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Taylor Marsh
University of Puget Sound

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The Future of Credit Unions

Taylor Marsh

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Senior thesis submitted in partial fulfillment
of the requirements for a
Bachelor of Arts (or Science) degree in Economics
at the University of Puget Sound

Introduction:

Before deregulation started in 1977, the roles of financial institutions were clear. Commercial banks primarily offered checkable deposits and made commercial loans. Mutual savings banks and savings and loan associations offered fixed rate passbook savings accounts and made residential mortgage loans. Credit unions offered share accounts, which paid dividends, and made consumer loans. Since deregulation, many of these distinct roles have disappeared and financial institutions have expanded their offerings to its members. Since the innovation of a 6-month money market certificate of deposit (CD) linked to the 6-month Treasury bill rate was approved by regulators in 1977, credit unions are the fastest growing depository institution in terms of assets in the United States (Kaushik, 1994).

The increase in banking amenities offered by all financial institutions has created a much more level playing field in the financial services industry, leading to an extremely competitive market. The competitive and legislative environment of credit unions has changed in recent years, causing their tax exempt status to become an ever increasing concern.

The taxation of credit unions has been under question for several reasons, such as the equity principle that calls for a “level playing field” or “treating equal equally.” Bankers are continually attempting to remove the tax exempt status from credit unions in order to eliminate a considerable part of their competition. The broadening of the common bond principle and the ability of credit unions to serve low-income people in

their communities are other reasons that the tax exempt status of credit unions has been increasingly challenged. The continual growth, and diversification of credit unions, brings up the question, how well they are serving their local communities?

In February of 1998 the Supreme Court decided that credit unions must enforce tight common bond requirements in order to obtain and maintain their charters and tax exemption. Congress reacted quickly and within six months passed the Credit Union Membership Access Act (CUMMA). This act authorized the very multiple group fields of membership that the Supreme Court had just invalidated (Tatom, 2003). The tax exempt status of credit unions is currently being backed heavily by congress, even though large credit unions appear to be able to compete with for-profit banks.

The objective of this paper is two fold. First, this study will analyze the market failures that justify credit unions to operate as a non-profit organization, such as helping the poor and generating higher social benefits to communities in which they operate. More specifically, this article will look at several models used to describe the efficiency of credit unions in the market place, and how credit unions have operated in the past. This will be done by looking at the effects of the tax subsidy, constant returns to scale, and credit unions marginal social benefits to society. Second, the study will analyze how credit unions are operating currently and what direction they might be heading in the future. The paper will investigate the effects of multiple bond credit unions in the banking market and the positive and negative externalities that are generated from the transition from small to large credit unions.

Review of Literature:

Since 1977, when the deregulation began of financial institutions, banks were required to take part in the “Community Reinvestment Act” (CRA), causing members of different institutions to take sides. In the beginning, banks and their members weren’t offended by the CRA requirements which credit unions didn’t have to abide by, including federal and sometimes state tax exemptions. Banks started to take a stand as credit unions began to increase their asset size, and amenities, making them resemble a commercial bank, rather than a small financial cooperative with a very tight common bond. Sides are clearly drawn in the financial services industry and options are clear cut and one sided.

Reasons for Tax Exemption:

Credit unions were given the tax exempt status in exchange for serving what Congress defined as people of low and modest means. Kurt R. Bauer (2007), the president and CEO of the Wisconsin Bankers Association, argues that banks do a better job of serving populations of low and modest means than credit unions. He also argues that credit unions in Wisconsin are giving out fewer and fewer home loans to low and moderate income borrowers. Brett Thompson (2007), president and CEO of the Wisconsin Credit Union League, counters these claims by stating that banks have no problem competing with credit unions. According to the Wisconsin Bankers Association

(WBA) in 2007, banks in Wisconsin have ninety percent market share, and have increasing profits every year. Credit unions pay all taxes but one, the corporate income tax. Credit unions are able to provide \$157 million in annual savings to Wisconsin consumers, and Wisconsin's lower income consumers save \$44 million because they have access to credit unions. Despite what Kurt Bauer argues, Brett Thompson states that low income borrowers were almost twice as likely, and minorities two-thirds more likely in 2005, to have their home loans approved by a credit union.

The Credit Union National Association (2004) is the largest credit union trade association, representing approximately 8,370 of the 9,300 state and federal credit unions and their 86 million members. The U.S. Department of the Treasury's (2001) argument is that taxing credit unions on their shares, similar to how banks are taxed on their capital shares, "places a disproportionate and excessive burden on credit unions because their shares function as deposits", and because credit unions are mutual or cooperative organizations operated entirely by and for their members.

As stated by United States Government Accountability Office (GAO)(2005), under current law state credit unions are exempt from tax under Internal Revenue Code section 501(c)(14)(A). This section states that credit unions operating on a nonprofit basis, organized without capital stock, and are operating for mutual purposes can qualify. One of the main ways that credit unions are able to provide for America's working class and modest income consumers is by charging lower and fewer fees than banks do. In particular, minimum balances are lower at credit unions than banks. Credit unions offer

lower rates on loans for used cars, along with smaller loans which allow people of modest means greater alternatives.

