

# Revenue Potential from Taxation of Credit Unions

William B. Conerly, Ph.D. | February 2013



# Introduction and Summary

A proposal is before the Oregon legislature to tax the profits of credit unions under certain circumstances. The Oregon Bankers Association asked me to assess the revenue potential of such a tax change. I conclude that in the first five years of tax eligibility, credit unions would pay approximately \$38 million to the State of Oregon. Had credit unions been taxed at the same level as Oregon banks for the past 12 years, they would have paid approximately \$54 million in income taxes to the State of Oregon.

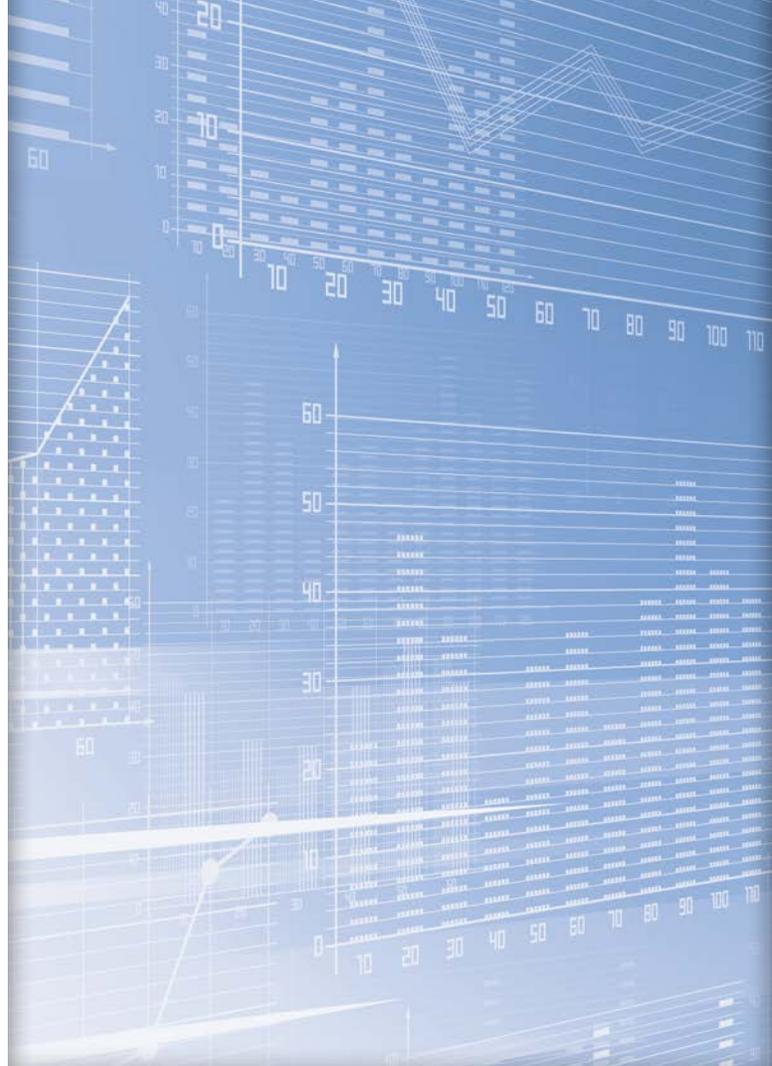
The tax proposal applies to state-chartered credit unions but not to federal-chartered credit unions (which the state is not allowed to tax under federal law). A state-chartered credit union would be subject to a tax on its profits only if it met either of two criteria:

- It took in one or more public deposits in excess of \$250,000, or
- It had business loans equal or exceeding ten percent of its assets

The first element was only allowed to credit unions beginning in 2013, and then subject to certain conditions contained in HB 3700 passed in the special session of 2010. The second element credit unions have been able to do for years. In fact, some credit unions currently hold more than ten percent of their assets in business loans.

