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Taxicab Medallions and Heirloom Tomatoes to the Rescue

How Expanding Credit Union Lending can Help Small Businesses survive the Credit Crunch

By Eli Lehrer[*]

When they seek to buy inventory, expand, or hire new employees, businesses need credit. And small businesses, which generate between 60 to 80 percent of America's new jobs, need credit most of all.[1] In fact, when businesses fail, they most often do so because of undercapitalization.[2] Each time a good business fails simply because it cannot get credit, the economy has snuffed out another potential Microsoft or General Electric.

A strong economy requires innovative ways to expand the supply of credit to smaller enterprises. It may surprise many policy makers, but a review of the literature suggests that small businesses often rely on credit cards and home equity loans for financing. Few go directly to banks, credit unions, or other lenders for business loans while they remain small.[3] Yet nearly any small business seeking to grow large cannot do so with credit cards alone: It must go to a lender—often a bank or credit union—to get a loan.

This paper examines one way in which the nation might increase the supply of small business credit: relaxing restrictions on credit union business lending. It consists of three sections. The first describes credit unions in general. The second outlines the role that credit unions play in business lending. The third assesses a proposal to expand credit union business lending and speculates as to its likely consequences for the economy as a whole.

Credit Unions and Business Lending. Credit Unions make loans and offer consumers a variety of checking and savings accounts. While they sometimes use

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different terminology (offering “dividends” rather than “interest,” on deposits), credit unions operate similarly to banks. They are almost always backed by federal deposit insurance, and provide a product lineup almost indistinguishable from banks.

Like banks, credit unions can opt for either federal or state charters. Although federally chartered credit unions sometimes make loans ultimately used for business purposes, they cannot actually accept businesses as members. When state law allows it—as it does in most states—businesses can join state chartered credit unions (The statistics on business lending used in this paper aggregate the two types of credit unions).

Credit unions, however, differ from banks in three important ways. First, unlike banks—who can serve anybody who walks through their doors—credit unions have a defined “field of membership.” Most started out as institutions for employees of a certain company, students and faculty at a university, or members of an organization. Many still operate that way. Others are “community” credit unions that serve residents in a defined area, typically a city or county.

Second, credit unions, on balance, face more regulation than banks: They deal with many more restrictions on who they can lend to, the types of loans they can make, and the interest rates they can charge.

Finally, credit unions operate on a non-profit basis. Although nearly all retain some earnings in order to grow, they are theoretically guided only by member interest, not shareholder value. While a few get subsidies from companies whose employees they serve, credit unions typically seek or receive donations. For the most part, credit unions have to make it as businesses in a competitive marketplace, yet they operate on a non-profit basis and do not pay federal income taxes.

Because of their small size—they collectively control only about 6 percent of American deposits—most operate under conservative guidelines and rarely make risky loans. On the other hand, many offer relatively safe loans that yield a miniscule return on investment—loans that bank shareholders might dismiss as a poor deployment of resources.

The preponderance of the evidence indicates that credit unions serve a modest but important role in regulating consumer and small businesses interest rates. As of July 2007, credit unions charged about 100 basis points less on a typical loan and paid slightly more on savings products.[4] According to a University of Wisconsin study, credit unions that convert into banks raise their interest rates on loans.[5] Another study finds that greater credit union membership tends to reduce overall interest rates even for those who do not belong to credit unions.[6]

The banking industry argues that credit unions compete with banks unfairly, especially in business lending The American Bankers Association, the leading bank trade group, argues that credit unions take advantage of their tax–exempt status to transform themselves into institutions “indistinguishable from community banks” that compete

directly with banks while paying no taxes to the community.[7] One recent advertisement (signed by every banking trade association in the country) takes particular aim at credit union business lending, saying that credit unions are "using their tax exemption to finance shopping centers, hotels and other multi-million-dollar corporate projects."[8]

The Shape of Credit Union Business Lending. Do the banks have a point? While they do face direct competition from credit unions in many lines of businesses and the law may give credit unions some advantages in general, credit unions simply do not compete directly with banks for business loans. By necessity, credit unions must focus on small businesses. Credit unions make very few business loans and overwhelmingly make them to small business. They play no meaningful role in making large business loans overall. Federally chartered credit unions cannot even take businesses as members. Indeed**,** credit unions often accept unusual types of property as collateral, and may well be picking up the slack for banks that have reduced small business lending.

