan Parity Act, would amend the FCU Act to revise the statutory definition of member business loans, further enhancing the capacity of credit unions (satisfying the net worth capitalization requirements) to make more member business and commercial loans. These policies are discussed in this report. The balance sheet terminology defined in the box below will be used throughout this discussion.

Credit Union Balance Sheet Terminology

- Credit union assets include consumer (e.g., automobile, credit card, installment) and mortgage loans as well as cash and other financial securities that are held in their portfolios. Commercial member business loans, which are discussed in more detail below, are also assets for credit unions. Assets generate earnings (revenues) or losses, depending upon whether share deposit members repay or default on their loans. Federally insured credit union loans are generally restricted to maturities of 15 years or less with the exception of primary mortgages and other designated loans.
- Credit union liabilities include the funds that they borrow (for shorter periods of time). When customers (share depositors) make savings or checking share deposits into a credit union, the credit union is essentially borrowing those funds short-term in order to lend them out for longer periods of time. Liabilities are, therefore, the costs incurred by the credit unions to obtain the funds necessary to originate loans to members.
- Credit union net worth is the difference between assets and liabilities, which is analogous to bank capital. Net worth consists of retained earnings, or the allotment of profits not paid to members in the form of dividends. Given that the share deposits are federally insured, credit unions are required to maintain sufficient net worth to absorb loan defaults by their shareholders. Asset (loan) defaults are less likely to result in failure of a credit union to repay its shorter-term obligations if sufficient net worth is maintained to absorb the losses. If, however, a credit union's net worth falls below minimum regulatory threshold levels, it would be considered undercapitalized and faces the prospect of being shut down by the NCUA, which also serves as the receiver of the insolvent institution. Consequently, compliance with regulatory capital requirements means that asset (lending) portfolios can only grow if net worth grows proportionately.

Enhanced Capitalization Requirements

The credit union system, which largely facilitates residential and consumer lending, inherently faces financial risks, some of which were realized in the recent financial crisis. For example, the NCUA reported that the *corporate* credit unions faced liquidity pressures and placed five of them

[7] For more information on the NCUSIF status, see CRS Report R41718, *Federal Deposit Insurance for Banks and Credit Unions*, by Darryl E. Getter.

into conservatorship in 2008.[8] Corporate credit unions operate as wholesale credit unions, meaning that they provide financing, investment, and clearing services for *natural person* (retail) credit unions, which interface directly with customers. The corporates accept deposits from, as well as provide liquidity and correspondent lending services to, retail credit unions. This reduces the costs that smaller institutions would bear individually to perform various financial transactions for members.[9] Given that retail credit unions are cooperative owners of corporate credit unions, they are also federally insured by the NCUA. The NCUA chairman reported that the five corporates under conservatorship had represented approximately 70% of the entire corporate system's assets and 98.6% of the investment losses within the system at that time. A Temporary Corporate Credit Union Stabilization Fund (TCCUSF) was established by Congress in May 2009 to accrue and recover losses from the corporate credit unions.[10] The TCCUSF borrowed from Treasury to help cover the costs of conservatorship, and the NCUA also raised assessments on all federally insured credit unions, including those that did not avail themselves of corporate credit union services.[11]

Credit unions, like all financial institutions, are susceptible to the usual risks associated with lending or the financial intermediation process.[12] Safety and soundness regulation includes the requirement to hold sufficient capital reserves, which is intended to reduce the insolvency (failure) risk of financial institutions. Although higher capital requirements may not prevent adverse financial risk events from occurring, more capital enhances the ability of financial firms to absorb greater losses associated with potential loan defaults. The enhanced absorption capacity may strengthen public confidence in the soundness of these financial institutions and increase their ability to function during periods of financial stress.

In May 2012, the NCUA issued a Supervisory Letter regarding large concentrations of 30-year traditional fixed rate mortgage loans held in portfolio by some credit unions, which could develop into an adverse financial event in the future.[13] Credit unions that made large amounts of mortgage loans during the current low interest rate environment could find themselves receiving lower

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[8] See Statement of Deborah Matz, chairman, National Credit Union Administration, "The State of the Credit Union Industry," p. 3, at http://www.ncua.gov/News/Documents/SP20101209Matz.pdf, which was given in U.S. Congress, Senate Committee on Banking, Housing, and Urban Affairs, 111th Cong., 2nd sess., December 9, 2010. A significant portion of mortgage-backed securities held by corporate credit unions had lost value and were downgraded below investment grade due to deterioration of the underlying collateral. In March 2009, the NCUA placed two corporate credit unions, the U.S. Central Federal Credit Union and the Western Corporate Federal Credit Union, into conservatorship. In September 2010, Constitution Corporate Federal Credit Union, Members United Corporate Federal Credit Union, and Southwest Corporate Federal Credit Union were also placed into conservatorship.

The U.S. Central Federal Credit Union, which is one of the 28 corporate credit unions, functions as a wholesale corporate and provides services to the other 27 corporates.

[9] See "How Many Corporate Credit Unions Will Be Standing by Year End?," at http://www.cutimes.com/2011/03/02/how-many-corporate-credit-unions-will-be-standing?page=3.

[10] P.L. 111-22, Division A, Helping Families Save Their Homes Act of 2009.

[11] In January 2011, the authority to assess premiums on the credit union system to repay Temporary Corporate Credit Union Stabilization Fund (TCCUSF) advances was clarified by P.L. 111-382, the National Credit Union Authority Clarification Act. See "NCUA 2013 Financial Statement Audits for Temporary Corporate Credit Union Stabilization Fund," at http://www.ncua.gov/about/Leadership/CO/OIG/Documents/2013-FSA(OIG-14-05)-TCCUSF.pdf and "NCUA Board Gets TCCUSF Report, OKs Joing Agency Appraisal Rule," at http://www.nafcu.org/News/2014_News/March/NCUA_Board_gets_TCCUSF_report__OKs_joint_agency_appraisal_rule/.

[12] See CRS Report R40417, *Macroprudential Oversight: Monitoring Systemic Risk in the Financial System*, by Darryl E. Getter.