To reach my conclusion, I engaged in the following steps:

- An historical analysis as if all credit unions had been taxed in the past
- A forecast of tax revenue as if all credit unions would be taxed in the future
- A forecast of tax revenue from those institutions that would meet either or both of the tax criteria



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# Background

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The proposal under consideration has two fundamental aspects to it. First, it levels the playing field among those financial institutions serving businesses by making tax rates for credit unions the same as those for banks. Second, it furthers the principle that businesses operating in the state should contribute to the taxes that support state government.

Banks and credit unions historically operated under different laws. In Oregon, banks could accept public deposits—funds from municipalities, school districts and other government entities—but credit unions could not. Banks were subject to the corporate income tax, but credit unions were not. Each credit union served a narrow group of people, such as employees of a particular company or industry, or members of a particular union or fraternal organization.

Over time, the largest credit unions have shifted to community focus. They market their services to everyone living in specific counties or even states. The community-focused credit unions have grown. Although they constitute fewer than half of all credit unions in Oregon, they account for 87 percent of credit union assets. Among Oregon-chartered credit unions, half have a community charter, but those hold 95 percent of the assets.

Credit unions have also been consolidating into fewer but larger enterprises. In 2011 they numbered 75 institutions headquartered in Oregon, down from 114 in 2000. Although there were fewer credit unions, they held larger assets and garnered higher revenues. The four largest credit unions increased their market share as well, from 34 percent of total industry revenue in 2000 to 39 percent of revenue in 2011. The largest Oregon credit union has over three billion dollars of assets. Were it a bank, it would be the second-largest Oregon-headquartered bank and in the top three percent of all banks in the country ranked by size.

If all other things were equal, a group of businesses with a tax advantage should be able to push aside those

businesses that pay higher taxes. The inability of credit unions to raise capital by selling stocks limits their growth rate somewhat, but the largest credit unions have grown so much that they can add millions of dollars a year to their capital, allowing them to increase total assets by tens of millions of dollars a year. Access to the business market further enables the largest credit unions to use their tax exemption to fuel further growth.

The issue is not just about fairness. The gain in business lending that credit unions are likely to achieve will be matched by less lending (than otherwise would have occurred) in the taxable sector. The greater the shift of economic activities from the taxable sector to the non-taxed sector, the more that state tax revenue will suffer. ■



# Historic Analysis

To understand revenue potential from the proposed bill, I calculated how much tax revenue would have accrued to the State of Oregon had all state-chartered credit unions been taxed from 2000 through 2011. (Data for 2012 are not available as of this writing.)

State Chartered Credit Unions			
	Revenue	Net Income	Hypothetical Tax Liability
2000	389,515,518	48,077,453	3,781,305
2001	418,490,354	45,644,897	3,515,432
2002	420,163,276	72,264,150	5,645,201
2003	424,551,691	73,606,730	5,746,278
2004	432,950,946	68,052,694	5,313,691
2005	500,345,687	74,155,561	5,976,257
2006	577,684,090	66,684,322	5,142,058
2007	644,551,013	60,616,261	4,795,549
2008	677,648,687	14,229,559	1,622,673
2009	699,167,909	30,152,464	4,286,839
2010	639,101,455	47,656,650	3,348,562
2011	497,972,731	65,097,580	4,665,191
<b>Total</b>	<b>\$6,322,143,357</b>	<b>\$666,238,321</b>	<b>\$53,839,035</b>

Oregon's tax rates, had they been applied in the past to all state-chartered credit unions, would have generated \$54 million in the past 12 years. (This calculation applies the tax rates to all state-chartered credit unions, not just those that meet the threshold specified by the proposed legislation.)

The number of Oregon state-chartered credit unions has dropped from 27 in 2000 to 18 in 2011, plus four credit unions chartered by other states that operate in Oregon. However, their assets have more than doubled over that time period.

Several caveats are needed to understand these numbers. To begin, the proposed law is not at all retroactive. So this calculation simply provides a sense

of potential size. In addition, there are several small statistical issues described in the following section.

## Methodology

The analysis began with data downloaded from the National Credit Union Administration web site ([www.ncua.gov](http://www.ncua.gov)). The NCUA is the nation's regulatory authority for credit unions and collects information on "call reports" from every federally insured credit union in the country. I pulled call report data for all credit unions headquartered in the state over these years and identified those credit unions that were chartered by the state.