The U.S. Department of the Treasury (2001) reported in 1999 that 45% of credit union business loans were to borrowers with a household income below \$50,000, and that credit union financial services are much more regulated than that of banks. Credit unions have limits on who they can serve, in terms of business lending, and their lack of access to capital markets. The tax exemption is an incentive that is meant to encourage CEOs and board members to continue to operate these financial institutions as credit unions instead of converting them into a commercial bank.

CUNA's research and policy analysis White Paper (2004) reported that the benefits credit unions offer in the form of lower fees, lower loan rates, and higher yields on savings, far exceed the amount of the tax exemption in monetary terms. CUNA estimated that these benefits, in terms of lower fees and favorable rates, would total over \$6 billion a year. This number is the amount that the CUNA estimated credit union members save by banking at a credit union versus that of a bank. The CUNA also estimates that credit unions would pay about \$1.5 billion in taxes every year if they were required to pay income taxes. The \$1.5 billion dollar tax exemption allows credit unions to offer their members \$6 billion in savings every year.

Bank officials argue that credit unions only deserve their tax exemption if they follow the rules that were initially given to them by Congress. One of those rules, the "common bond" of the members has begun to have very fuzzy guidelines in recent years.

The “common bond” requirement initially forced credit unions to only allow members to join if they all had a similar link to one another. This link could be in the form of everyone being a part of the same organization, or working for the same company. Credit unions have begun to expand their membership guidelines, and are allowing people to join that do not all share a strict common bond. Banks don’t feel that large credit unions with multiple common bonds should be allowed to hold onto their tax exempt status, while essentially running and acting like a commercial banking institution.

Frame, Karels and McClatchey (2001) found that occupational credit unions are potentially exposed to higher concentration risks, and try to account for this by holding additional capital. On the other hand, they also discovered that occupational credit unions have fewer delinquencies in their loans, possibly because their members and employees have informational advantages over other types of credit unions. Their cross sectional statistical model found that multiple bond credit unions have greater investment opportunities and are subject to less membership concentration and fewer delinquencies than single-bond credit unions. Having fewer delinquencies on loans is a great asset to a community. Since community members are more secure financially, they are able to stimulate the economy more freely.

Reasons against Tax Exemption:

Frank Schmid (2004), reports that banks offer superior bundles of financial services to its members, as compared to credit unions. This occurs even though credit

unions benefit from subsidies in forms of tax exemptions and other financial stipends from their sponsor, allowing them to grow in the market. A credit unions sponsor is normally the organization or the company that is offering a credit union program to their employees or members. Schmid finds that as credit unions increase their membership numbers as a whole, it is associated with higher levels of retail banking concentration. This shows that credit unions have the ability to affect the local banking market and that competition is still local by nature. The tax exemption, might then take away some of the banks' members, since credit unions are able to grow because of higher retained revenue used for growth instead of taxation. This might also be negative for the community since banks possibly offer a broader service base.

Tatom (2003), argues that fiscal neutrality would require removing the special tax treatment for credit unions in order to be fair to banks. One of his suggestions is to remove the tax exemption for large credit unions that have an equally broad customer base, expenses, and income, all similar in comparison to that of a bank, while leaving the tax exemption for small credit unions. The tax loss from credit unions is stated to be around \$2 billion a year in 2003 and over \$30 billion over the next 10 years. Tatom investigates whether or not credit unions are compelled to serve low and moderate income households, or if their members are just like consumers who use commercial banks. The idea that all the members are the same, is the same notion that the common bond is deteriorating in large credit unions. Therefore, a broad membership base should force credit unions to be treated equal to other banking institutions requiring them to pay income taxes.

Wendy Cassity (2000) argues against the tax exemption for different reasons. Banks are forced by the government to comply with the Community Reinvestment Act (CRA), a complicated and costly community lending program. The CRA forces banks to make an effort to give out loans to a certain portion of the community in which they are located, and to meet the credit needs of the entire community. This law was enacted because it was thought that banks were purposefully neglecting certain portions of the community because they are high risk. This method of denying credit is a practice known as “redlining.” Credit unions were exempt from the CRA in 1977 because they were small institutions made up of community members who ran the institution and would have no incentive to redline.

Another reason for the CRA is because of disinvestment. Disinvestment occurs when banks take deposits from their local community and then ship them to major money markets in search of higher interest rates. This can be very detrimental to local housing, small businesses, and farms. Cassity argues that because of the diminishing common bond rule in credit unions, they are now able to engage in redlining and disinvestment activities equal to that of banks. The CRA was created to limit these activities, so she concludes that credit unions should lose many of their privileges such as being exempt from taxes and the CRA. While credit unions once were created for the needs of a specific group in a close knit community, they are now very large diverse financial institutions that need and require more government regulation.

Competition between Banks and Credit Unions:

Timothy Hannan (2002) examined the impact of the market presence of credit unions by measuring the rates of three different types of consumer deposits offered by banks. The accounts he studied were money market deposit accounts, interest checking accounts, and three-month certificates of deposit. He analyzed 356 institutions in one-hundred different metropolitan areas. Credit unions accounted for about 7.5 percent of deposits in 1998 and the ratio of credit union members to the adult population averaged about .27. Hannan made it very clear that credit union member's accounted for a substantial part of the adult population in the areas tested. Credit unions are growing in importance representing a competitive force in urban banking markets. Banks, thrifts, and financial regulators alike will have to be more careful in the future to take them into account.