[13] See National Credit Union Association, "Interest Rate Risk Policy and Program Requirements," Letter No.: 12-CU-05, May 2012, footnote 4, at http://www.ncua.gov/Resources/Documents/LCU2012-05.pdf and NCUA, "Supervisory Letter on Concentration Risk," at http://www.ncua.gov/Resources/Documents/LCU2010-03Encl.pdf.

amounts of revenue relative to what may be necessary to pay share depositors if interest rates increase in the future. Furthermore, the interest rate risk may grow into a systemically important crisis or "too *many* to fail" event if numerous credit unions simultaneously became insolvent.[14] The NCUA guidance requires vulnerable credit unions to submit plans outlining the measures that will be taken to reduce or manage interest rate risks.[15]

On January 23, 2014, the NCUA announced increases in capital requirements for a subset of natural person credit unions that will be designated as *complex*.[16] A complex credit union was initially defined by NCUA to have at least $50 million in assets.[17] On January 27, 2015, the NCUA revised the initial proposed rule, amending the definition of a complex credit union as having at least $100 million in assets.[18] On October 29, 2015, the NCUA finalized the risk-based capital rule.[19] Some of the specific requirements of the rule include the following:

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[14] The Savings & Loan (S&L) crisis of the 1980s is an example of a "too many to fail" event. S&L institutions are nonprofit, member-owned financial institutions specializing in taking savings deposits to facilitate residential home mortgage lending. During the early 1980s, hundreds of S&Ls, which were holding portfolios consisting primarily of traditional fixed-rate mortgages, failed after the short-term interest rates paid to depositors rose to historic levels. Regulation Q interest rate ceilings, which stem from the Banking Acts of 1933 and 1935, imposed interest rate ceilings on time and savings deposits. Depositors were subsequently incentivized to withdraw funds from accounts with interest rate restrictions and deposit them in unregulated accounts such as money market mutual funds. Many S&Ls that were unable to maintain enough depositors to fund loans when deposit rates soared with rising inflation became insolvent. See Alane Moysich, "Chapter 4: The Savings and Loan Crisis and Its Relationship to Banking," Federal Deposit Insurance Corporation, *History of the 80s: An Examination of the Banking Crises of the 1980s and Early 1990s*, Washington, DC, December 1997, at http://www.fdic.gov/bank/historical/history/167_188.pdf. A chronology and bibliography of the S&L crisis is provided at http://www.fdic.gov/bank/historical/s&l/; Paul Calem, "The New Bank Deposit Markets: Goodbye to Regulation Q," *Business Review*, Federal Reserve Bank of Philadelphia, Philadelphia, PA, November/December 1985, at http://www.philadelphiafed.org/research-and-data/publications/business-review/1985/brnd85pc.pdf; Alton Gilbert, "Will the Removal of Regulation Q Raise Mortgage Interest Rates?" *Federal Reserve Bank of St. Louis Review*, St. Louis, MO, December 1981, at http://research.stlouisfed.org/publications/review/81/12/Removal_Dec1981.pdf; Charlotte E. Ruebling, "The Administration of Regulation Q," *Federal Reserve Bank of St. Louis Review*, St. Louis, MO, February 1970, at http://research.stlouisfed.org/publications/review/70/02/Administration_Feb1970.pdf.

[15] The issue of credit union industry concentrations in mortgages is analogous to community bank concentrations in commercial loans. Federal bank regulators expressed concern about the risk management practices of smaller, regional banking institutions after observing rapid increases in commercial real estate loan concentrations on their balance sheets. See Office of the Comptroller of the Currency, Treasury; Board of Governors of the Federal Reserve System; and the Federal Deposit Insurance Corporation, "Concentrations in Commercial Real Estate Lending, Sound Risk Management Practices," 71 *Federal Register* 74580-74588, December 12, 2006, at http://www.gpo.gov/fdsys/pkg/FR-2006-12-12/pdf/06-9630.pdf. Addressing these risks may result in community banks entering into more participation loans agreements with larger banks to further diversify their portfolios. See Rachel Witkowski, "Small Banks Slowly Reconsidering Loan Participations," *American Banker*, March 14, 2012. Similar to the NCUA, the FDIC issued more guidance for bank purchases of participation loans to mitigate risks to the deposit insurance fund for banks, which can be found in its Financial Institution Letters, FIL-38-2012, at http://www.fdic.gov/news/news/financial/2012/fil12038.html.

[16] See "NCUA Board Advances Greater Protection and Modern Regulation," at http://www.ncua.gov/about/Pages/Board%20Actions/BAB20140123.aspx.

[17] The Credit Union Membership Access Act of 1998 (CUMAA; P.L. 105-219) required the NCUA to develop the definition of a "complex" credit union. The Regulatory Flexibility Act (RFA; P.L. 96-354) requires federal agencies to consider the impact of their proposed and final rules on small entities. Consequently, the NCUA currently defines a complex credit union as a natural person credit union with at least $50 million in assets. This definition became effective on February 19, 2013, reflecting an increase from the 2003 definition that used the asset threshold of at least $10 million. See National Credit Union Administration, "Prompt Corrective Action, Requirements for Insurance, and Promulgation of NCUA Rules and Regulations," 78 *Federal Register* 4032-4038, January 18, 2013.

[18] See National Credit Union Administration, "Part II: Risk-Based Capital; Proposed Rule," 80 *Federal Register* 17, January 27, 2015.

[19] See National Credit Union Administration, "Risk-Based Capital," 80 *Federal Register* 66626-66723, October 29,

- A new asset *risk-weighting* system is introduced and would apply to *complex* credit unions, and it will be more consistent with the methodology used for U.S. federally insured banking institutions.[20]
- A new risk-based capital ratio (defined using the narrower risk-based capital measure in the numerator and total risk-weighted assets, which are computed using the new risk-weighting system, in the denominator) of 10% is now required for complex credit unions to be *well-capitalized* under the prompt corrective action supervisory framework.[21] The risk-based capital ratio is designed to be more consistent with the capital adequacy requirements commonly applied to depository (banking) institutions worldwide.[22] Complex credit unions must comply with the risk-based capital ratio requirements as well as the existing statutory 7% net-worth asset net worth ratio by January 1, 2019, to avoid NCUA supervisory enforcement actions.
- Non-complex credit unions with assets below $100 million would not be required to comply with the new risk-weighting system, and they would no longer be required to risk-weight their assets. Instead, non-complex credit unions must comply with the existing statutory 7% net-worth asset ratio.[23]

According to the NCUA, 1,455 credit unions (or 22% of all credit unions) reported having at least $100 million in total assets as of December 31, 2013, representing 89% of all assets held in the credit union system; 19 of those institutions would need to raise capital to avoid being undercapitalized.[24] The ability of undercapitalized credit unions to continue lending would arguably be constrained until they become compliant with the higher capital buffer requirements.

2015, at http://www.gpo.gov/fdsys/pkg/FR-2015-10-29/pdf/2015-26790.pdf.

[20] See "Summary of the Risk Weights" in the NCUA final rule, which includes a comparison of NCUA and FDIC risk weights. The system for risk-weighting assets was adopted by the Board of Governors of the Federal Reserve System and the Office of the Comptroller of the Currency on July 2, 2013; the Federal Deposit Insurance Corporation adopted it on July 9, 2013. See "Regulatory Capital Rules: Regulatory Capital, Implementation of Basel III, Capital Adequacy, Transition Provisions, Prompt Corrective Action, Standardized Approach for Risk-weighted Assets, Market Discipline and Disclosure Requirements, Advanced Approaches Risk-Based Capital Rule, and Market Risk Capital Rule," at http://www.federalreserve.gov/bcreg20130702a.pdf. The risk-based capital measure primarily accounts for credit (default) and concentration risk; interest rate risk will be addressed by NCUA via alternative regulations and supervisory processes.

