Testimony of Jeff Plagge

on behalf of the

American Bankers Association

before the

Committee on Ways and Means

United States House of Representatives

November 3, 2005
Mr. Chairman, my name is Jeff Plagge. I am president and CEO of First National Bank, a $200 million community bank located in Waverly, Iowa. The American Bankers Association (ABA) appreciates the opportunity to comment to the Ways and Means Committee on the tax exemption of credit unions. Our comments focus on the evolution of traditional credit unions serving “people of small means” to full service, financially sophisticated institutions that compete head-to-head with tax-paying banks and fail to serve the mission for which they have been exempted from all federal taxation.

ABA on behalf of the more than two million men and women who work in the nation’s banks, brings together all categories of banking institutions to best represent the interests of this rapidly changing industry. Its membership — which includes community, regional and money center banks and holding companies, as well as savings associations, trust companies and savings banks — makes ABA the largest banking trade association in the country.

This statement addresses three central points:

I. A new breed of credit union has abandoned its mission to serve those of small means. In fact, studies show banks are more often a source of credit to low- and moderate-income people than are credit unions.

II. Being a non-profit cooperative does not, alone, justify a tax exemption. Fairness dictates equal tax and regulatory treatment for similarly situated institutions. Yet complex credit unions take advantage of their tax-exempt status to unfairly compete with tax-paying banks, offering virtually indistinguishable products and services in the same markets.

III. Congress has repeatedly recognized that there are limits to tax exemptions and has acted to eliminate them for entities that stray from their intended public policy goals. Credit unions that have abandoned their core mission should be taxed or required to convert to bank charters.
I. Complex Credit Unions Outgrow Justification for Tax Subsidy

Chairman Thomas, as you stated earlier this year, “Tax-exemption is an important benefit and the Congress has a responsibility to oversee and assure the American taxpayer that the tax-exempt sector is living up to its legal responsibilities.” We agree. ABA recommends that Congress examine credit unions’ tax-advantaged status, particularly those that have strayed from the original credit union mission. While many credit unions remain true to their original mission, today a growing number of credit unions have abandoned their roots and inappropriately taken advantage of their tax-exempt status.

Continuing the special tax treatment for institutions that look and act like tax-paying banks has public policy consequences. The size of the “tax expenditure” as the Office of Management and Budget (OMB) calls it, is already big — more than a billion dollars per year. And basic economics tells us that it will get bigger as tax-favored firms take business away from taxpaying firms. Simply put, as these credit unions get larger, so does the tax expenditure.1

This is not how the credit union movement began. Closely-knit groups of people would pool their resources to provide small loans for one another. Credit unions were originally created and granted their tax exemption to fill a market void that existed in consumer finance in the early 20th Century. Few, if any, banks at that time offered consumer loans, and consumers, especially people of modest means, had few options to obtain credit.

By 1934, the United States had approximately 2,500 credit unions, with 38 states and the District of Columbia offering credit union charters. Later that year, a federal credit union charter became available. Whether chartered by a state or the federal government, membership was limited to people with close bonds because familiarity was critical to the “character” loans made by credit unions. The commonality of interest among members — their common bond — was the essence of credit unions. It was the justification for their unique place in our financial system.

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1 Tax expenditures are defined in the law as “revenue losses attributable to provisions of the federal tax laws which allow a special exclusion, exemption, or deduction from gross income or which provide a special credit, a preferential rate of tax, or a deferral of liability.”
Who Serves Low- & Moderate-Income Consumers? Increasingly, Not Credit Unions

Today, an array of options for credit is available for everyone, dramatically reducing the justification for granting credit unions special treatment. In fact, studies reveal banks serve more low- and moderate-income people than credit unions do, despite credit unions’ supposed focus on “people of small means,” as required by the Federal Credit Union Act.