Tokle and Tokle (2000) studied deposit rates in 1998. They examined the relationship between deposit rates offered by 122 banks located in Idaho and Montana to the share of market deposits by credit unions. Using a regression to compare bank deposit rates to the deposit shares of credit unions and other explanatory variables, they found that a credit unions rates effected the rates banks were able to set. Statistical significance was found in the case of the one and two year CD rates. Even though it applies to a fairly limited sample size, it still shows that there is a competitive impact of credit unions on bank deposit rates.

Feinberg and Rahman (2006) consider two types of loans important to most credit unions, even though they may not be the most important ones for banks. They are 24-month non credit card loans, and 48-month new vehicle loans. They found despite common influences on pricing, banks and credit unions behave differently in local markets for consumer loans. Credit union new vehicle loan rates are roughly 2 percentage points lower than banks loan rates. Since these two institutions have different loan rates, it is very difficult to call banks and credit unions perfect substitutes in this market. The differing loan rates show that the two financial institutions behave differently in local market for consumer loans, and thus one shouldn't assume that competition will be great enough between the two to have any negative impact on banks.

Economies of Scale:

Even though subsidies for credit unions assist them in staying small and limit their need for economies of scale, it doesn't mean that communities and the institution itself are not positively affected by economies of scale. Esho (2000) studies the impact of mergers between small and larger credit unions. In his paper he provides evidence that credit unions with assets smaller than \$5 million should consider merging with larger credit unions. Economies of scale help everyone in the community because small credit unions receive substantial space subsidies of around 17%, while medium and large credit unions receive very little in that regard. Space subsidies are most often in the form of banking office space at the organization or business. The credit unions sponsor either

provides the required space for free or at a discounted price. The average range of subsidies varies from 26% for large credit unions to 100% for small and private ones. Economies of scale visible in large credit unions allow the government to spend less on subsidizing credit unions.

Economic Theory:

Why we have credit unions:

The first credit union was chartered in 1909 by the state of New Hampshire, and an administrative ruling by the Attorney General in 1917 exempted credit unions from federal taxation. Tatom (2003) argues that a credit union is a nonprofit financial cooperative for tax purposes, often being organized as corporations for legal purposes. Credit union regulators allow four different types of common bonds for credit unions to operate under. Single occupational bonds limit credit union members to all be employees of the same firm or workers that all reside in a single occupational class. The second type of common bond includes all people that are members of social or civic groups. The third type, multiple common bonds, allows people with different occupations to join together. This bond has been avidly appealed by bankers across the nation because of its effect on the way credit unions are able to operate and compete with banks. The fourth bond is the community common bond. The community common bond allows all

members of a credit union to be people who reside in or are employed in a well defined area.

Single occupational bond credit unions allow employers to offer cheap, yet valuable amenities to their employees. It was difficult for blue collar workers to find time to make deposits at their local banks, since banks had very limited operating hours. The reason for the limited operating hours is because of the time and resources it took to have proper checks and balances. Credit unions solved this problem by locating themselves in the office building of the company, so that employees had easy access to their bank, which greatly lowered transaction costs. Frame (2001) claims credit unions distinguish themselves from banks by being member owned and directed, having a volunteer board of directors, are nonprofit, have a public purpose, and operate on a common bond.

Having a credit union at your office not only made banking much more convenient, but also encouraged members of the credit union to pay off their debt, knowing that they were borrowing from their friends and co-workers. Credit unions are run as member cooperatives, consisting of a volunteer board of directors that also bank at the institution. Members that take out loans might not want their friends and co-workers on the board of directors to see that they are struggling to pay off their debt, so they make their loan payments a higher priority. Another way that credit unions helped their members lower their default rates was by deducting or garnishing their monthly debt payments directly from their pay check. Since the credit union is a part of the company that the members work for, the members are able to have direct deposits into their savings

account. This was an option that many banks didn't offer when credit unions were getting their start in the banking industry, making it possible for credit unions to gain a small competitive advantage.

The amenities that are listed above are some of the reasons why employees benefit from joining a credit union, along with the financial benefits and incentives.

Figure 1 shows a shift outward in the marginal social benefit curve (MSB), from MSB_B to MSB_{CU} . MSB_B is the marginal social benefit generated by banks for their members and communities, while MSB_{CU} is the marginal social benefit seen from credit unions. The marginal private cost (MPC) to that community should be much higher for the credit union, but the income tax subsidy lowers the MPC by having a credit union as compared to a commercial bank.