[21] Under the prompt corrective action supervisory framework, regulators examine whether credit unions and banks meet the requirements to be considered well-capitalized, adequately capitalized, under-capitalized, significantly undercapitalized, and critically undercapitalized. The level of scrutiny, restrictions, and penalties imposed by regulators increases as the financial health of a depository institution deteriorates.

[22] See CRS Report R42744, *U.S. Implementation of the Basel Capital Regulatory Framework*, by Darryl E. Getter

[23] The statutory net worth requirements for credit unions may be found at Illustration 17-A—Statutory Net Worth Category Classification on the NCUA website, at http://www.ncua.gov/Legal/GuidesEtc/ExaminerGuide/chapter17.pdf. For the sake of comparison, banks with less than $250 billion in consolidated assets currently must comply with an unweighted leverage ratio of 4% to be "well-capitalized," which is analogous to the unweighted 7% net worth requirement for all credit unions to be considered well-capitalized. Banks, however, must comply with a minimum total risk-weighted capital-asset ratio of 8% and a capital-conservation buffer of 2.5%, for a total of 10.5% to be well-capitalized by the end of 2019. All credit unions, therefore, would have higher unweighted-leverage ratio requirements than banks with less than $250 billion in assets; but *non-complex* credit unions would not have an analogous risk-weighted asset-ratio requirement. The bank risk-weighted asset requirement of 10.5% would be 0.5% higher than the 10.0% risk-weighted net worth requirement for *complex* credit unions.

[24] See "Frequently Asked Questions and Answers: NCUA's Risk-Based Capital Revised Proposed Rule January 2015," at http://www.ncua.gov/Legal/Documents/RBC/RBC-2015-Proposed-Rule-FAQs.pdf.

Increasing the MBL Cap: Implications and Optional Policy Tools

There was no commercial lending cap on the amount of member business loans that credit unions could make until 1998. In response to a Supreme Court decision, Congress passed the Credit Union Membership Access Act of 1998 (CUMAA; P.L. 105-219), which among other provisions, established a commercial lending cap.[25]

First, the CUMAA codified the definition of a credit union member business loan (MBL). An MBL is any loan, line of credit, or letter of credit used for an agricultural purpose or for a commercial, corporate, or other business investment property or venture. Second, the CUMAA limited the aggregate amount of outstanding business loans to one member or group of associated members to a maximum of 15% of the credit union's net worth or $100,000, whichever is greater. Third, the CUMAA limited the aggregate amount of MBLs made by a credit union to the lesser of 1.75 times the credit union's actual net worth or 1.75 times the minimum net worth amount required to be well-capitalized under the prompt corrective action supervisory framework.[26] Finally, three exceptions to the credit union aggregate MBL limit were authorized for (1) credit unions that have low-income designations or participate in the Community Development Financial Institutions program;[27] (2) credit unions chartered for the purpose of making business loans (as determined by the NCUA); and (3) credit unions with a history of primarily making such loans (as determined by the NCUA).

Legislation has been introduced in the 114th Congress that would allow credit unions to enhance their member business lending activities. H.R. 1188, the Credit Union Small Business Jobs Creation Act, was introduced on March 2, 2015; the companion bill, S. 2028, was introduced on September 10, 2015.[28] H.R. 1188 and S. 2028, would amend the Federal Credit Union Act (particularly 12 U.S.C. 1757) to gradually increase the current business lending cap to 27.5% of the total assets of the credit union from the current 1.75 times of the actual net worth or 12.25% of the total assets, whichever is less. The bills would also require credit unions that make MBLs to have net worth and risk-based capital ratios that satisfy the requirements to be *well capitalized*.

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[25] For a discussion of the Supreme Court decision and congressional response to it that resulted in P.L. 105-219, see *National Credit Union Administration, Petitioner, v. First National Bank & Trust Co., et al.; AT&T Family Federal Credit Union, et al., Petitioners, v. First National Bank and Trust Co., et al.*, 118 S. Ct. 927 96-843, 96-847 (1998). See also William R. Emmons and Frank A. Schmid, "Credit Unions and the Common Bond," *Federal Reserve Bank of St. Louis Review*, September/October 1999, at http://research.stlouisfed.org/publications/review/99/09/9909we.pdf.

[26] At the time of CUMAA, some Members of Congress were concerned that commercial lending, which is considered riskier than consumer lending, would increase the risk profile of the credit union system. In deliberations over the CUMAA, Members expressed concern that a cap calculated as 12.25% (1.75 multiplied by the 7% statutory requirement to be well-capitalized) of a credit union's total assets was too high if small loans (under $50,000) were not counted toward the cap, and were also concerned that such an exemption could open up a regulatory arbitrage opportunity enabling chartered credit unions to assume more financial risk and circumvent the cap limitation in the legislation. Hence, the 12.25% lending cap arguably represented a compromise. See additional discussions in U.S. Congress, Senate Committee on Banking, Housing, and Urban Affairs, *Credit Union Membership Access Act*, report to accompany H.R. 1151, 105th Cong., 2nd sess., May 21, 1998, S.Rept. 105-193.

[27] A designated Community Development Financial Institution (CDFI) works in financial market niches that are underserved by traditional financial institutions. For more information, see the CDFI website at http://www.cdfifund.gov/what_we_do/programs_id.asp?programid=9.

[28] Related bills were introduced in past Congresses. See CRS Report R42574, *Credit Union Commercial Business Lending: Key Issues for Legislation in the 112th Congress*, by Darryl E. Getter and CRS Report R40793, *Credit Union Member Business Loans*, by Pauline Smale.

In addition, a credit union would need to demonstrate a minimum of five years of experience of sound underwriting and servicing of member business loans.

Although the volume of credit union member business lending has increased over time, member business loans continue to account for a small share of lending in the credit union system. In other words, the total amount of MBLs provided by the credit union system may be constrained by the current cap. Credit unions collectively provided a total of $43.42 billion of MBLs in 2013, which equaled 4.08% of total credit union assets; approximately 85% of MBLs were secured by real estate, with some credit unions heavily concentrated in agricultural loans.[29]

The Importance of Asset Size and Market Purview

If the MBL cap were raised, smaller credit unions attempting to originate and increase their holdings of MBLs in portfolio would have to increase their net worth holdings substantially, which arguably would be challenging if the membership base is small. Small credit unions typically offer a limited range of services, such as a few savings products and specialized consumer lending products such as (subprime) personal and automobile loans.[30] These credit unions would be unlikely to increase their presence in the commercial lending market substantially because it would not be cost effective for them to invest in the necessary underwriting systems for the volume of commercial lending that they would feasibly be able to do.[31] Hence, credit unions with assets under $10 million would be less likely to become more substantial providers of MBLs.