Only a handful of credit unions, about 100 across the country, even have the theoretical capacity to make large business loans while still maintaining a properly diversified overall lending portfolio. Credit unions can only lend to their own members and must demand collateral against the full value of the loan. In addition, current U.S. law limits credit unions to lending 12.5 percent of assets to businesses.[9] The average credit union has total assets of about $90 million and thus faces a $10 million cap on overall business lending. Since the presence of a few large credit unions drives up the average asset figure, the majority of credit unions do not have the means to make *any* large loans to *anybody* (the median credit union has less than $13 million in assets).[10] Many will not even write "jumbo" mortgages, defined by Fannie Mae and Freddie Mac as loans over $417,000.[11]

The typical credit union loan used for business purposes does not even count as a business loan at all under current government record keeping standards. Under current federal regulations, loans of less than $50,000 secured by a family's primary residence (or meeting a few other tests), get tallied as personal loans even when used for business purposes.[12] Only 14 percent of all credit unions make any loans counted as "business loans" at all.[13] About 70 percent of all credit union business loans fall into what the Small Business Administration (SBA) classifies as "micro loans"—loans under $100,000.[14] Under all circumstances, under-$50,000 personal loans used for business purposes—by definition, suited only to the smallest of businesses—are likely to continue to make up the bulk of credit union business lending for the foreseeable future. And their market share is tiny: Credit union loans currently total about 0.5 percent of all small business loans.[15]

Only a minority of credit unions make loans that the government tallies as business loans. Nonetheless, such loans appear to serve an important function for a small subset of businesses. A 2001 Treasury Department study provides an interesting snapshot of credit union lending practices. At first, the patterns appear unsurprising: non-agricultural real estate (mostly personal residences) provided collateral for over 50 percent of credit union business loans.[16] Getting past the real estate-secured loans, however, things get more

interesting. About 13 percent of credit union loan value had backing from farms, crops, or farm equipment, while almost 23 percent of all value—nearly all of it from New York City—had backing from taxicab medallions. The national patterns, however, mask stark regional differences. According to the Treasury Department:

> Taxicab medallions secured 64 percent of the member business loans in the Albany region, whereas non-agricultural real estate secured 85 percent or more of the member business loans in the Atlanta, Capital, and Pacific districts. The remaining two districts—Austin and Chicago—make almost all of the credit union member business loans backed by some type of agricultural collateral, either real estate, equipment, or crops and livestock.[17]

These patterns are not surprising: The Austin and Chicago regions cover the nation's breadbasket, while in New York City long-term government rationing, coupled with the city's enormous population density, has made the city's taxicab medallions uniquely valuable.[18]

Loans backed by these unusual types of collateral help unlock wealth that owners might not be able to access otherwise. Quite simply, it takes specialized knowledge to assess the value of a taxicab medallion, an uncommon piece of farm equipment, or a non-commodity agricultural product. Although they are frequently bought and sold, there is no stock exchange for taxicab medallions and prices are not always made public. In fact, one company, Medallion Financial, accounts for an absolute majority of taxicab medallions loans, while credit unions, including operations like the League of Mutual Taxi Owners Credit Union, have the next biggest share of the medallion lending market.[19]

Given the small number of lenders, lending against taxicab medallions requires a large degree of specialized knowledge. The same holds for farm equipment, non-commodity crops, and some rare types of livestock. It is relatively easy to appraise a Ford F Series Pickup by visiting Edmunds.com or a field of feed corn by looking at commodity prices; it requires extremely specialized knowledge to know if some milking machines have any value on the secondary market or figure out the market value of a field full of organic vegetables grown from heirloom seeds.

By virtue of their small size and defined fields of membership, credit unions simply have an advantage in discovering ways to lend against unusual kinds of collateral. For certain categories of smaller enterprises in some regions of the country, credit unions serve as repositories of this specialized knowledge and help unlock wealth.

What to Do? One proposal currently before Congress—the Credit Union Regulatory Improvements Act (CURIA)—would allow credit unions to use 20 percent of their assets (rather than 12.5 percent under current law) to make business loans.[20] As written, the proposal would have a modest but positive consequence for small business lending and the overall health of small businesses. Bank consolidation and a tightening in the mortgage market have reduced the supply of small business credit. Reduced restrictions

on credit union business lending could well make up some of the difference in some economic sectors.

Banks are becoming less willing to offer the small business loans in which credit unions specialize. A comprehensive 2005 Small Business Administration (SBA) study concluded that "in general larger [bank holding companies] tend to do less small business lending."[21] Although the SBA finds some exceptions, it appears likely that bank consolidation will further reduce the credit supply for small businesses. Unless credit unions depart a great deal from their established lending pattern—and nothing indicates that they would—credit unions are likely to pick up some of the business lending slack left by banks. It is worth noting that credit unions have also consolidated even as their total assets have increased (there are about 1,000 fewer credit unions in the United States today than there were in 2003),[22] yet all other things being equal, broader credit union lending would expand the supply of credit for small businesses.

The current tightening of the sub prime mortgage market has had negative consequences for small businesses around the country. As of early September 2007, one website tracking the housing market crisis found that 145 mortgage lenders had gone belly up.[23] Given the enormous percentage of business startups that rely on it to grow, reducing the availability of home equity financing seems almost certain to reduce the availability of credit for small businesses.[24] Credit unions might help here as well.

Under CURIA, the average credit union could make about $17 million in total business loans rather than the current limit of about $10 million. Multiplied across the nation's credit unions, this would thus make available about $4.25 billion in additional credit, most of which would likely go to small businesses.[25] While that number may appears small in the grand scheme of things—the SBA estimates that small businesses took out a total of over $600 billion in loans during 2006—more credit will provide a significant boost to the businesses that already rely the most on credit union loans[26]—especially those that rely on unusual types of assets as collateral.