The Federal Reserve’s 2001 Survey of Consumer Finances revealed that only 36 percent of the households that primarily used credit unions had low- and moderate-incomes in contrast to 42 percent of the households that primarily used banks. In 2003, the Government Accountability Office (GAO) released a report that showed that 64 percent of households that primarily use a credit union are middle and upper income, as compared to 58 percent of households that primarily use banks. It also found that banks provided 34 percent of their mortgage loans to low- and moderate-income borrowers while credit unions issued just 27 percent of their loans to these borrowers in 2001.

A recent study conducted by the National Community Reinvestment Coalition (NCRC) concluded that banks are more often a source of credit to people of modest means than credit unions are. “In the year 2005, after 70 years of federal supervision of credit unions, most people would be surprised to learn that banks are doing a better job of serving low- and moderate-income people than credit unions,” the NCRC study said.²

Think Federal Credit Union exemplified in its 2003 Annual Report how credit unions’ focus has changed when it stated: “Yesterday our challenge was to provide financial services to members who could not get services elsewhere. Today our challenge is to provide financial services to members who can get services anywhere.”

Instead of focusing their resources on people of modest means, today a new breed of institution that bears little resemblance to a traditional credit union is capitalizing on its tax-exempt status to offer products and services far beyond any meaningful common bond. There are now more than 100 credit unions each with assets greater than $1 billion. There are 263 credit unions with assets of more than $500 million each.

² “Credit Unions: True to Their Mission?” NCRC, 2005.
In nearly half the states in this country, a credit union would rank among the top ten banks in terms of size. As Gene Portias, president of the Credit Union Association of Oregon, stated: “In a lot of places, credit unions are the major financial institution.” Complex, aggressive institutions increasingly dominate the industry, yet still try to hide behind the veil of a “traditional” credit union.

The credit unions’ own surveys suggest that their image of serving moderate- and lower-income people is no longer valid. The profile of the average credit union member today — higher than average income, better educated, and more likely to be in a professional occupation than his or her non-member counterpart — is not one typically associated with people needing taxpayer-supported financial services. According to a recent demographic survey conducted by the Credit Union National Association (CUNA), the average household income of credit union members is 20 percent higher than nonmembers — $55,120 versus $45,790.4

The fact is that bank customers are more likely to be from low- and moderate-income households than are credit union customers — yet credit unions continue to enjoy the tax expenditure purportedly because they serve people of modest means. As Bruce Shawkey of Credit Union Management magazine stated, “…[C]redit unions’ ‘bread and butter’ members are middle-aged white males with mid-to-upper-incomes.”

Even credit union executives are disturbed that credit unions have strayed so far from their original mandate to serve people of small means. Citing CUNA’s numbers on the average household income of members served by credit unions, Armando Cavazos, president of Credit Union One in Ferndale, Michigan, said, “We should almost feel guilty about serving people of affluence.”

Jim Blaine, CEO of State Employees CU in Raleigh, NC, conceded, “Maybe we’ve gotten so sophisticated we don’t want to get our hands dirty with poor folks any more. That’s what we were created to do, and sometimes I think we’re forgetting that.”

And, Ed Gallagly, president/CEO of Central Florida Credit Union, says, “There’s no question that subconsciously — and even consciously — some credit unions are trying to run-off unprofitable members. I hate to use that term run-off but that’s what’s happening.”

Credit Union Subsidy is Used Inappropriately

As morphed credit unions stretch their fields of membership across ever-larger geographic areas and venture into new business activities, is the tax benefit being passed on fully to credit union members? In more and more cases, the answer is no.

In some cases, it is going to build elaborate corporate headquarters like Golden 1 Credit Union’s new 200,000 square foot headquarters in Rosemont, California, costing more than $30 million and GTE Federal Credit Union’s new 125,000 square-foot headquarters located on a 12.5 acre campus in Tampa, at a cost of about $22 million. And Digital Credit Union in Massachusetts paid $5.2 million for the naming rights for an arena in Worcester (MA) in 2004 and University FCU in Texas is contributing $13.1 million to the renovation of the University of Texas’s baseball stadium in exchange for naming rights. Is this an appropriate use of the credit union tax exemption?

