credit union

SYSTEMBRIEF

Competitive balance in the financial sector

The case for a federal capital growth tax credit

Credit Union Central of Canada

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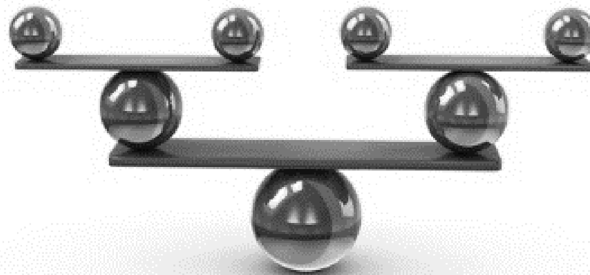

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introduction

By now, most people have probably forgotten most of what they knew about the 2013 federal budget, policies like the promise to balance the budget, eliminate tariffs on sporting goods (e.g., hockey gear), or implement a new jobs grant.

For Canada's credit unions however, the 2013 budget is still a very present document because, unexpectedly, the federal government chose to eliminate a tax deduction that for more than 40 years recognized the limited ability of credit unions to easily raise capital and helped offset some of the tax preferences enjoyed by banks.

Credit unions are beginning to feel the impact of the five-year phase-out of this deduction. Higher taxes will limit credit unions' ability to lend to families and local businesses. There will be less money available to invest in technology, growth, and the local sponsorships, charitable giving and community impact that credit unions are well regarded for.

This *System Brief* briefly reviews some of the history behind the soon-to-be-eliminated additional deduction for credit unions (ADCU) and then discusses a proposal for a new tax credit called the capital growth tax credit (CGTC). The last section of this brief outlines the policy rationale for this proposal.

section 1

historical context: achieving competitive balance

Canadian credit unions first became taxable in 1972 following a sweeping overhaul of the income tax system in the wake of the 1966 Royal Commission on Taxation, better known as the Carter Commission.

At the same time, credit unions were also given access to the preferential income tax rate available to small business corporations that are Canadian-controlled private corporations. In the current context, this means that small credit unions with up to $500,000 in taxable income and less than $10 million in taxable capital are taxed at 11 per cent instead of 15 per cent. This favourable rate phases out as the credit union's taxable capital climbs to $15 million. Over the years, the value of the small business deduction (SBD) has declined as the gap between large and small corporate tax rates has narrowed and tax rates more generally have fallen.

Credit unions were also given an additional deduction, available only to them, which provided them the same small business tax rate for income in excess of that eligible for the SBD. This became known as the additional deduction for credit unions (ADCU). To obtain the ADCU, a credit union had to pass a test that compared the value of the "preferred rate amount" – essentially the cumulative total of the credit union's taxable income since 1972 – with the "maximum cumulative reserve," calculated as 5 per cent of the credit union's deposits and share capital. Credit unions could claim the ADCU so long as the preferred rate amount was less than 4/3 times the maximum cumulative reserve.

The policy logic behind the SBD and ADCU recognized two basic facts about credit unions that are as true today as they were in 1972: (1) credit unions are the "small businesses" of the financial services sector. Most Canadian credit unions currently qualify for that label under standard definitions; and (2) the credit union's co-operative structure makes it challenging to raise capital in a hurry.

In subsequent years, "it would appear that each successive government recognized the need to continue to support the credit union and *caisse populaire* systems in building their regulatory reserves through the taxation system."[1] For 40 years, the tax status of credit unions and the accommodation at the federal level went undisturbed, operating to create a competitive balance precisely as it was intended to by parliament.

[1] Deloitte, Memo to Credit Union Central of Canada, September 2013.

A lone call for change came in 1997, when a report by the Technical Committee on Business Taxation, chaired by Dr. Jack Mintz, recommended elimination of the ADCU and redeployment of saved tax revenue to other measures.

The federal government of the day did not act on the suggestion and only two years later, the Task Force on the Future of the Canadian Financial Services Sector rejected Mintz' recommendation, recognizing that the tax system helped credit unions provide the kind of competition that the Task Force believed was important. In particular, the task force led by Harold MacKay touted credit unions as better placed to assess risk at a more local level and provide more tailored services than banks or trusts traditionally could or would.

This is where matters stood until the 2013 federal budget.

