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IN FOCUS

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Introduction to Bank Regulation: Credit Unions and Community Banks: A Comparison

Depository institutions—specifically, credit unions and banks—provide financial services to savers (via accepting checking and savings deposits) and borrowers (via providing consumer and business loans). A credit union is a membership-owned cooperative organization established on the basis of its *common bond* (occupation, association, or geographical definition), specified by its federal or state charter. Credit unions face statutory restrictions on their customer base and commercial lending activities because, as specified in the Federal Credit Union Act of 1934 (FCU Act; 48 Stat.1216), they are formed for the purpose of promoting thrift among their members and providing them with a low-cost source of credit. Conversely, a bank is a for-profit institution owned by equity holders who may not necessarily be customers (depositors or borrowers). Although it must also obtain a state or federal charter, a bank does not have similar membership and commercial lending restrictions. Credit unions and banks—particularly community banks—still provide similar financial services as a result of financial market evolution over the last several decades. This In Focus highlights selected similarities and differences between credit unions and community banks for Congress as it deliberates regulatory policy issues that pertain to their roles as financial service providers. For the purposes of this In Focus, *community banks* will be defined as those with $1 billion or less in assets.

Selected Similarities

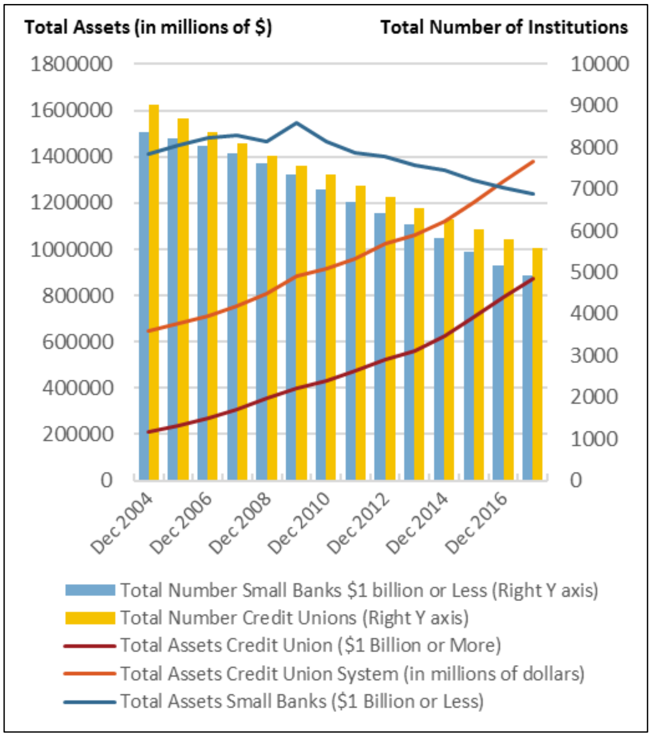
Business models. The business models of credit unions and community banks share some similarities, thus making them competitors. For example, community banks and credit unions both engage in *relationship banking*, which involves developing close familiarity with their customer bases. Because community banks frequently provide financial services within a circumscribed geographical area, the development of close relationships with customers helps them understand local and idiosyncratic lending risks. Similarly, developing close relationships with customers helps credit unions tailor financial product offerings and services to their defined memberships. For this reason, small depository firms have been able to provide financial services (e.g., small-dollar personal loans and small business loans, including microloans to businesses with five or fewer employees) to some niche markets with cost advantages in underwriting and servicing.

Community banks and credit unions rely primarily on borrowings from their depositors (and less frequently from the short-term financial markets) to obtain the funds necessary to provide customer loans. (The Federal Deposit Insurance Corporation [FDIC] insures bank deposits. The National Credit Union Administration [NCUA] insures credit union *share deposits*, analogous to bank deposits.)

Consolidation trends. **Figure 1** presents the total number and total asset holdings of U.S. community banks (referred to as "small banks" in **Figure 1**) and credit unions from 2004 to 2017.

Figure 1. Credit Unions and Community Banks: Number of Firms and Total Assets

2004-2017



Source: CRS, using data provided by the FDIC and the NCUA.

Figure 1 illustrates the following trends over 2004 to 2017.

- Community banks declined in numbers (blue bars), from 8,379 to 4,920, and in total aggregate assets, from $6.47 trillion to $1.38 trillion.
- The total number of credit unions (yellow bars) declined from 9,014 to 5,573. The number of small credit unions with total assets below $1 billion declined from 8,915 to 5,176 (not depicted separately in **Figure 1**).
- The number of credit unions with $1 billion or more in total assets increased from 99 to 287. By 2017, large credit unions held 63.5% of aggregate assets in the credit union system.