By contrast, increasing the MBL cap would benefit credit unions that already enjoy a presence in the commercial lending market or a sufficiently large asset base. Lifting the MBL cap would allow credit unions already operating close to the current statutory limit to increase their presence in the commercial lending market. These credit unions may also already have the capacity to offer a broader range of consumer financial products and services. Some of the larger credit unions, therefore, could become more important competitors with small community banks as well as some midsize and regional banks.[32]

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[29] See NCUA, "Overall Trends," December 31, 2013, at http://www.ncua.gov/legal/documents/reports/ft20131231.pdf. For the sake of comparison, credit unions collectively provided a total of $39.58 billion of MBLs, which equaled 3.87% of credit union assets in December 2012; approximately 84% of MBLs were secured by real estate. (See http://www.ncua.gov/legal/documents/reports/ft20121231.pdf.) Credit unions with assets of $10 million or less collectively made 458 of the MBLs originated by the credit union system in 2012; the median of the average size for this group was approximately $60,000. Credit unions having more than $10 million in assets made the remaining 175,514 or 99.7% of the MBLs in 2012. Credit unions with over $1 billion in assets made 68,088 or 38.7% of the MBLs in 2012. The median of the average MBL size in 2012 was $99,228 for credit unions with $10 million to $100 million in assets; $159,396 for credit unions with $100 million to $500 million in assets; $242,079 for credit unions with $500 million to $1 billion in assets; and $303,958 for credit unions with over $1 billion in assets. These data were provided to CRS by the NCUA.

[30] Church or faith-based organizations that are open for very limited hours during the week, perhaps after church services, with an all-volunteer management and staff are likely to fall into this small asset size category.

[31] MBLs are perhaps the most complex lending activity for credit unions and would require significant resources that many smaller credit unions would find cost prohibitive. See the testimony of the Honorable Debbie Matz, Chairman of the NCUA in U.S. Congress, House Committee on Financial Services, Subcommittee on Financial Institutions and Consumer Credit, *H.R. 1418: The Small Business Lending Enhancement Act of 2011*, 112th Cong., 1st sess., October 12, 2011, pp. 11-12, at http://financialservices.house.gov/UploadedFiles/101211matz.pdf.

[32] According to the Federal Reserve's Survey of Lending Terms, the average commercial and industrial loan size for all domestic commercial banks (excluding U.S. branches and agencies of foreign banks) by the end of 2012 was approximately $374,000; the average loan size at small domestic banks was approximately $119,000; the average loan size at large domestic banks was approximately $457,000. See Board of Governors of the Federal Reserve System, E.2

Although the ability to originate and keep large loans in portfolio until fully repaid is highly dependent upon the size of a credit union, the credit union *system* as a whole can support increased member business lending by increasing its use of *participation (syndicated) loans*. Loan participations are used by financial institutions to provide credit jointly. A loan originator, who often structures the loan participation arrangement, typically retains the largest share of the loan and sells smaller portions to other institutions.[33] This practice allows the originator to maintain control of the customer relationship (including the loan servicing) and overcome funding limitations. In addition, all of the institutions involved in the participation loan use their individual portions of the loan to diversify their asset (loan) portfolios, which can be a cost-effective financial risk management tool. Only credit unions with MBL programs are allowed to enter into MBL loan participations given that all participants must have the ability to and are responsible for performing underwriting due diligence.

Since 2007, the number of credit unions purchasing loan participations increased 15%, and the dollar value of loan participations on credit unions' balance sheets grew by more than 40%.[34] If the MBL cap is raised, then both small and large institutions may purchase portions of these loans and distribute the risk throughout the system, similar in practice to how the banking industry distributes its risks. The credit union system could, therefore, become a more prominent competitor with the banking system in commercial lending markets.

Insolvency Risks to the NCUSIF

Proceeds from the National Credit Union Share Insurance Fund are used to pay share depositors if member institutions fail. In the event of many simultaneous credit union failures, the risk of insolvency of the NCUSIF increases and may require congressional action to replenish the fund. Credit unions can be particularly vulnerable to failure, given that their membership affiliations are restricted to a particular industry or geographical area that could be disproportionately affected by an adverse economic event. For example, an increase in unemployment that is concentrated in a particular industry or geographical location may trigger numerous loan defaults if such an event adversely affects the majority of a credit union's membership.

Increasing the lending cap arguably may allow the credit union system to increase its MBL holdings, possibly resulting in more diversification. If, however, participation lending were to become a more customary practice used to finance MBLs, then losses on loan participations could also pose a "too many (small institutions) to fail" risk to the NCUSIF, given that multiple credit unions are involved in the lending arrangements. The NCUA also reported that participation loan charge-offs increased by more than 160% over the same period that credit unions increased their purchases of participation loans.[35] The NCUA has subsequently provided

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Survey of Lending Terms, February 4-8, 2013, at http://www.federalreserve.gov/releases/e2/current/default.htm. Although large banks originate larger loans relative to the large credit unions, larger credit unions are originating loans larger relative to most banks with assets less than $1 billion. Hence, raising the MBL cap would allow credit unions with $10 million or more in assets to increase their competition with small banks and those with over $1 billion in asset to increase their competition with the larger banks. See Richard G. Anderson and Yang Liu, *Banks and Credit Unions: Competition Not Going Away*, Federal Reserve Bank of St. Louis, The Regional Economist, St. Louis, MO, April 2013, pp. 4-9, at http://www.stlouisfed.org/publications/pub_assets/pdf/re/2013/b/Banks_CreditUnions.pdf.

[33] Although credit unions often enter into participations together (and banks often enter into participations together), loan originators can sell loan portions to any financial entity. This activity should not be confused with a securitization given that the loan portions are sold directly to specific entities rather than restructured into new public offerings.

[34] See "NCUA Board Approves New Rule for Loan Participations," *Board Action Bulletin*, June 20, 2013, at http://www.ncua.gov/about/Documents/Agenda%20Items/BAB20130620.pdf.

[35] See "NCUA Board Approves New Rule for Loan Participations," *Board Action Bulletin*, June 20, 2013, at

more rules for participation loans to mitigate risks to the NCUSIF while still attempting to maintain the viability of this diversification tool for individual credit unions.