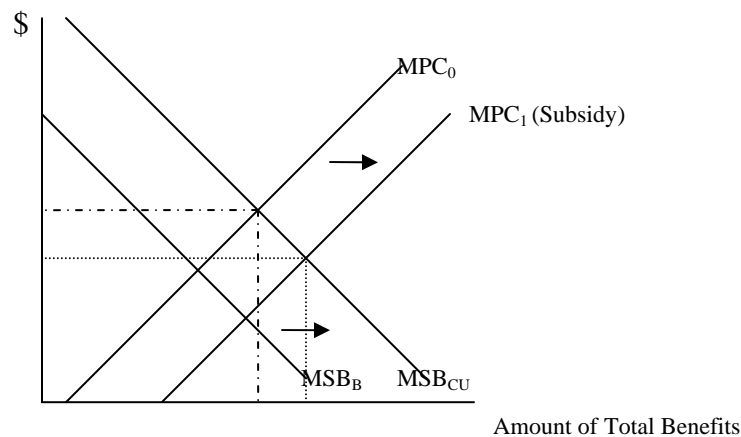


Figure 1

The Credit Union National Association (2004) estimated that the 86 million credit union members in 2004 received benefits totaling 6 billion every year in the form of lower fees, lower loan rates, and higher returns on savings. That is the additional amount

that credit union members would pay if they were to conduct all their business at a bank rather than a credit union. The tax subsidy helps credit unions compete with banks even though they are on a much smaller scale in terms of total assets.

In order for a small firm to compete with a large firm, you would initially assume constant returns to scale. Frank (2006) states that for a constant returns to scale production function, doubling the output exactly doubles costs. This assumes that input prices remain the same as the output varies. In this constant return to scale model, long run costs are exactly proportional to output. If this were the case, commercial banks would have no incentive to increase their size and would see no financial gain from an increase in total assets. Since this is not the case in the banking industry it leads one to believe that there are some type of economies of scale to be seen in the banking market. Figure 2 shows what the long-run total cost curve (LTC) looks like, along with the long run average cost (LAC) curve and long run marginal cost (LMC) curve if there

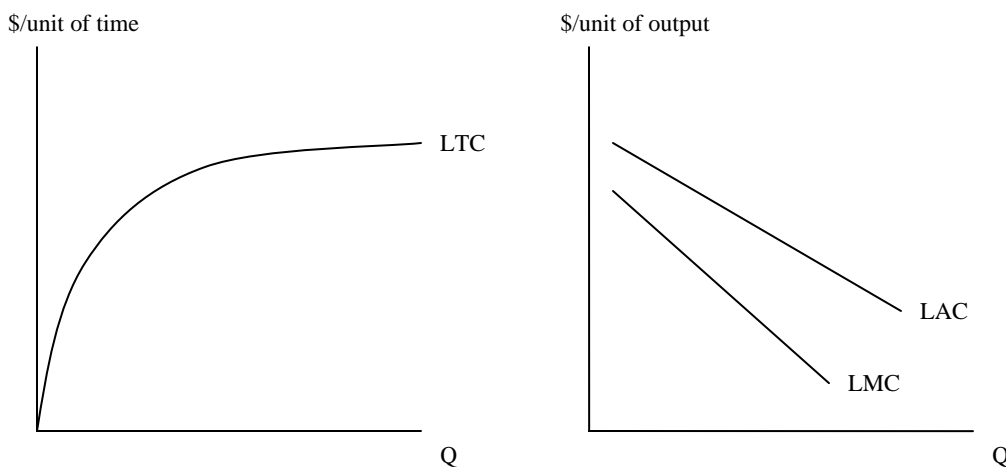


Figure 2

were increasing returns to scale. In this graph, output grows more than in proportion to the increase in inputs. As a result long run total cost rises less than in proportion to increases in output. The LAC and LMC curves are downward sloping.

Chmura (2004) suggests that the “moral hazard” of borrowers, in essence the risk that borrowers will engage in risky activities making it more likely that they will default on their loans, was increased for credit unions that serve concentrated groups of people. Occupational credit unions are a great way to help employees out and give them favorable banking rates with vary little transaction costs, but at the same time is risky to have such a concentrated group. If a credit union with all its members working at one company has that company goes under, then the credit union will have most of its members out of a job, plus possibly defaulting on their loans. Credit unions with very concentrated member groups are forced to keep more assets on hand so they are able to deal with this type of situation more favorably.

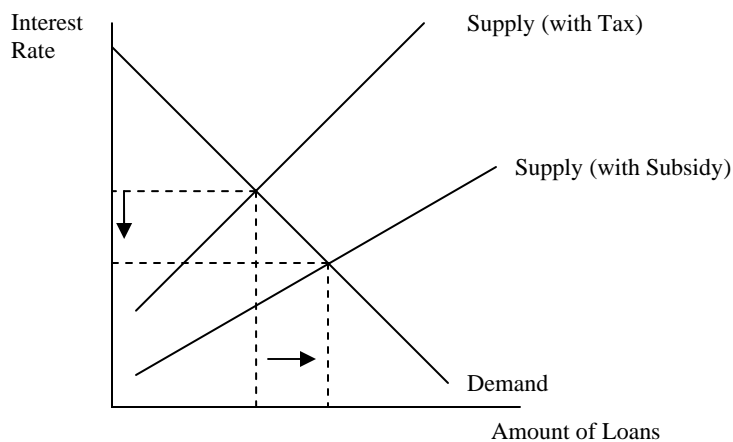


Figure 3

The income tax subsidy is another way that the government tried to step in and help lower the risk for single bond credit unions. Figure 3 shows the effects of an income tax on a credit union and how the subsidy assists in their operations. If credit unions had their tax subsidy removed, it would raise the interest rates on loans and reduce the total amount of loans that the credit union was able to give out to its members. The tax subsidy allows them to take more risks on lower income members, since they have lower operating costs.