The increase in aggregate assets of the credit union system (orange line) exceeded the amount of aggregate assets held by small community banks by the end of 2016, an outcome associated with the aggregate asset growth of large credit unions (red line). Hence, lending and membership growth rates are higher for the larger credit unions, which is similar to trends observed in the banking industry.

Selected Differences

Business lending activities. Unlike community banks, credit unions have a statutory cap on their business lending activities. The Credit Union Membership Access Act of 1998 (CUMAA; P.L. 105-219) codified the definition of *credit union member business loan* (MBL) to be any loan, line of credit, or letter of credit used for an agricultural purpose or for a commercial, corporate, or other business investment property or venture. The CUMAA limited the aggregate amount of outstanding business loans to one member or group of associated members to a maximum of 15% of the credit union's net worth or $100,000, whichever is greater. The CUMAA limited the aggregate amount of MBLs made by a credit union to the lesser of 1.75 times the credit union's actual net worth or 1.75 times the minimum net worth amount required to be well-capitalized under the prompt corrective action supervisory framework. (P.L. 115-174 amended the FCU Act to exclude loans made on any 1-to-4-unit residential dwelling from counting toward a credit union's MBL cap.) The CUMAA authorized an exception to the MBL limit for credit unions that either have low-income designations, participate in the Community Development Financial Institutions program, or are chartered specifically for the purpose of making business loans. Because credit unions with assets under $10 million generally lack the resources and expertise to become more substantial MBL providers, larger credit unions are more likely to compete with community banks for business loans.

Tax treatment. Depositors in banks and credit unions pay taxes on the interest received on their deposit (e.g., checking, savings) accounts. Although the interest received by share deposit holders is referred to as "dividends" because credit unions are financial cooperatives, share depositors are analogous to bank depositors (as opposed to bank equity shareholders).

At the entity level, credit unions are exempt from federal income tax because they are not-for-profit financial cooperatives. Some credit unions may pay unrelated business income tax (UBIT) for tax-exempt organizations. For example, if a credit union were to provide financial services (e.g., check-cashing) to non-members, any revenue generated from those activities would be subject to UBIT. By contrast, community banks are for-profit financial institutions that generally pay taxes at the corporate level.

Whether credit unions' exemption from federal income tax affords them a competitive advantage relative to community banks must be determined on a case-by-case basis, taking into account the nature of competition and market size. For example, the difference in the tax treatment of a small credit union that offers a very limited range of financial services is likely to have a negligible impact on the activities of a nearby community bank. Conversely, a large credit union that serves a regional or national market may arguably benefit from the difference in tax treatment relative to (community) banks of similar sizes that serve similar markets.

Fair lending requirements. Congress enacted the Community Reinvestment Act of 1977 (CRA; P.L. 95-128) in reaction to perceptions that banks were not sufficiently addressing the credit needs of low- and moderate-income (LMI) neighborhoods. The CRA requires that federal banking regulatory agencies evaluate how regulated institutions meet the credit needs of their entire communities. No statutorily set rules are imposed. Banking institutions, however, typically receive CRA credits after providing LMI loans (subject to existing federal prudential regulations for safety and soundness) or other financial retail services in their communities. Because banks may accept deposits from all individuals in a community, CRA provides them with a reciprocal obligation to meet credit needs, as much as possible, of their communities at large. CRA credits are useful to banks when they apply for charters, branches, mergers, acquisitions, and other applications that require approval from their regulators. By contrast, credit unions are not subject to the CRA. Credit unions are not awarded credits that would allow them to expand beyond the common bonds defined in their membership charters. Instead, a credit union may add an underserved area to its field of membership and provide financial services in that designated area.

Minority ownership. As of December 31, 2017, the FDIC reported 155 banking institutions with minority ownership; 128 of them had assets of $1 billion or less (and thus would be considered community banks in this In Focus). For these firms, a majority of the equity shares are held by minorities. Bank customers, however, are not required to be equity owners. The NCUA reported supervising 580 credit unions designated as minority depository institutions as of June 30, 2017. As previously discussed, credit unions are owned by their memberships (analogous to customers). Thus, the membership composition of minority credit unions consists primarily of minorities.

CRS Resources

CRS Report R43167, *Policy Issues Related to Credit Union Lending*, by Darryl E. Getter.

CRS Report R44439, *Taxation of Credit Unions: In Brief*, by Donald J. Marples.

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

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