Updates to MBL Rules and Definition

On July 1, 2015, the NCUA proposed updates to the MBL rules to remove "prescriptive" requirements and adopt "principles" based approach.[36] The prescriptive approach required credit unions that wanted to originate MBLs to submit waivers to NCUA for approval, among other requirements. The NCUA reported that the prescriptive approach took significant time and resources from both credit unions and NCUA, resulting in delays in processing MBL applications.[37] The principles approach, by contrast, is intended to streamline the MBL underwriting process by granting credit unions more flexibility and individual autonomy. Credit unions are still expected to comply with prudential underwriting practices and commensurate net worth requirements. Furthermore, credit unions with a concentration in commercial lending in access of 50% of their total assets will be required to hold higher amounts of net worth to abate the higher levels of concentration risk.[38]

In light of the greater autonomy associated with the principles based approach, the NCUA also provided more detailed guidance for distinguishing between commercial loans and MBLs to help credit unions better determine which loans to count toward the MBL cap.[39] Despite the distinguishing features, the net worth requirements for both commercial and MBLs would still be identical. H.R. 1422 and S. 1440, the Credit Union Residential Credit Union Loan Parity Act, would amend the FCU Act to revise the statutory definition of MBLs, further enhancing the capacity of credit unions (satisfying the net worth capitalization requirements) to make more MBLs and commercial loans.[40]

Alternative Tools and Policy Options

The MBL cap is not the only policy tool that can be used to influence the lending ability of the credit union industry. From an economics perspective, a lending cap imposes an arbitrary limit that may be too high for some credit unions and too low for others, thus resulting in MBL shortages in the latter situations. For those credit unions that provide very few or no MBLs, a cap is irrelevant. Those credit unions facing an active MBL market must abruptly cease this type of lending when the volume of activity reaches the cap, which some may argue is set "too low," given that they can no longer satisfy the financial needs of their memberships. Hence, a lending

http://www.ncua.gov/about/Documents/Agenda%20Items/BAB20130620.pdf.

[36] See National Credit Union Administration, "Member Business Loans; Commercial Lending," 80 *Federal Register* 126, July 1, 2015.

[37] NCUA reported approving 115 MBLs of the more than 1,000 waivers submitted in 2014.

[38] A risk weight of 150% will be applied to commercial loans should the total amount exceed 50% of total assets. For more information on NCUA risk weights, see "Risk-Based Capital Proposal Comparison: 2015 Revised Proposal Changes Compared to 2014 Original Proposal," at http://www.ncua.gov/Legal/Documents/RBC/RBC-Proposal-Comparison.pdf.

[39] See "Table—Comparison of Member Business Loans and Commercial Loan Definitions" for distinguishing characteristics in the proposed rule, p. 37909.

[40] The current statutory definition of MBL includes a loan to purchase a 1-4 unit *non-owner* occupied residential dwelling as a business loan subject to the MBL cap. H.R. 1422 and S. 1440 would exclude from the MBL cap member loans for the purchase of 1-4 unit rental properties, thus increasing the capacity to make more commercial loans without having to reduce the amount of non-owner occupied residential loans.

cap is arguably a blunt instrument to the extent that it imposes the same requirement on all institutions without taking into account differences in asset size and market purview.

Policy tools with a greater focus on the costs to originate MBLs would still impose restraints on credit unions without directly capping their lending ability.[41] For example, increasing the asset risk weights for MBLs imposes costs without resulting in an abrupt discontinuation of this activity for those credit unions approaching the cap. As previously discussed, the NCUA has narrowed the definition of net worth and introduced a risk-weighting system, which is more consistent with the capital adequacy requirements used by the banking system. Another policy tool having a similar effect would subject the net income derived from member business lending activities (particularly for credit unions over a certain asset size) to unrelated business income tax (UBIT) for tax-exempt organizations.[42] In short, policy tools that operate through cost disincentives instead of quantity restrictions (at a fixed level) may still allow those credit unions with a presence in this market to increase their member business lending activity.

Other Proposed Lending Enhancements

In addition to revising policies associated with member business lending, other legislative actions have been introduced in the 114th Congress to facilitate credit union lending, discussed below.

Supplemental Capital

Because credit unions do not issue common stock equity, they do not have access to capital sources beyond retained earnings. Hence, if alternative sources of capital, referred to as supplemental capital, can be used in addition to retained earnings (net worth), then credit unions would be able to increase their lending while remaining in compliance with their safety and soundness net worth requirements.

An NCUA working group has developed three general sources of supplemental capital, all of which would be repaid in the event of the liquidation of an insolvent credit union and after reimbursement of the NCUSIF.[43] Credit unions could raise

- *voluntary patronage capital* (VPC) if (non-institutional) members of a credit union were to purchase "equity shares" in the organization.[44] VPC equity shares

[41] Using market based incentives to affect the costs of MBLs and, thus, determining the optimal distribution is analogous to the use of environmental (e.g., carbon) taxes to manage pollution emissions. For examples, see CRS Report RL33799, *Climate Change: Design Approaches for a Greenhouse Gas Reduction Program*, by Larry Parker; and John Norregaard and Valerie Reppelin-Hill, *Taxes and Tradable Permits as Instruments for Controlling Pollution: Theory and Practice*, International Monetary Fund, WP/00/13, Washington, DC, January 2000, at http://www.imf.org/external/pubs/ft/wp/2000/wp0013.pdf.

[42] See "Statement for the Record on behalf of the American Bankers Association before the Oversight Subcommittee of the Committee on Ways and Means, United States House of Representatives, July 25, 2012," at http://www.aba.com/Advocacy/Testimonies/Documents/72512StatementUBITCU.pdf. The **Appendix** discusses the circumstances in which some credit unions pay UBIT.

[43] NCUSIF is the federal deposit insurance fund for credit unions. See National Association of State Credit Union Supervisors, "Q&A on Supplemental Captial for Credit Unions," press release, http://www.nascus.org/Regulatory/1-09-Q&A-Supplemental-Capital.php; and the Executive Summary "NCUA Supplemental Capital White Paper prepared by the Supplemental Capital Working Group," April, 12, 2010, at

http://www.ncua.gov/Legal/GuidesEtc/Documents/Publications/20100412SupCapital.pdf.

[44] Credit union members hold *shares* because credit unions are not banks. If they were banks, shares would be called *deposits*. In discussions of supplemental capital, the term *equity shares* is used to help distinguish from the way the term shares is generally used in discussions about credit unions.

would pay dividends; however, a VPC investor would not obtain any additional voting rights, and no investment would be allowed to exceed 5% of a credit union's net worth.

- *mandatory membership capital* (MMC) if a member pays what may be conceptually analogous to a membership fee. MMC capital would still be considered equity for the credit union but, unlike VPC, it would not accrue any dividends.
- *subordinate debt* (SD) from external and institutional investors. SD investors would have no voting rights or involvement in the management affairs of a credit union. SD would function as a hybrid debt-equity instrument, meaning that the investor would simply be a creditor with no equity share in the credit union while it is solvent and would not be repaid principal or interest should the credit union become insolvent. SD investors must make a minimum five-year investment with no option for early redemption.

Net worth for credit unions is defined in statute; therefore, Congress would need to take legislative action to permit other forms of supplemental capital to count toward their net worth requirements. H.R. 989, the Capital Access for Small Business and Jobs Act, referred to the House Committee on Financial Services on February 13, 2015, would redefine net worth for credit unions to include additional sources of supplemental capital in a manner consistent with the three forms discussed in the NCUA white paper. H.R. 989 may arguably complement bills H.R. 1188 and S. 2028, but these bills are not dependent upon concurrent enactment. H.R. 989 would allow credit unions to increase all types of lending (including MBLs) as long as overall net worth, which would then be able to include supplemental capital, grows proportionately.