Communities are not being served, either. Credit unions, unlike banks, are not required to meet the obligations set forth in the Community Reinvestment Act (CRA). In a study of Virginia credit unions, professors Murphy and O’Toole found that “banks and savings institutions in Virginia are putting a greater percentage (88 percent) of their deposits back into the community in the form of loans than are credit unions (76.3 percent). In other words, tax treatment of credit unions has not resulted in a higher proportion of loans going to meet the needs of the communities they serve.”

Business Lending — Extending Tax-Subsidized Services to Commercial Entities

In addition to serving a wealthier customer base, the new breed of credit unions is looking for profitable opportunities in commercial lending, thus further extending the tax exemption beyond its original purpose. Business lending by credit unions grew by almost 50 percent in 2004. More than 420 credit unions have at least 5 percent of their total loans in business loans and almost 240 have at least 10 percent of their loan portfolio in business loans. Nearly 250 credit unions are designated guaranteed lenders by the Small Business Administration (SBA), and more than 300 credit unions

7 “Are Members Really Leaving Credit Unions? CEOs Offer Their Take,” Credit Union Times, April 14, 2004, p. 42.
have either purchased or participated in business loans made to non-members. Should members’ savings fund business loans to non-members?

“Successfully banking the small-business owner is one of the keys to increased credit union profitability,” the Credit Union Executive Society noted. And many credit unions are following this course to boost profits. Jean Faenza, EVP for Telesis Community CU, describing her credit union’s pursuit of business owners, stated: “Remember, every business owner is a consumer who has other accounts… small business are employers. We’re greedy — we want all of those accounts.”

Lending by credit unions is big business. For example:

- Less than one year after commencing operations, CU Business Group, LLC said it had processed more than $50 million in business loans — with the average-sized loan worth more than $600,000. Larry Middleman, CU Business Group’s President/CEO, noted that the “[l]oan packages are much larger than we anticipated.”

- The average business loan outstanding at Florida’s Vystar Credit Union is $463,000; at California’s Telesis Community Credit Union, it is $693,100.

- Coastal Federal Credit Union with $1.5 billion in assets has ventured into complex commercial real estate transactions where the average size loan exceeds $4 million.

- Texans CU has approximately $382 million in business loans on its book and funded Prism Hotel’s acquisition and construction financing of the 280-room Radisson Memphis Hotel in Tennessee.

- Spokane Teachers CU financed a $3 million renovation of the Montvale Hotel, a luxury hotel in Spokane, Washington.

These are all loans for which a bank would likely compete. It is inappropriate that credit unions leverage their tax subsidy to compete unfairly head-to-head with tax-paying banks and become “super competitors.” It also begs the question of who is indirectly subsidized by the credit unions tax exemption: Luxury hotels and commercial real estate developers? Is this what Congress intended?

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10 Credit Union Journal, September 1, 2003.
11 Credit Union Times, March 30, 2005, p. 23.
Subsidizing a “Super Competitor” That Preys on Community Banks & Small Credit Unions

Although the credit union industry argues that the issue of credit union competition is about big banks against little credit unions, it is really about the billion dollar credit unions − fueled by their federal tax subsidy − against the community banks in this country. Competition in financial services occurs on the local level. The fact that the banking industry as a whole is much larger than the credit union industry has no bearing on head-to-head competition in the local market.

There are nearly 8,000 community banks in this country with assets of less than $500 million each. The credit union tax exemption adversely affects these tax-paying banks. It gives credit unions a significant price advantage over tax-paying banks that offer the same products and services and enables credit unions to grow much more rapidly.

The fact is that in more and more communities, it is the credit union that is many times larger than the local banks. This trend facilitates a market share shift from tax-paying institutions to tax-exempt credit unions. For example:

- In North Carolina, State Employees Credit Union (SECU), which has assets of over $12.7 billion and 185 branch locations and 860 ATMs, competes directly with almost one hundred community banks, but is 44 times larger than the average-sized community bank.