I calculated tax liability separately for each credit union. That is important under Oregon's tax structure. Simply adding up industry profits is misleading. Imagine that one company has \$100 of profit, and the only other company in the industry has \$100 of loss. The industry as a whole has zero net profit. However, the profitable company pays income tax on its earnings.

In calculating potential tax liability for each credit union for each year, I allowed losses to be carried forward. There were several cases of credit unions with operating losses merging with other credit unions. In these cases the surviving entity was assumed to benefit from those tax losses.

The timing of loan losses differs between accounting practices and tax practices. The call reports are based on accounting principles that require a provision for loan losses to be taken even before an actual loss is incurred. For instance, if many loans are made today, we know that the lender will have a loss on one or more of them. We don't know which ones will be a loss (if that were known, the institution would not make those loans), but we do know there will be a loss. So under accrual accounting, we recognize a loan loss immediately. The tax system, though, takes a different approach: the lender doesn't have a loss until the money stops coming

in. The two approaches will produce identical results over time if loan volumes and loan performance are both stable. However, during cycles of loan performance and periods of changing loan volume, the two approaches generate different loss figures, eventually coming together at the time that the loans mature.

There are also several small issues making this analysis somewhat less than perfect. First, the definition of net income for taxes is not exactly the same as the call report definition. Most prominently, expenses for meals and entertainment is subject to a 50 percent limitation in tax law. The call reports do not separate out this category of expense, but I expect it to be negligible in relation to total earnings.

The second tax issue is that the data begin in 2000. There may have been tax losses from prior years that would have reduced tax liabilities in the early portion of my analysis. However, neither did I take into account tax liabilities beyond 2011, which would certainly be reduced by the losses many credit unions took in the recession. The net effect of this issue is probably small.

The third notable issue is that this analysis excludes credit unions headquartered out of state but operating in Oregon. It also includes the out-of-state profits of Oregon-headquartered credit unions. Cross-border operations are fairly small in magnitude and occur in both directions. Oregon's Department of Consumer and Business Services collects limited information from credit unions with out-of-state charters. The data show that the assets of out-of-state chartered credit unions constitute less than one percent of the assets of Oregon-chartered credit unions. DCBS does not collect data on revenue or net income, so it would be impossible at this time to calculate their potential tax liability. I have no data on the out-of-state assets of Oregon credit unions. I believe that inaccuracies due to interstate branching are small.

There may be other issues that cause these estimates to be somewhat at variance from what actual tax returns would show. Nonetheless, this analysis gives a very good approximation to revenue potential. ■

## Future Tax Payments: Entire Industry

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My next step is to project future tax payments if the new tax is implemented. I do this in two parts. First, I project taxes as if all state-chartered credit unions are subject to the tax. That is the subject of this section. The next section will address the question of how many of the state-chartered credit unions will engage in the gathering of public deposits or the issuance of commercial loans to trigger the tax.

The projection begins with a forecast of assets of state credit unions. My goal is to capture the trend for credit unions over the coming decade, rather than to accurately pinpoint every single year's taxes. There will certainly be fluctuations in the economy in the coming decade. Rather than trying to predict the next recession, I employ long-term relationships that will hold on average. My projections may be off in particular years, but the years of overestimates are likely to be matched by years of underestimates.

I developed a regression equation that models state credit union assets as a function of Oregon personal income. That equation captures the major trend of credit union revenues over the historic period. I used data from 2000 through 2010. Data for 2011 were omitted because the merger of First Technology Credit Union with a California-based federal credit union caused a large change to the totals for state-chartered credit unions. I reviewed other changes in credit union charters, including closures, openings and mergers. I concluded that these changes, except for First Technology, were of trivial magnitude and could be ignored. There is no trend toward credit unions moving to federal from state

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charters, or vice versa. Total revenue of state chartered credit unions has held fairly steady at 65 to 70 percent of total credit union revenue. So I concluded that an accurate assessment of the growth of state chartered credit unions could be obtained by analyzing data through 2010.