However, because credit unions would still face a tight cap on the amount and type of business loans they can make, CURIA is only a small step in the right direction. So long as they avoid force and fraud, entrepreneurs should have the freedom to participate in any financial arrangement they choose. Those who favor CURIA in principle should ask why the bill does not go further in lifting restrictions on credit unions' ability to make loans as they wish in accord with prudent business practices.

Credit union lending plays a significant—albeit specialized—role in the health of many American small businesses. Any proposal that expands it will help those businesses and, by extension, the nation's economy.

Notes

[1] Small Business Administration. "Frequently Asked Questions," http://app1.sba.gov/faqs/faqIndexAll.cfm?areaid=24.

[2] Amy E. Knaup "Survival and Longevity in the Business Employment Dynamics Database" *Monthly Labor Review,* vol. 128, no. 5 (May 2005), 50-56.
[3] Robert D. Manning. *Credit Card Nation: The Consequences of America's Addiction to Debt.* Basic Books: 2000, 229.
[4] Datatrac Inc. "Credit Union and Bank Interest Rates," July 2007.
[5] Jeff Heinrich and Russ Kashian. "Credit Union to Mutual Conversion: Do Rates Diverge?," University of Wisconsin – Whitewater Working Paper, February 13, 2006.
[6] Robert Feinberg and A.F.M. Artuer Rahman, "A Causality Test of the Relationship Between Bank and Credit Union Lending Rates in Local Markets". *Economic Letters* 71, 2001. p 271-275.
[7] See e.g. American Bankers Association. "Credit Unions, a Changing Industry," Winter 2004, http://www.aba.com/NR/rdonlyres/804662A0-4225-11D4-AAE6-00508B95258D/34880/CreditUnionsAChangingIndustry012705.pdf. See also: American Bankers Association. "Credit Union Competition," http://www.aba.com/Industry+Issues/Issues_CU_Menu.htm
[8] American Bankers Association et al. "Dear Members of Congress:" http://www.aba.com/NR/rdonlyres/804662A0-4225-11D4-AAE6-00508B95258D/46013/ABAadhill.pdf
[9] The Federal Credit Union Act. (12 USC 1757a(a))
[10] Credit Union National Association. "Frequently Requested Bank/Credit Union Comparisons," http://advice.cuna.org/download/freq_compar.pdf . It's worth noting, of course, that no prudent lending officer capable of making $10 million in loans would offer a $10 million loan (or, in all probability, a $1 million loan) to anybody.
[11] Fannie Mae. "Loan Limits," http://www.fanniemae.com/aboutfm/loanlimits.jhtml;jsessionid=XR3LITGDXTVRJJ2FQSISFGQ?p=About+Fannie+Mae&s=Loan+Limits . The $417,000 limit refers to a single family home in 2007.,
[12] National Credit Union Association, "Frequently Requested Bank/Credit Union Comparisons.".
[13] Department of the Treasury. "Credit Union Member Business Lending," January 2001, 10.
[14] Department of Treasury, 2001, 26. Although personal residences are used as collateral, these loans are officially tallied as business loans and the borrowers tell the credit unions that they intend to use them for business purposes.
[15] Small Business Administration. "Small and Micro Business Lending: 2004-2005," Office of Advocacy, Small Business Administration, December 2006 and U.S. Department of the Treasury, 3; Ibid, 37.
[16] Except where noted, data in this paragraph come from Department of Treasury, January 2001. Table 1 (Page 26).
[17] Ibid 31.
[18] For a map of the regions see: National Credit Union Administration, "NCUA Organizational Chart," http://www.ncua.gov/AboutNCUA/org/OrgChart.htm . NCUA's regions do not correspond to the federal regions.
[19] Katherine Herrup. "Hailing the Taxicab Business," *The New York Sun,* May 15, 2006. League of Mutual Taxi Owners Credit Union. "About Us." http://www.lomto.org/about_us/default.aspx
[20] H.R. 1537 (2007), Sec 201.
[21] Diana Hancock et al. "The Effects of Mergers and Acquisitions on Small Business Lending by Large Banks," Small Business Administration, Office of Advocacy, March 2005. Second unnumbered page.
[22] Credit Union National Association. "U.S. Credit Union Profile," March 2007, 6.
[23] Aaron Krowne. "The Implode-o-Meter," http://ml-implode.com/ (As of September 6, 2007). The authors' review indicates that none of these lenders were credit unions.
[24] For estimates on business financing through home equity see. Steven Rogers. *The Entrepreneur's Guide to Finance and Business: Wealth Creation Techniques for Growing a Business,* 251. And Manning, 229.
[25] There are several reasons for this number not being higher. Most of this new lending is likely to come from credit unions that already lend to small businesses but are constrained from lending more. A credit union that makes no business loans now is not likely to start making them because federal law that raises its lending ceiling. A credit union that wishes to get into the business lending field will almost certainly start below the current ceiling of 12.5 percent**.**
[26] Small Business Administration. "Small and Micro Business Lending: 2004-2005," Office of Advocacy, Small Business Administration, December 2006 and U.S. Department of the Treasury, 2.