Federal Home Loan Bank Membership

The Federal Home Loan Bank (FHLB) System provides secured loans to banks, credit unions, and insurance companies engaged in housing finance as well as in agricultural and small business lending.[45] Membership in the FLHB System generally requires institutions to hold at least 10% of their total assets in mortgage-related assets. *Community financial institutions*, however, are exempt from this eligibility requirement. According to the Federal Home Loan Bank Act (FHLB Act; P.L. 72-304, 47 Stat.128), community financial institutions are defined as having less than $1 billion in assets and deposits insured by the Federal Deposit Insurance Corporation (FDIC). This definition allows for some small banks, particularly those designated by the U.S. Treasury as Community Development Financial Institutions (CDFI), to qualify for the exemption; but it excludes NCUA-insured credit unions.[46]

H.R. 2642 and its companion, S. 1491, the Community Lender Regulatory Relief and Consumer Protection Act of 2015, along with H.R. 299, the Capital Access for Small Community Financial Institutions Act of 2015, would amend the FHLB Act to require the treatment of a state-chartered credit unions as insured depository institutions, among other things; thus making it possible to harmonize FHLB membership requirements for small banks and credit unions. In addition, H.R.

[45] For more information about the Federal Home Loan Bank (FHLB) System, see CRS Report RL32815, *Federal Home Loan Bank System: Policy Issues*, by Edward V. Murphy. The FHLB System provided liquidity for mortgage lenders that retained mortgages in portfolio; Fannie Mae and Freddie Mac, which are also government-sponsored enterprises were established to facilitate secondary mortgage markets for originators that wanted to sell their mortgage loans.

[46] See Community Development Financial Institutions (CDFI) Fund, U.S. Department of the Treasury, at https://www.cdfifund.gov/Pages/default.aspx.

2473, Preserving Capital Access and Mortgage Liquidity Act of 2015, would redefine community financial institution to include either a federal or state credit union. The House passed H.R. 299 on April 13, 2015, and its language was included in an amendment to H.R. 22, the Surface Transportation Reauthorization and Reform Act of 2015, which was passed in the House on November 5, 2015. S. 1484, the Financial Regulatory Improvement Act of 2015, and S. 1910, the Financial Services and General Government Appropriations Act, 2016, also contain language similar to H.R. 299.

Appendix. Credit Unions, Community Banks, and Competition

Community banks, which are commonly defined as financial institutions that hold less than $1 billion in assets, are arguably similar to credit unions with respect to their business models.[47] For example, community banks and credit unions engage in "relationship banking," which involves developing close familiarity with their respective customer bases. Community banks typically provide financial services within a circumscribed geographical area. The development of close relationships helps community banks understand idiosyncratic lending risks in their local areas that may not be easily understood using a computerized underwriting methodology.[48] Similarly, credit unions provide financial services to their restricted memberships. The development of close relationships helps credit unions tailor product offerings to their unique memberships. Both credit unions and community banks also rely primarily upon deposits to fund their assets (loans). In other words, community banks and credit unions borrow primarily from their depositors to obtain the funds necessary to provide customer loans rather than from the short-term financial markets that the larger banking institutions access more frequently.

This section discusses some similarities among and differences between credit unions and community banks. Both industries serve similar types of consumer markets, and larger institutions appear to enjoy some advantages relative to their smaller counterparts. There are some regulatory differences in fair lending and taxation between credit unions and banks. These differences may be less important for small credit unions and small banks that operate in very narrowly defined markets, as discussed below. By contrast, both the credit union and banking industries are experiencing similar consolidation trends. Membership size and the ability to offer a full range of financial services may ultimately explain any comparative advantages that large credit unions (and large banks) enjoy relative to small credit unions and small banks. These issues are examined below.

Differences in Fair Lending Requirements

Congress enacted the Community Reinvestment Act of 1977 (CRA; P.L. 95-128) in reaction to perceptions that banks were not sufficiently addressing the credit needs of low- and moderate-income (LMI) neighborhoods.[49] The CRA requires that federal banking regulatory agencies evaluate how regulated institutions meet the credit needs of their entire communities. No statutorily set rules are imposed; banking institutions, however, typically receive CRA credits after providing LMI loans (subject to existing federal prudential regulations for safety and soundness) or other financial retail services in their communities. CRA credits become important when a bank seeks permission from its regulator to move offices or to merge with another financial institution.

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[47] An alternative and more extensive definition of a community bank is associated with its functions as opposed to its asset size. See Federal Deposit Insurance Corporation, *FDIC Community Banking Study*, Washington, DC, December 2012, at http://www.fdic.gov/regulations/resources/cbi/report/cbi-full.pdf.

[48] Large financial institutions perform "transactional banking" or high-volume lending that relies heavily upon automated underwriting. For more information on automated underwriting, see Wayne Passmore and Roger Sparks, *The Effect of Automated Underwriting on the Profitability of Mortgage Securitization*, Federal Reserve Board, Finance and Discussion Series 1997-19, Washington, DC, 1997, at http://www.federalreserve.gov/pubs/feds/1997/199719/199719abs.html.

[49] See CRS Report R43661, *The Effectiveness of the Community Reinvestment Act*, by Darryl E. Getter.

Credit unions are not subject to the CRA. Given that banks may accept deposits from all individuals in a community, CRA provides them with a reciprocal obligation to meet credit needs, as much as possible, of their communities at large. CRA credits are useful to banks when they apply for charters, branches, mergers, acquisitions, and other applications that require approval from their regulators. By contrast, credit unions are not awarded credits that would allow them to expand beyond the common bonds defined in their membership charters. Instead, a credit union may add an underserved area in its field of membership and provide financial services in that designated area.[50]

If, however, the CRA did apply to credit unions, some of them may enjoy a competitive advantage in terms of achieving its policy goals, particularly if their membership consists predominately of minority groups and the credit unions' financial services can be tailored to these groups. Not-for-profit institutions generally may enjoy a cost advantage providing higher risk, unsecured loans at lower rates and fees relative to for-profit banks. In other words, credit unions seek to make enough money to continue operating their organizations, but they are not necessarily incentivized to make a return for equity investors. For example, a credit union affiliated with a faith-based organization that specializes in small-dollar lending may find it less costly (relative to banks or larger credit unions) to devote resources to monitor the repayment patterns of a small group of borrowers that might otherwise remain unbanked or underbanked.[51] Low-cost payday lending to individuals and micro-business lending, which is the granting of small loans between $500 and $35,000 to small businesses with 5 or fewer employees, have been viable businesses for some credit unions.[52] Thus, smaller financial institutions generally may enjoy cost advantages to provide services to riskier consumer markets, and such advantages may be even greater for small not-for-profit credit unions.[53] As of 2012, there were 180 banking institutions with minority ownership; 150 of them would be considered community banks with assets less than $1 billion.[54] In contrast, there were 809 credit unions with over 50% minority membership as of 2012.[55]

Differences in Tax Treatment

Given that credit unions are not-for-profit financial cooperatives, the institutions are exempt from federal income tax. Share deposit holders pay taxes at individual tax rates when they receive

[50] See National Credit Union Administration, "*Underserved Area Expansions*," Letter No.: 01-FCU-02, April 2001, at http://www.crs.gov/pdfloader/R41398.