To project forward, I used the economic forecast of the Oregon Office of Economic Analysis, issued November 20, 2012, the most recent forecast as of the time of this analysis. That forecast only goes through 2021. I extended the official state forecast to 2022 by assuming that the out year would have growth rates equal to the last year of the state forecast (4.7 percent growth). That assumption is consistent with the behavior of out-year forecasts in economic models of the type used by the Office of Economic Analysis.

I used that methodology to project credit union assets in 2011. The forecast clearly differed from actual because the forecast included First Technology, but the actual data did not. I took that forecast error and applied it to every future year's forecast, so that all forecasts exclude the assets of First Technology.

Next I calculated the average return on assets of state-chartered credit unions over the 2000-2011 period. These years included recessions in 2001 and in 2008-09, as well as a boom in between. Thus the time period captures a wide variety of experience. I applied this average return on assets to the projection of assets described earlier. The result is a forecast of profits to be earned by state-chartered credit unions.

The final step is to estimate tax liabilities. The historical analysis used data from individual credit unions, taking into account losses sustained by some credit unions even while others are making profits. It also took into account tax-loss carryforwards as well as the minimum tax in Oregon's corporate tax structure.

My projections, however, are at the industry level, rather than at the institution level.

To forecast future tax liabilities, I begin with another historical analysis. I calculated what the average effective tax rate for the credit union industry would have been if it had been subject to the tax at Oregon's new tax rates. That is, for each year from 2000 through 2011 I summed up the tax liability (as if the new tax had been in effect during this era) of the various state-chartered credit unions. I also summed the profits of all state-chartered credit unions. I calculated the effective tax rate using these inputs, then averaged those annual figures to obtain an average effective tax rate, which is 8.5 percent of profits. To project future tax revenues as if all institutions would be subject to the tax, I applied this tax rate to projected profits.

The results of these calculations are as follows:

Hypothetical Future Taxes	
	Total for 2014-2018 (millions)
Profits	\$544
Tax Liability	\$46

# Future Tax Payments: How Many Institutions Will Be Taxed?

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Determining actual tax collections is more complicated than the forecast shown in the preceding section because some state-chartered credit unions may not be subject to the tax. To predict future collections, we need to answer three questions:

1. **How many will take enough public deposits to qualify for the tax?**
2. **How many will make commercial loans of ten percent or more of their total assets?**
3. **How many credit unions will switch from state charters to federal charters to avoid the tax?**

## Public Deposits

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On the question of credit unions taking public deposits, it is clear the credit union industry wanted this ability to take public deposits. Credit unions are generally happy to take more deposits any time they can, so it appears that the majority of credit unions would want public deposits. At one time a credit union was formed by a group of members who had a common employer or some other common bond. In recent years, though, many credit unions have expanded into “community charters” which allow membership to anyone living in the state, the metropolitan area or county.

The law enabling credit unions to take public deposits requires that at least five credit unions participate, and there are also cross collateralization requirements. State Treasurer Ted Wheeler announced in October 2012 that five credit unions have submitted the required paperwork and cross collateralization agreements and would begin accepting public deposits on April 1, 2013. Five additional credit unions would participate starting at a later date, according to the credit union trade association. Six of the ten participating credit unions are state chartered, and they hold 70 percent of the assets of all state-chartered credit unions, as of December 31,

2011. Seven other credit unions provided startup funds for the cross-collateralization program.

Would public entities want to deposit funds at credit unions? Treasurer Wheeler’s statement named five cities which have pledged to deposit funds at credit unions: Portland, Beaverton, Corvallis, Independence, and Klamath Falls. These cities have a combined population of 760,920 as of July 1, 2011, out of a total state population of 3,857,625, or 20 percent.

The National Credit Union Administration reports that credit union interest rates on deposits run slightly higher than comparable bank rates, which means that many public entities would place their deposits with credit unions. I conclude that the credit unions which accept public deposits will constitute a very large percentage of total credit union assets and earnings. The exceptions are most likely to be institutions which are focused on the traditional credit union practice of serving members clearly defined by occupation or other close bond.