- The Credit Union of Texas, with $1.6 billion in assets, is almost seven times larger than the 17 community banks it competes with in its market.

- Visions FCU with $1.6 billion in assets boasts that it was the largest mortgage lender in Broome County (NY) for 2003.

Some aggressive credit unions are now so large that they dominate the deposit market in their areas, competing head-to-head with large and small banks alike. For example:

- With $2.9 billion in assets, Vystar Credit Union in Northeast Florida dominates its market area with more deposits in the region than First Alliance, Wachovia and Bank of America combined.

- With $5.6 billion in assets, Boeing Employees’ Credit Union in Washington State dominates its market area with more deposits there than Washington Mutual and Bank of America combined.

- With $1.8 billion in assets, ENT Federal Credit Union in Colorado dominates its market area with more deposits in the region than Wells Fargo and World Savings Bank combined.

It is obvious that the tax subsidy provides credit unions a very large pricing advantage. For example, professors Murphy and O’Toole found that “…credit unions are enabled to offer a 67 basis point advantage in loan pricing and deposit pricing over banks as a direct result of the fact that credit
unions do not pay state or federal taxes. In a highly competitive industry, the 67 basis point
government subsidy is substantial.”

And the competition is not just banks versus credit unions, but also morphed credit unions against
traditional credit unions. Lorraine Ratoni, CEO of Sacramento County Grange Credit Union noted:
“We’re losing members to larger credit unions. We’re having a harder and harder time
competing.” Again, who does Congress intend to subsidize?

Laura Bruce, writing for Bankrate.com, states, “To say credit unions don’t compete with one
another or with banks just doesn’t ring true anymore. There’s competition. Some of it’s for sheer
survival; some of it’s for market share. Not all credit unions have jumped into the fray. Some
employment or organization-based credit unions may have a very successful niche and be able to
stay small and survive, maybe even thrive — but they’re part of a shrinking minority.”

Policies Fuel Credit Union Consolidation and Unlimited Growth

While credit unions have grown to serve wealthy
customers and offer commercial loans, NCUA
continues to expand their tax subsidy without
restraint. Through pro forma approvals of multiple
common bonds, rapid approvals of community
charters beyond any reasonable definition of
“local,” and liberal interpretations facilitating
expansion of business lending and other service
offerings, NCUA has fueled the evolution towards
larger, more complex credit unions. Today, a
single credit union can serve thousands of
unrelated groups, or huge geographic areas with
millions of people. This is not what Congress
intended.

Mergers and acquisitions have also played an
important role in the expansion of many large
credit unions. The result is fewer, but larger, credit
unions. Since 2000, the credit union industry has
consolidated at twice the rate of the banking
industry. Over the last 4 years, nearly 1,100 small
credit unions have disappeared.

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13 A Study of the Evolution and Growth of Credit Unions in Virginia: 1997-2002, by Neil Murphy and Dennis O'Toole,
November 2003.
14 “Friendly Foes: Once Allies, Credit Unions Now Compete for Customers,” by Barbara Marquand, Sacramento
Community charters are the fastest expanding segment of the credit union industry. Federal law permits a credit union to serve anyone in a “well-defined, local community, neighborhood or rural district.”17 In fact, the number of federal credit unions with community charters has more than doubled from 464 in 1999 to 1,051 as of year-end 2004.

The use of the term “community” has reached absurd proportions. NCUA and various state regulators have approved community expansions that include some of the largest cities in the country, entire Metropolitan Statistical Areas (MSAs), multiple counties across state lines and even entire states as part of a credit union’s field of membership. The result, according to GAO, is that the average size of a community charter approved by NCUA jumped almost three-fold from a population of 134,000 people in 1999 to 357,000 in 2003.18 And this growth occurred in spite of NCUA’s acknowledgment that when Congress, in 1998 legislation, added the requirement that community credit unions be “local,” it intended to limit the size of such credit unions.