[51] For more information on the credit union industry's role in providing financial services for disadvantaged communities, see the Office of Small Credit Union Initiatives at http://www.ncua.gov/Resources/OSCUI/Pages/default.aspx and remarks made by U.S. Congress, House Committee on Appropriations, Subcommittee on Financial Services and General Government, *Financial Services for Disadvantaged Communities*, Statement, JoAnn M. Johnson, Chairman, National Credit Union Administration, 110th Cong., 1st sess., March 1, 2007, at http://www.ncua.gov/News/Press/CT20070301Johnson.pdf.

[52] See "CUNA Council White Papers Explore Business and Microlending," *Credit Union Times*, May 14, 2008, at http://www.cutimes.com/2008/05/14/cuna-council-white-papers-explore-business-and-microlending; and Dave Grace, *Microloan Feasibility Study: Can Small Business Lending Become Big Business for Credit Unions?*, Finlene Research Institute, September 6, 2013, https://filene.org/assets/pdf-reports/305_Grace_Microlending.pdf.

[53] See Credit Union National Association, "Equifax: Sub-prime Borrowers Grew Across Lending Sectors," press release, March 29, 2012, at http://news.cuna.org/articles/Equifax:_Sub-prime_borrowers_grew_across_lending_sectors.

[54] See the FDIC's Minority Depository Institutions Program fourth quarter 2012 report, at http://www.fdic.gov/regulations/resources/minority/MDI.html.

[55] See Minority Institution Report, which can be found at the NCUA's Office of Minority and Women Inclusion, at http://www.ncua.gov/about/leadership/pages/page_mwi.aspx.

interest (referred to as "dividends") on their share deposits, as do bank equity shareholders; but the credit union does not pay taxes at the corporate level. Some credit unions, however, may still pay unrelated business income tax (UBIT) for tax-exempt organizations.[56] For example, if a credit union were to provide financial services (e.g., check-cashing) to non-members, any revenue generated from those activities would be subject to UBIT.

Community banks are for-profit financial institutions that may accept deposits and provide lending services without any restrictions on their customer base. Community banks generally are publicly owned and issue common equity shares, so their depositors do not necessarily have to be equity shareholders. Community banks generally pay taxes at the corporate level and the shareholders pay taxes on their equity dividends at the individual tax rates; thus, the corporate profits are taxed twice. In 1997, however, small banks meeting eligibility requirements were allowed to become "S corporations," meaning that their income is taxed only once (at the individual income tax rates).[57] As of 2013, the FDIC reported that 2,210 insured banking institutions were organized as S corporations; thus, these institutions are taxed in a manner similar to credit unions.[58] Small banks organized as S corporations would not experience a tax disadvantage relative to credit unions. The difficulty of converting to an S corporation increases for larger banks if much of their equity is held in Individual Retirement Accounts, which are not allowed to hold equity in S corporations.[59]

The difference in tax treatments of credit unions and banks that are not organized as S corporations would need to be determined on a case-by-case basis. As previously noted, a necessary first step would be to determine the nature of competition. For example, the difference in the tax treatment of a faith-based credit union offering a very limited range of financial services is likely to have a negligible impact on the activities of a nearby community bank. A large credit union able to offer a full range of financial services to a regional or national market, however, may arguably benefit from the difference in tax treatment relative to banking institutions of similar sizes that serve similar markets. The nature of competition in terms of size and market, therefore, determines whether a cost advantage exists.[60]

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[56] See Internal Revenue Service, "Chapter 76. Exempt Organizations Examination Guidelines, Section 22. Credit unions—IRC 501(c)(14)," at http://www.irs.gov/irm/part4/irm_04-076-022.html; "Statement for the Record on behalf of the American Bankers Association before the Oversight Subcommittee of the Committee on Ways and Means, United States House of Representatives, July 25, 2012", at http://www.aba.com/Advocacy/Testimonies/Documents/72512StatementUBITCU.pdf; Kevin E. Fincher, "Unrelated Business Income Tax: A CU's Guide to UBIT Rules & Exceptions, Executive Summary," http://www.cues.org/data/wppc-nonmembers/35_UBITexecsummary.pdf; and Claude R. Marx, "Bellco Credit Union Wins a Clean Sweep on UBIT," *Credit Union Times*, April 14, 2010, at http://www.cutimes.com/2010/04/14/bellco-credit-union-wins-a-clean-sweep-on-ubit.

[57] P.L. 104-188, Small Business Job Protection Act of 1996. For more information about S corporations that pass income through individual tax rates as opposed to C corporations that pay taxes at both the corporate and individual levels, see CRS Report R42359, *Who Earns Pass-Through Business Income? An Analysis of Individual Tax Return Data*, by Mark P. Keightley.

[58] See FDIC Statistics on Depository Institutions, at http://www2.fdic.gov/sdi/index.asp.

[59] See U.S. Congress, House Committee on Ways and Means, Subcommittee on Select Revenue Measures, *Testimony of Independent Community Bankers of America*, "S Corporation Reforms", 108th Cong., 1st sess., June 19, 2003, at http://www.icba.org/advocacy/testimonydetail.cfm?itemnumber=542&pf=1. To compute the number of community banks that are subchapter S corporation banks (by state), see http://www.fdic.gov/bank/analytical/stateprofile/.