## Business Loans

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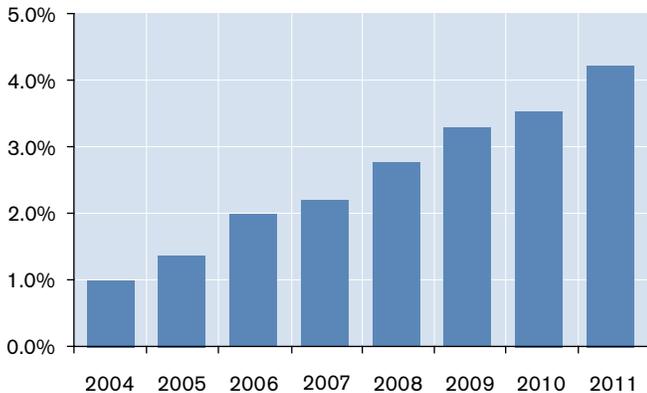
The second issue is how many credit unions will make business loans beyond ten percent of their assets. As of December 2011, two Oregon state-chartered credit unions had business loans that exceeded ten percent of their assets. These institutions accounted for 16.3 percent of all assets among Oregon state-chartered credit unions. Had these two credit unions been subject to tax, they would have paid about \$1,100,000 to the state. Three other credit unions had business loans between eight and ten percent of their assets.

There seems to be no middle ground on business lending. Of the 18 state-chartered credit unions, there were none with business loans between 3.3 and 3.9 percent of assets: all were either lower or higher than this range.

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The trend toward business loans has been rising, as can be seen in the following chart.

**Business Loans as % Assets**  
Oregon State-Chartered Credit Unions



There are several reasons for credit unions to want business loans. First, business loan pricing is often higher than interest rates charged by many credit unions on consumer loans. The National Credit Union Administration reports that in June 2012, credit unions were charging between 3.0 and 3.3 percent on new car loans (their most popular type of loan). The Federal Reserve Board survey of bank lending terms for August 2012 (the closest date available) shows banks charging 4.15 percent on business loans of moderate risk with maturities over one year.

Business loans have a lower average delinquency rate than consumer loans. Call report data on Oregon's state-chartered credit unions show an average net loss rate on business loans of 0.12 percent, compared to 0.74 percent on consumer loans. Business loans would be better for credit unions than consumer loans even if the interest rates were no higher.

Business loans help credit unions diversify their risk. Consumer credit defaults don't perfectly correlate with business defaults, so an institution with both types of loans outstanding will have less overall risk than an institution with only one type of loan.

The fourth advantage of business lending for credit unions is that it helps manage interest rate risk.

Consumers typically want deposits that enjoy a flexible interest rate, but they want loans that have a fixed rate. Business loans often have floating rates, which can reduce the interest rate mismatch of a credit union's consumer business.

There are certainly some disadvantages that will partially offset the benefits to a credit union of business lending. The credit union will have to do some marketing. A low level of business lending comes naturally with respect to current members and their families. To seriously grow business lending, however, takes further efforts.

Credit unions may have to hire more people experienced in both marketing and underwriting business loans. In addition, some additional monitoring systems may be needed.

Would the tax be a serious disincentive to making business loans? Clearly if a credit union were just a few dollars under the 10 percent threshold, making one additional business loan would not be profitable, as the new tax liability would apply to the credit union's entire earnings. However, the more relevant question is whether it would be worthwhile for a credit union to substantially exceed the 10 percent business loan threshold.

It appears that it would be profitable for credit unions to substantially increase their business loan activity. I developed a hypothetical case study, shown in detail in the appendix. It assumes that a one billion dollar credit union has 9.5 percent of its assets in business loans. I calculate their profits if they expand business lending to the federal ceiling of 12.25 percent. I find that using current interest rates on business loans and deposits, and assuming historic loss ratios, the credit union would be better off making the additional business loans and paying corporate income taxes.

Rolling all of these factors together, I anticipate that most of the largest credit unions will continue to expand their business lending.