As Scott Waite, Senior Vice President and Chief Financial Officer of the $3 billion-plus Patelco Credit Union, said on the credit union’s expansive community charter in Northern California: “[I]f you walk past our front door, you can join.”19

A few of the many other examples that illustrate just how far the definition of “local community” has gone include:

- NCUA approved a community charter application for LA Financial CU to serve the 10 million plus residents of Los Angeles County — larger than the population in 42 states and a geographic area equivalent in size to the states of Rhode Island and Delaware combined.
- Wescom Credit Union’s field of membership includes the 16 million people living in Los Angeles, Ventura, Orange, Riverside, and San Bernardino Counties.
- In 1999 and 2000, Meriwest Credit Union added the three million residents of Alameda and Santa Clara Counties and expanded its reach into Contra Costa and San Mateo Counties with a combined population of 1.7 million, and into the City and County of San Francisco — representing another 750,000 people.
- Boeing Employees CU in Washington State amended its field of membership to include the whole state of Washington.

To evade field of membership limitations, credit unions have been forming charitable foundations. Anyone who makes a donation to the foundation is eligible to join the credit union. For example, $2.1 billion GTE FCU advertises on its website: “You can join GTE FCU even if you are not eligible for membership through your employer or a family member. GTE FCU sponsors a non-profit educational financial club, CUSavers.”

17 Public Law No.: 105-219.
19 Bankrate.com.
And some credit unions do not even go through the pretense of having a common bond. As Greenwood CU in Rhode Island states, “membership ... is open to all responsible people who want to be a member.”

II. Being a Not-for-Profit Cooperative Does Not Justify the Tax Exemption

Since morphed credit unions no longer embody the traditional characteristics that justify continuing their tax exemption, they have been forced to offer a new justification. According to Dick Ensweiler, Chairman of the Credit Union National Association, “Credit unions have the tax status that they do because they are not-for-profit, cooperatively owned, democratically governed, and generally led by volunteers from among the membership.”

But being a not-for-profit cooperative does not justify being tax exempt.

In fact, most financial institutions that had traditionally been described as “cooperative, member-owned and not-for-profit” are now subject to federal taxation. Those institutions include mutual insurance companies, mutual savings banks, and mutual savings and loan associations. Each of these financial institutions lost their tax exemption years ago — mutual insurance companies in 1942, and mutual savings banks and mutual S&Ls in 1951. Why?

In the 1951 decision, Congress determined that:

- These cooperative and mutual institutions were in “active competition” with taxable institutions and continuing their tax exemption would be “discriminatory;” and,

- They had evolved into institutions whose “investing members are becoming simply depositors, while borrowing members find dealing with a savings and loan association only technically different from dealing with other mortgage lending institutions in which the lending group is distinct from the borrowing group.”

Thus, Congress determined that mutuality alone was not sufficient to continue the tax exemption for these institutions. This conclusion is particularly telling because of the similarities between mutual savings institutions and credit unions, as noted by the U.S. Treasury Department: “Mutual thrifts are the federally insured depository institutions most similar in structure to credit unions, because like credit unions, mutual thrifts generally do not have corporate stock, are not-for-profit entities, and are owned by their depositors, or members, rather than by shareholders.”

In fact, in a letter to the editor appearing in the September 28, 2005 edition of the Credit Union Times, Ralph Leas, president and CEO of Golden Bay FCU writes, “I have long believed that the original logic of a credit union tax exemption has expired and that credit unions, like other business cooperatives in the United States, should pay their fair share.”

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21 56 Stat. 798.
22 Comparing Credit Unions with Other Depository Institutions, United States Department of the Treasury, January 2001, p.25.
The tax preference originally provided to credit unions was a way to subsidize financial services for individuals with low and moderate income. Many traditional credit unions still dedicate themselves to this purpose. But the metamorphosis to healthy and sophisticated credit unions shows how quickly this goal can be abandoned.