Multiple bond credit unions and community credit unions are now beginning to take over the market because they are able to hedge more of the risk than small credit unions. Large multiple bond and community credit unions aren't forced to worry as much about the well being of one particular company, since their members have diverse backgrounds and different occupations. The Federal Reserve Bank of San Francisco (2006) supports the idea that small credit unions have been disappearing, while large credit unions have been taking their place. From 1980 to 2004, the number of small credit unions (assets less than \$100 million) shrank from 17,132 to 7,859, while the number of large credit unions (assets over \$1 billion) grew from 2 to 98. This data shows economies of scale when you have large credit unions with a diverse member base.

Economies of scale are more difficult to come by when you have a single bond credit union. Increasing the number of members could possibly make you more efficient, but at the same time increases the risk of the credit union going bankrupt if the sponsor company collapses. Figure 4 shows a production function of a single bond credit union. As the number of member's increase it becomes more and more productive until the

benefits do not outweigh the risks of taking an additional member. At the inflection point, the graph changes and begins increasing at a decreasing rate, and the credit union becomes less productive. The main reason for this decrease in productivity is that the credit union may have already given out loans to all the qualified members. In an attempt to achieve economies of scale and increase their assets base, the credit union is forced to give out loans to less qualified members.

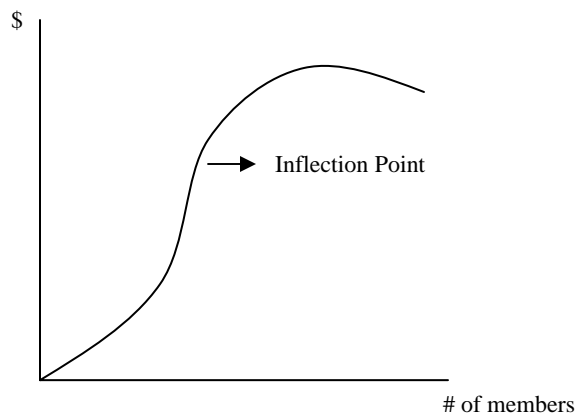


Figure 4

Few studies have looked at the loan rates that credit unions give out and whether or not they affect similar rates of banks in the same market. Feinberg and Rahman (2006) found that credit union new vehicle loan rates are roughly 2 percentage points lower and credit card rates are 3 percentage points lower than bank rates. In their study they found that the larger the amount of credit unions in the deposit market, the lower the new car loan rates at banks. Their evidence suggests that tax exempt credit unions in a given market lower the overall rates for car loan at all financial institutions. Credit unions are able to have a competitive impact on the banking market in the community,

even if banks and credit unions are competing for all the same members. This competition helps all citizens, but especially is favorable to people of lesser means, seeing as they will be able to receive a more favorable loan and deposit rate.

As deposit rates increase from switching from a bank to a credit union, an individual's budget line shifts outward. Figure 5 shows isocost lines between

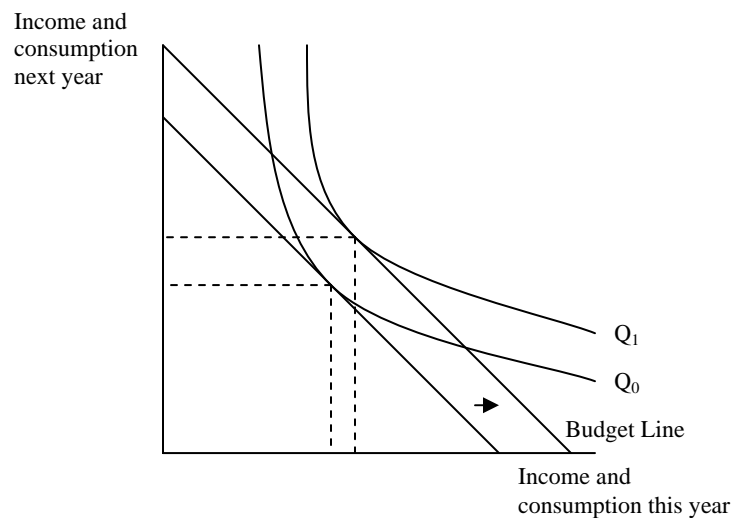


Figure 5

consumption today and future consumption. If interest rates increase, simulating having a higher deposit rate at a credit union than a bank, the graph shows that you would spend more and save more. This is depicted in the graph by the budget line shifting outward because of the realized gain in income, and the isocost line shifting outward also from Q_0 to Q_1 . The model assumes that it is a normal good and not a Giffen good or an inferior good. A Giffen good is a specific type of inferior good, that when the price of it rises, demand for it increases. An inferior good is a good that decreases in demand, when a consumer's income increases.

The Future of Credit Unions:

Credit unions were established in order to help their communities and their member's, live better and more comfortable lives. Currently, with the shift from small single bond credit unions to large multiple bond credit unions, it looks as though their roles in society may be changing. In reality however, the roles of credit unions still hold the same fundamental values and goals, although on the surface they may look more like commercial banking institutions than ever before. Banks have been lobbying for credit unions to start paying income tax ever since they became exempt in 1977, and now with credit unions starting to become of similar size to that of commercial banks, the debate between credit unions and banks has increasingly intensified.