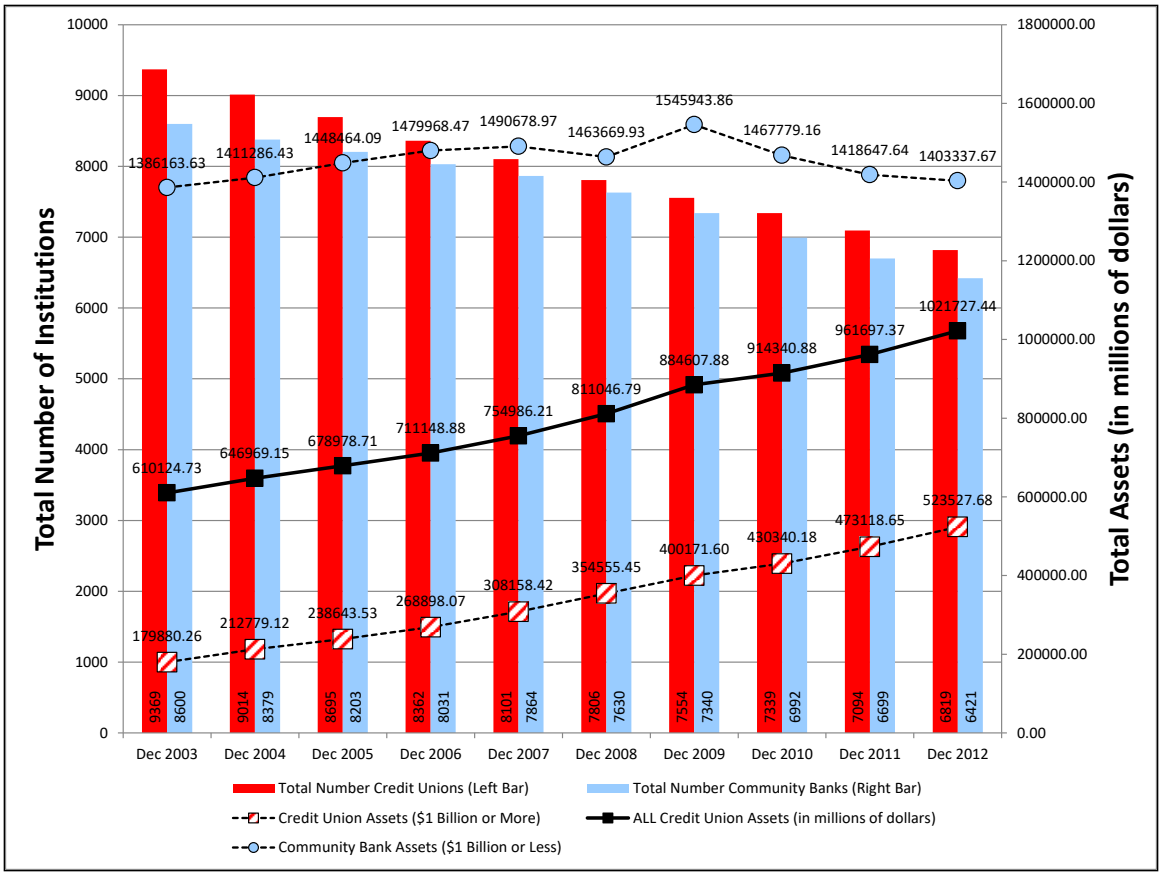
[60] A study was conducted to see if there is a profitability advantage for commercial banks operating as S Corporations compared with those operating as C Corporations. Ken B. Cyree, Scott E. Hein, and Timothy W. Koch, *The Impact of Taxes and Ownership on the Performance and Capital Structure of S Corporation Banks*, May 2010, at http://finance.ba.ttu.edu/hein/Research%20Papers/Impact_of_Taxes_and_Ownership_onCapital_Structure_S_Corp_Banks%20May2010%20to%20JFI.pdf.

Similarities in Consolidation Trends

Using data from the NCUA, **Figure 1** illustrates the total number and total asset holdings of U.S. credit unions over the 2003 to 2012 period. Total credit union assets have risen while the total number of credit unions has been shrinking over time. Credit union assets increased from $610.1 billion in 2003 to $1,021.7 billion by 2012. The total number of credit unions, however, declined from 9,369 to 6,819 over the same period. Furthermore, industry assets are not evenly distributed. The largest 197 credit unions with over $1 billion in assets held 51.2% of total industry assets in 2012 compared with the 29.4% share held in 2003. Loan and membership growth rates were positive for credit unions with assets exceeding $100 million; the highest growth rates were observed for institutions with $500 million or more in assets.[61] By contrast, institutions with $100 million or less in assets saw negative loan growth; institutions with less than $10 million in assets also saw negative membership growth. These trends are similar to the consolidation trends observed in the depository banking system.[62]

Figure 1. Federally Insured Credit Unions and Community Banks and Assets

2003-2012



Source: NCUA and the Federal Deposit Insurance Corporation (FDIC).

[61] For summary statistics, including information on average assets by various credit unions sizes, see NCUA "Overall Trends," December 31, 2012, at http://www.ncua.gov/Legal/Documents/Reports/FT20121231.pdf.

[62] For more information on the consolidation trends in the federal depository banking industry, see CRS Report R43002, *Financial Condition of Depository Banks*, by Darryl E. Getter

For the sake of comparison, **Figure 1** also includes the total number and assets of community banks. As of 2012, there were approximately the same number of community banks and credit unions, 6,421 and 6,819, respectively. The community banks, however, collectively had approximately $400 billion or 37.3% more in assets than the credit union industry. When compared with credit unions of similar size (less than $1 billion in total assets), community banks collectively have approximately $904 billion or 181.7% more in assets. Hence, the assets of most credit unions are on average much less than the assets of most community banks.

Although community banks collectively have more aggregate assets relative to the entire credit union industry, total credit union assets in **Figure 1** appear to have slightly greater trend growth relative to the total assets of community banks. This trend is driven by growth of the large credit unions, which are holding a greater share of industry assets over time. On November 5, 2011, which became known as Bank Transfer Day, thousands of consumers moved their (deposit) accounts to credit unions due to their frustration with large bank fees.[63] Based upon the trends in asset and membership growth, the migration of customers from (large) banks appears to have benefitted larger credit unions able to offer more financial services relative to small credit unions or small banks (with less than $1 billion in assets).

Regulatory differences that are unrelated to safety and soundness may also present comparative advantages, particularly for smaller institutions. For example, recent restrictions placed on the amount of debit interchange fees that can be collected by large banks and credit unions may reduce revenues that could be used to cross subsidize some of the costs associated with providing other financial services, thus creating a competitive advantage for institutions not covered by the regulation.[64] Differences in the reporting requirements related to consumer protection regulations may create cost advantages for smaller financial institutions, especially those that provide services to financially riskier customers.[65] By contrast, compliance with various or a multitude of regulations may place a higher cost burden on small institutions relative to those with size and transaction volume advantages, which generate substantial fee revenue for larger institutions.[66] Hence, regulations that provide cost advantages for one set of financial firms may be offset by cost advantages generated by other regulations that favor another set of financial institutions.

[63] See Claude R. Marx, "CUNA Revises to 210,000, Not 650,000, New Members in Bank Transfer Day Runup," December 5, 2011, at http://www.cutimes.com/2011/12/05/cuna-revises-to-210000-not-650000-new-members-in-b.

[64] See CRS Report R41913, *Regulation of Debit Interchange Fees*, by Darryl E. Getter.

[65] The consumer financial protection supervision of financial institutions with $10 billion or less in assets will remain with their prudential regulators rather than with the Consumer Financial Protection Board. See CRS Report R41338, *The Dodd-Frank Wall Street Reform and Consumer Protection Act: Title X, The Consumer Financial Protection Bureau*, by David H. Carpenter. Thus, various financial practices provided on a smaller scale by small institutions may not receive the same scrutiny as those conducted by large institutions that will be examined by the Consumer Financial Protection Board.

[66] See Thomas J. Curry, "Remarks Before the Florida Bankers Association," Office of the Comptroller of the Currency, Miami, FL, October 23, 2012, at http://www.occ.gov/news-issuances/speeches/2012/pub-speech-2012-151.pdf; and Louise Bennetts, "Thanks to Dodd-Frank, Community Banks Are Too Small to Survive," *American Banker*, November 9, 2012.

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