If the tax exemption is no longer conditioned upon the policy goal of serving low- and moderate-income individuals and offering a limited menu of products and services, the special tax treatment for morphed credit unions cannot be justified.

III. Congress Has Acted to Limit Tax Exemptions

Financial entities that have retained their tax-exempt status are generally subject to limitations that restrict either their size or the breadth of their membership. Moreover, their tax-exempt status remains based on narrowly crafted congressional directives relating to the service of niche markets or to achieving limited policy goals. With the erosion of both the common bond and the easing of limits on credit union products and services, credit unions’ are free to stray from their original mission.

The question of where the line should be drawn to control the taxpayer expenditure needs to be answered. Every expansion of a morphed credit union expands the tax expenditure. OMB estimates that the credit union “tax expenditure” will exceed $7.5 billion over the next five years, and this figure does not take into account additional lost state tax revenue. And most of the tax subsidy goes to the most aggressive credit unions — those that are least likely to embrace traditional credit union principles. In fact, the largest 100 credit unions absorb 40 percent of the tax expenditure — quite a contrast with the 29 percent of just 6 years ago.

This is a substantial subsidy and, with inadequate restraints, it will grow rapidly. Basic economics tells us what happens when a tax-exempt firm and a taxpaying firm offer the same products: the tax-exempt firm grows at the expense of the taxpaying firm. As business flows to the tax-exempt firms and away from taxpaying institutions, the size of the tax expenditure will grow. The public deserves a thorough review to assure that the tax expenditures are being appropriately spent and not disadvantaging competing businesses that carry out the same activities on which they pay taxes or fueling abandonment of the mission for which the exemption was created.

As mutual insurance companies and mutual savings banks became similar to, in the words of the Congressional Budget Office, “profit-seeking corporations”, Congress eliminated their tax exemption. In the Revenue Act of 1942, Congress made mutual insurance companies with annual gross receipts in excess of $75,000 subject to federal income tax. This change was made to restrict the exemption to smaller institutions deserving of the class exemption. Since that time, the threshold for eligibility for this exemption has been changed to annual net written premiums not exceeding $350,000.

23 OMB, February 2005, for the fiscal years 2006 through 2010.
24 Budget Options, CBO, March 2003, p. 218.
Conclusion & Recommendations for Change

Congress needs to ask: “At what point do large, diversified credit unions cease to be the type of institutions the Congress envisioned to be worthy of a tax exemption?” Complex credit unions, which have evolved into full-service financial institutions serving the general public, are a far cry from the small, traditional credit unions that served distinct groups of “people of small means” that Congress sought to assist when it provided tax subsidies to credit unions in the 1930’s.

These credit unions are very different from the many credit unions that have remained true to the spirit of the original credit union charter. Credit unions that are indistinguishable from tax-paying banking institutions no longer deserve their tax exemption and should be required to pay taxes or to convert to a bank charter.

One possible tax model currently applies to most cooperatives organized for economic purposes (as opposed to charitable or limited purposes), i.e., Subchapter T of the Internal Revenue Code. Members, or “patrons” would be responsible for paying taxes on earnings (i.e., interest on deposits) passed through to them (at their individual tax rate). Retained earnings — which do not benefit individual members — would be taxed at the general corporate rate. Under this approach, credit unions could continue to pass on their financial profits to their members, either through higher interest rates on deposits or through lower interest rates on loans. Their tax-advantaged growth, however, would be eliminated. At a minimum, Congress needs to curb the ability of credit union regulators to expand the size of the subsidy at the taxpayers’ expense.

Removing the tax exemption for mutual savings institutions and mutual insurance companies did not diminish their vitality. These institutions are healthy, well-capitalized, and profitable. During the last five years, mutual savings banks and mutual savings and loans paid $2.9 billion in corporate income taxes. Just like my bank, they pay their fair share. The same cannot be said for today’s new breed of credit unions.

Thank you.