As credit unions get larger in terms of total assets, there are several variables that will need to be addressed in order to properly assess the effects on the credit union market and the banking market as a whole. The variables that are important to look at are split into two categories, the positive affects of growth and the possible negative affects of growth.

The hypothesized positive variables of increasing quantities of large credit unions in the market are as follows. The multiple bond enables them to serve a more diverse group of citizens, helping a broad group improve their banking portfolio. At the same time this allows the credit union to spread out more of their risk. By not operating as a single employer credit union, if the sponsor company goes bankrupt, the credit union

doesn't go under as a result. Increased asset size allows credit unions to pay more beneficial rates to members, especially in the form of used car loans, home loans, credit card rates, and 12 to 24 month certificates of deposit. To attract quality CEO's and management to run the credit union properly, you need to be able to pay them a competitive salary. An increase in asset size will allow management the opportunity to receive higher salaries, since the credit union will be on the same level as larger banks that pay management more.

Non-profit institutions are only allowed to pay their management what is called, "reasonable compensation." Credit union management aren't allowed to be paid anything more than what is reasonable, and this can be debated based on credit union size, assets, and numerous other variables. In the end, federally chartered credit unions are regulated by the National Credit Union Administration, who will make the final judgment regarding if the salaries set are fair or not.

The hypothesized negative variables of having large credit unions are as follows. The tight common bond is lost between the members and they might not feel the same devotion and allegiance for the credit union. Mission drift is a very common problem that goes along with increasing the size of an organization. As you become large many small details tend to be over looked which were very important when the company was founded. Credit unions may tend to look at the bigger picture, losing focus, and not helping people of modest means as much as they should.

This model will look at how large credit unions use extra revenues that are generated from their tax exempt status to fund important aspects of their banking services. One aspect that needs to be analyzed is the impact of increasing the number of loans given out by large credit unions and how this might positively or negatively impact critical banking strategies. As large credit unions gain market share their mission might be altered accordingly, and while they may generate more MSB as a whole, the way in which it is generated may differ from that of a small credit union.

Results:

The main operating factor that allows credit unions to compete in the banking market is that they receive an exemption on their income taxes. Figure 6 shows the average total costs (ATC) of a credit union. With the tax subsidy in place, it lowers the ATC of their entire institution generating greater amounts of revenue for the credit union.

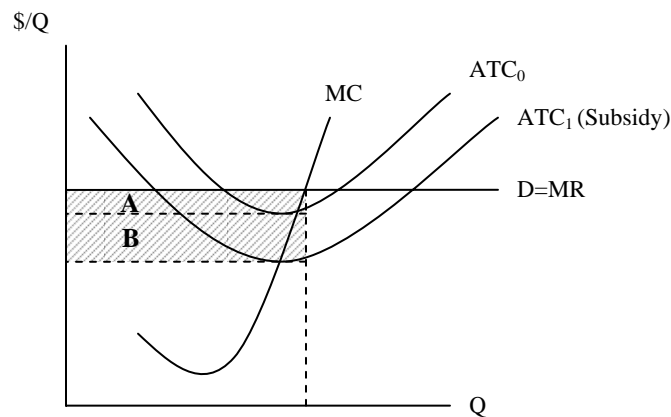


Figure 6

Since this revenue is used for its members, and not to pay shareholders, it enables the credit union to grow in size, offering more attractive rates to its members than they could receive at another financial institution. By having lower rates than competing banks it forces bank rates to decrease in order to gain more of the market share. ATC_0 illustrates the costs with out the tax exemption and ATC_1 shows that the total costs for the credit union decrease since they don't have to pay income taxes.

Shaded section "B" is the increase in revenue seen by the credit union because of lower ATC. This revenue can be used for many operational needs such as, favorable rates to its members, growth (better technology, and other new banking amenities), and is one of the main ways that they are able to attract and pay quality management and CEO's. Credit unions would have a difficult time landing quality CEO's to run the company if it were not for the tax exemption since CEO's will not make as high of salaries working at a credit union as they would working for a commercial bank. The CUNA (2004) discusses that the tax exemption is an incentive for CEO's and boards to continue operating the charter as a credit union rather than converting it to a bank. The tax exemption allows credit unions to pay their board and CEO competitive salaries so that they can have quality management, further benefiting the community and their members.

As credit unions increase their size, it doesn't always have a positive influence on their members. The risk of the entire credit union defaulting and going under is almost completely avoided by becoming a large multiple bond credit union, but the interest rates for their members don't always co-inside as favorably as the size increases. As credit

unions start expanding they are forced to take on more members, some of which have higher default risks than they would like. Credit unions are then forced to charge higher interest rates on loans, as more loans are allocated to their members. Figure 7 illustrates a small credit union (CU_1) and the interest rates it charges versus a larger credit union (CU_2). This model is able to show the affects of increasing the amount of loans and how it not only increases the interest rates for depositors, but also increases the interest rates for people taking out the loans. Increasing the size helps members that are making deposits, but hurts those that are in need of securing a new loan.