## Credit Unions Subject to the Tax

To project out future industry profits that would be subject to the tax, I evaluated each state-chartered credit union with two criteria. First, had they stated an intention to take public deposits? That criterion was met by six state-chartered credit unions. I did not include the credit unions that provided start-up funding for the cross-collateralization program, though they are likely candidates to take public deposits.

Second, I looked at business loans as a percentage of assets. Three institutions currently meet the ten percent threshold; two of these credit unions were included in the list of those taking public deposits.

Third, I looked at credit unions whose business loans were close to the ten percent threshold. Two institutions that had not publicly announced an intention to take public deposits had business loans between seven and ten percent of assets. One of these was clearly growing its business lending concentration in recent years and was thus determined to be likely to face the tax. The other institution was reducing its business lending and was thus unlikely to not be subject to the tax.

This process leaves eight out of 18 state-chartered credit unions subject to the proposed tax. They account for 82 percent of the assets of state-chartered credit unions in Oregon, even though they are less than half of the institutions. I assume that this percentage holds going forward. There may be some movement in and out of the taxable category, but the percentage appears likely to be fairly stable.

Potential Tax Revenue from State Chartered Credit Unions			
	% CU Earnings Subject to Tax	Tax If Applied to All CUs	Tax Due from Taxable CUs
2014	81.70%	7,700,810	6,294,330
2015	81.70%	8,488,888	6,294,330
2016	81.70%	9,305,287	7,605,764
2017	81.70%	10,070,678	8,231,364
2018	81.70%	10,866,714	8,882,012
<b>Total</b>	<b>81.70%</b>	<b>46,432,376</b>	<b>37,951,942</b>

The column, “% CU Earnings Subject to Tax” shows what percentage of credit union activity (assets, revenues and profits) are in institutions that would be subject to the tax. The column “Tax If Applied to All CUs” uses my earlier projections of taxes that would be due if all credit unions paid tax. The final column, “Tax Due from Taxable CUs” is the product of the two preceding columns and shows my forecast of actual taxes from credit unions should the proposed tax change be enacted.

Over the first five years of application of the tax, 2014 through 2018, the tax would bring in about \$38 million. The amount would grow, due to both economic growth as well as credit union expansion. In the second five years of implementation, the tax would bring in another \$55 million.

There are two important caveats to the projection so far. The first is that some credit unions might game the system, keeping their business loans just below the ten percent threshold to avoid the tax altogether. The key issue here is how beneficial public deposits and business lending are to credit unions. I believe that the most aggressive institutions will take public deposits and make substantial business lending, but the most traditional credit unions will continue serving their members without triggering a tax liability.

## Charters

The final issue is that credit unions might change from state charters to federal charters to avoid their tax obligations. That is certainly possible, but there are a wide variety of factors involved in a decision to change charters. In the past few years the trend has been away from federal charters and toward state charters. This factor may play a small role in reducing actual tax collections below the numbers presented above. ■

# Credit Union Concentration

Finally, I investigate whether this tax is likely to be levied generally across all credit unions or specifically to a small handful of institutions. I examined the four state-chartered credit unions with the largest profits in 2011. I added up their profits every year from 2000 and compared that sum with the total profits of all state-chartered credit unions.

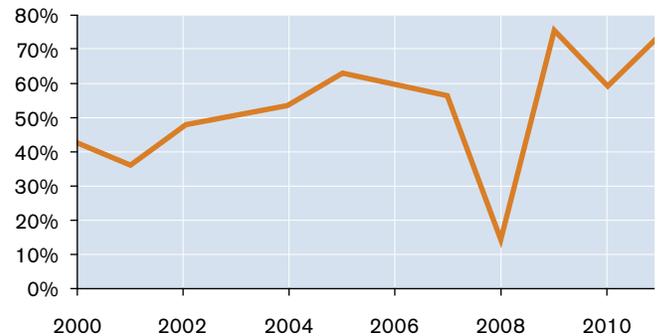
Two things stand out:

1. **The concentration of the four-largest institutions has been growing, from 42 percent of industry profits to 73 percent.**
2. **The recession hit the largest credit unions much harder than the rest, indicating that they take a higher risk than the smaller credit unions.**