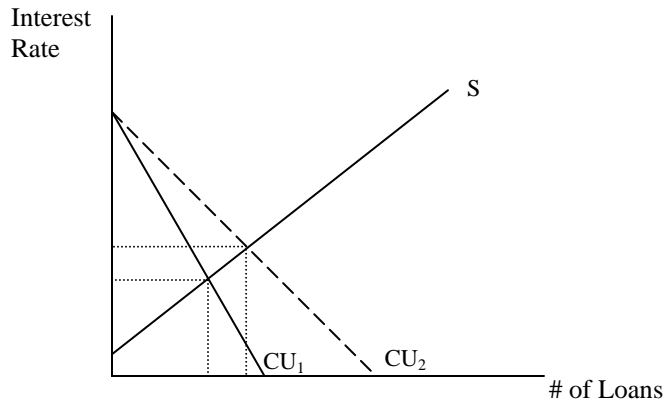


Figure 7

Credit unions counter act this trend by turning down people that don't qualify. This select denial process could be viewed as "redlining". Credit unions were established to help those of modest means and now they may be forced to deny many of these same populations in order to keep the risk at a reasonable level. This model analyzes credit

unions that are of the same common bond. This model is much more severe in the case of single bond credit unions, but still holds true for large multiple bond credit unions.

Mission drift could be one of the reasons that the management team might experience this type of problem. Management that gets caught up in the personal benefits of expansion, such as increased salaries, and power, could end up hurting their members in the long run. Non-profits as a whole attempt to counter act this greed in their managers because they can't make as much working in the non-profit industry as they could working for a for-profit company. This intends to eliminate management that has personal agendas that come before the good of the credit union. This does set up some barriers to entry, but doesn't work all of the time. Tax exemption is the way in which credit unions try to pay competitive rates for good management. The credit union board is forced to walk a fine line, paying high enough salaries to keep good management on staff, while not paying too high of salaries that attract management with personal agendas as their source of motivation.

Credit unions positively affect the banking market for consumers, by forcing banks to compete against credit unions for customers as Tokle and Tokle (2000) found. This competition benefits the entire society continuing to increase the MSB that credit unions deliver to the communities in which they reside. MSB is made up of marginal private benefit (MPB) and marginal external benefit (MEB). When credit unions were first organized, the majority of the MSB was generated in the private form, as members benefited from the tight knit aspect of the common bond. While helping individual

members, in turn helps the society as a whole, this will still be considered a private benefit. Currently, as multiple bond credit unions are taking over, the MPB of credit unions has stayed fairly similar, but the MEB have greatly increased. One of the ways MEB has increased is by forcing banks to compete with credit union rates. This lowers interest rates for citizens that aren't even credit union members. If credit unions weren't tax exempt and unable to compete against banks, banking rates could be devastating.

Subprime loans have currently demolished the housing market, and The Federal Reserve has been forced to lower short term interest rates (the Fed Funds Rate) continually in fear that the credit crisis could be damaging the economy beyond the housing market. Credit unions have devoted portions of their consumer lending departments to give loans to people that are having trouble paying off their subprime home loans. Credit unions are also able to give small high risk loans to communities that need help. Banks for the most part find loans of this size to be too small to be profitable, especially for all the risk that is involved. Large credit unions with their tax exempt status are able to help people that aren't even current members. While the individuals may end up becoming members in the process, the initial community outreach isn't restricted only to current members. Figure 8 is able to graphically illustrate this point.

Graph “A” in figure 8 emulates that of a small single bond credit union, with the idea that the members receive the majority of the MSB. There are greater amounts of MPB than there are of MEB in small credit unions. Graph “B” shows the changes that take place when a credit union increases in size, amount of assets, and number of loans. The MPB will decrease a little, taking into account the lack of common bond between members, but will not completely disappear since a portion of the MPB comes from banking at a credit union and receiving favorable rates. Not only does the MSB generated from the larger credit union increase, but the amount of MEB produced increases as well. If the supply line were to be analyzed also, an increase in members