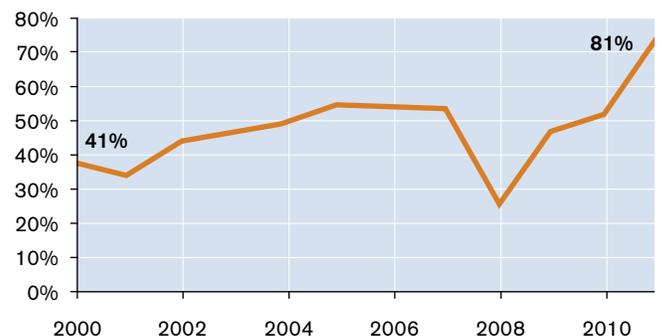
I also looked at my calculations of what state-chartered credit unions would pay in taxes if they were all taxed from 2000 through 2011. The big four account for a growing share of the hypothetical tax collections:

Looking forward, the bulk of tax revenue would clearly come from a handful of large credit unions. A majority of credit unions would pay no income taxes at all, and others would pay only a small portion of the total credit union tax bill. ■

**Top 4 State Credit Unions  
Percent of Profits**



**Top 4 State Credit Unions  
Percent of Hypothetical Taxes**



## Conclusion

Credit unions have substantially increased their loans to businesses in recent years, and a number of them anticipate taking public deposits. I expect both of these trends to increase in future years.

Taxing state chartered credit unions that take public deposits and make business loans in excess of ten percent of their assets would bring in several million dollars a year for the state general fund.

This study has not addressed other issues that should be considered in the decision about whether to tax credit unions. Issues of economic efficiency, equity and fairness should be considered along with revenue implications in reaching a decision on the proposed legislation.

# Appendix: Hypothetical Case Study

Starting point:		
Assets	\$1,000,000,000	
Bus loans	95,000,000	9.5% of assets
Profit	7,226,143	Average profit as % assets
Revenue	67,143,494	Average revenue as % assets

Alternate: More Business Loans		
extra	31,339,031	Bringing bus loans up to federal limit of 12.25%
rate	4.15%	From Fed'l Reserve; moderate risk loans of term > 365 days
revenue	1,300,570	
cost of funds	0.50%	Average rate on C.U. 1-yr CD
cost \$	-156,695	
loss %	0.12%	5-yr average C.U. loss rate on bus loans
loss \$	-36,497	
net profit	1,264,072	From additional loans

The higher volume of business loans triggers tax liability on entire institution.	
Assets	1,031,339,031
Profit	8,490,215
Revenue	68,444,064
Tax	667,477

The credit union is better off by \$596,595 of earnings (net profit on additional business loans less total tax liability).

This case study does consider the extra cost of making the loans. Personnel would certainly be needed, though not in proportion to the overall increase in assets. These costs would lower profits and also lower the tax liability. The net benefit is large enough that it would certainly cover additional non-interest expense. ■

## About the Author

Dr. Bill Conerly connects the dots between the economy and business decisions. As a consultant, he not only forecasts the economy but also helps business leaders understand how their challenges will change with the evolving economy. He was formerly Senior Vice President at First Interstate Bank and held positions in economics and corporate planning at two other major companies. As a consultant and speaker, he has advised business leaders from Bellingham to Boston to Miami to San Diego.

Studies at Duke University culminated with a Ph.D. in economics. He also took courses in finance and corporate planning. Dr. Conerly was awarded the Chartered Financial Analyst designation in 1999.

Dr. Conerly is an on-line contributor to *Forbes* and the author of *Businomics: From the Headlines to Your Bottomline—How to Profit in Any Economic Cycle*. He is co-author of *Thinking Economics*, a multi-media high school economics curriculum used in 34 states.

He has been interviewed on the *News Hour with Jim Lehrer*, CNN and local television and radio stations across the country. He has been quoted in the *Wall Street Journal*, *Fortune Magazine*, and *USA Today*.

Dr. Conerly is chairman of the board of Cascade Policy Institute, a longest-serving member of Oregon Governor John Kitzhaber's Council of Economic Advisors, and a Senior Fellow at the National Center for Policy Analysis. ■

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