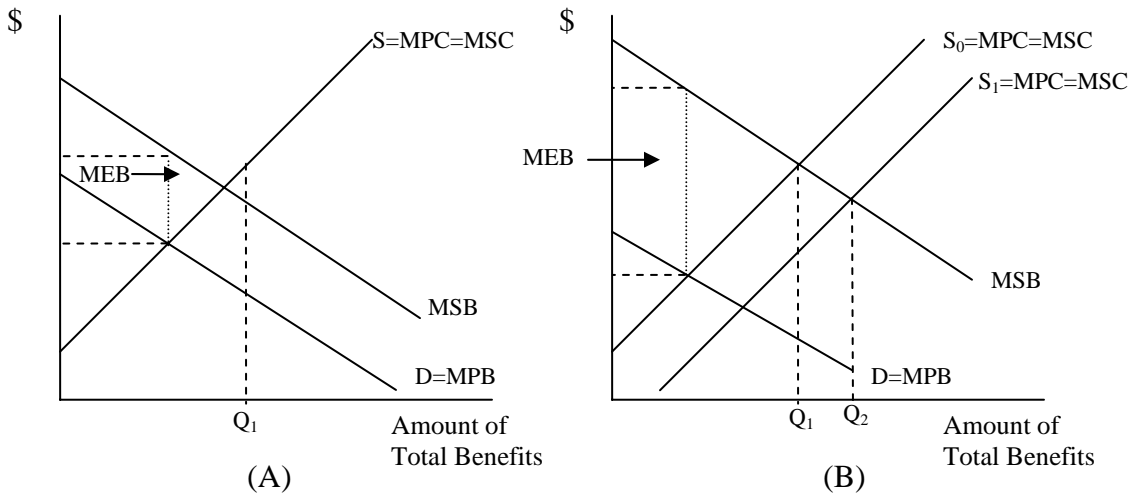


Figure 8

would shift the supply curve outward. On the graph this is illustrated as S_1 , and demonstrates an increase in the total benefits for a community to Q_2 .

Table 1 looks at the important question, do credit unions charge less and pay more interest than that of a bank? The first set of data is from 2003 and the second set is from

2007. In 2003 credit unions had favorable rates in home equity loans, 48 month new car loans, variable credit card rates and one-year CD over that of a bank. These numbers go along with all the past research that has been conducted about how credit unions behave in the market. Looking at the current data, certain rates don't seem to stay constant. The 2007 data shows credit unions charging a much lower interest rate than banks for home equity loans, and barely edging out banks for 1-year CD rates. In 2007 banks have taken the advantage in new car loans over credit unions. One of the main selling points for a credit union is that they always have more favorable rates as compared to banks for home equity loans, car loans, and CD rates.

Recently credit unions have lost the competitive advantage for car loans. Since credit unions have lower ATC from the tax exemption and are forced to keep more assets on hand in case of emergencies, they have been stronger during the subprime mortgage crisis. Commercial banks are dealing with billions in defaulting loans that people aren't able to pay, forcing them to charge much higher rates for home equity loans. Home loans are very risky, so banks may feel more secure dealing with new car loans, that are easier to pay off, and have much less risk. Credit unions on the other hand are creating programs to help people that are in trouble paying off their home loans, and want to give people a fair rate that are trying to purchase a home. This isn't to say that credit unions are taking unreasonable risks in the market right now, but because of their high asset backing, and low costs, they are able to reach out to their communities and help people

that are in need. Banks that have been severely crippled by home loans and are forced to find a portion of the market in which they are still able to compete in.

Conclusion:

Credit unions will continue to operate in the future as long as they are able to keep their tax exempt status. The non-profit status allows a credit union to operate as a tax exempt institution enabling them to function at a lower ATC, while still being able to pay quality management to provide for its' members. If credit unions were to lose their tax exempt status, a credit union could be forced to convert into a bank, or at least start to operate more like one. Even though increasing the size of a credit union may force a credit union to charge higher interest rates, if they have hired competent management that has the well being of the credit union held higher than their personal financial success, this shouldn't be much of an issue. If management continues to make good investments and properly screen members before giving out loans, then the loan rates should stay relatively low, especially compared to banks.

A credit unions ability to change and adapt to the times, is key to their survival. Their structure and size may vary, but the overall marginal social benefits seen by society will continue to stay at least the same if not improve. Just as credit unions have chosen to focus their resources more on home equity loans versus car loans, they have successfully found a niche and are able to benefit their communities in the best and most effective way they see possible.

Banks will continue to fight for the removal of the tax exemption for large credit unions if they continue to operate similar to banks. If this legislation were to be changed, the banking industry could look much different in the years to come. Banks are also starting to resemble credit unions in the sense that they can now operate as a “Subchapter S Bank”. This means that the bank doesn’t pay federal income taxes at the firm level, but instead it transfers the income to stockholders, where it is taxed at their individual tax brackets. This lowers the costs for the bank, but doesn’t necessarily mean that it is helping the bank run more efficiently, or is helping any of their members. It may just be a way to pay higher dividends to stockholders, and higher salaries to management.

Future research could look more specifically at how much of an impact credit unions have on the lending market as a whole, since most research has been conducted on a small scale. Studies could also be conducted to look at the impact of credit unions generating more MEB rather than MPB in communities. If legislation holds, then the future of banking may look very similar, but if Congress changes the non-profit status of credit unions, one can only imagine what the repercussions could possibly be.

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Table 1

| Loan | Credit Unions | Banks |
|---------------------------|----------------------|--------------|
| 30-year fixed mortgage | 5.88% | 5.83% |
| \$10,000 home equity loan | 4.54% | 5.03% |
| 48 month new car loan | 5.84% | 7.14% |
| Variable credit card rate | 10.20% | 13.13% |
| 1-year CD | 1.71% | 0.94% |

Based on data compiled on Dec. 18, 2003

Source: Bankrate.com

| Loan | Credit Unions | Banks |
|---------------------------|----------------------|--------------|
| 30-year fixed mortgage | 6.28% | 5.79% |
| \$30,000 home equity loan | 6.89% | 9.05% |
| 48 month new car loan | 7.18% | 6.86% |
| Variable credit card rate | 14.06% | 14.06% |
| 1-year CD | 4.63% | 4.38% |

Based on data compiled on Dec. 13, 2007

Source: Bankrate.com