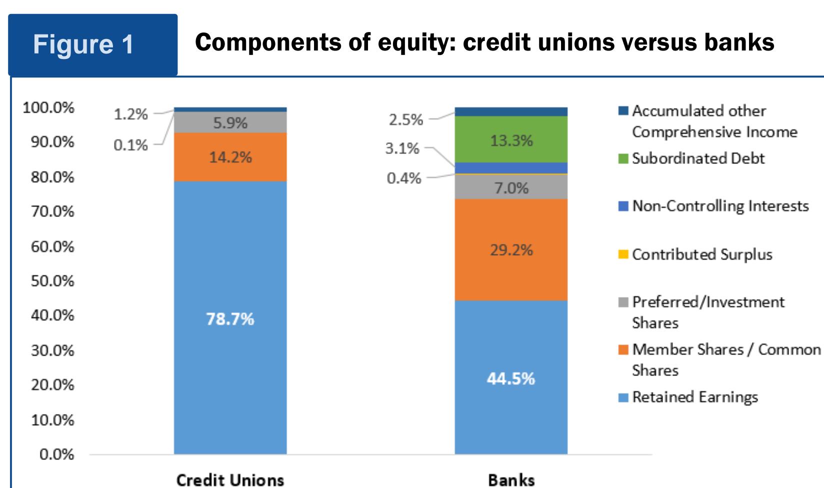
section 2

why the capital growth tax credit?

When the additional deduction for credit unions (ADCU) was put in place 42 years ago, it was widely understood – as indicated above – that member-owned credit unions rely much more heavily on retained earnings for capital than shareholder-owned banks.

Figure 1 illustrates this basic fact: whereas retained earnings accounted for almost 80 per cent of equity in credit unions in 2012, they accounted for less than 45 per cent of equity in the six largest banks.

Figure 1 **Components of equity: credit unions versus banks**



Additionally, while credit unions can, in many cases, count shares as equity under current regulations (14.2 per cent of the total), this will change as the provinces move to implement Basel III-like rules that are not very friendly to co-operative structures because of their requirement that share capital be non-redeemable and fully available to absorb losses. In other words, the need for credit unions to grow their retained earnings could be even more pronounced in the near future.

In addition to helping credit unions generate retained earnings, the ADCU also helped balance some of the ways in which the tax system favours large shareholder-owned financial institutions such as banks. For example, only 50 per cent of the gains from the sale of bank shares is subject to income tax. As a result, investors have a strong incentive to purchase bank shares. This favourable public incentive means banks can, as needed, easily put together a share offering to increase their capital. The capital gains exemption also generates a significant tax expenditure for the federal government. Yet, there is no corresponding incentive – or tax expenditure – in the tax rules to benefit member-owned

financial institutions such as credit unions as their member shares cannot create a capital gain.

The federal tax system, as currently structured, disadvantages credit unions in other ways. For example, credit unions incur proportionately higher goods and services (GST) or harmonized sales tax (HST) costs than shareholder-owned financial institutions because (i) credit unions buy and pay GST/HST on many services that banks can source in-house; and (ii) have fewer opportunities to calculate input tax credits because they tend to stick to bread-and-butter banking rather than engaging in other business lines that are subject to the GST/HST. These are classic examples of situations where equal treatment does not equate to fair treatment and where these kinds of "competitive balance" considerations should be brought to the forefront in the policy process. The proposal put forward by Credit Union Central of Canada (Canadian Central), discussed in more detail below, is aimed at this objective.

Finally, while smaller credit unions will continue to benefit from the small business deduction, they hold in aggregate only about 10 per cent of the system's assets and serve only 14 per cent of its members. Moreover, the strong and continuing trend towards mergers means that even these credit unions will soon become ineligible for the deduction. More importantly still, the existing size thresholds to qualify for the small business deduction are inadequate for capital intensive regulated financial institutions.

section 3

the capital growth tax credit proposal: recognizing and supporting the credit union difference

To help credit unions grow their retained earnings and re-establish a competitive balance in the tax system, Canadian Central is proposing a new tax credit – called the capital growth tax credit (CGTC) – set at five per cent of a credit union's retained earnings increase in the previous year. The tax credit would be used to reduce federal taxes payable on a dollar-for-dollar basis. Any unused amounts would be available to be carried back three years or carried forward 20 years.

Under this proposal, most credit unions would receive somewhat larger tax savings than with the ADCU. The next two charts (Figures 2 and 3) show the estimated impact of the proposal relative to the ADCU for 2012 for the three largest credit unions in the system and a selection of three mid-sized credit unions. Small credit unions would benefit similarly.

Reflecting these kinds of credit union level data, Figure 4 (next page) shows that in 2012 the estimated tax expenditure associated with the capital growth tax credit for Canadian Central-affiliated credit unions would exceed the estimated tax expenditure associated with the ADCU for 2012.

Figure 2 **Tax Savings: ADCU vs CGTC at the three largest credit unions (2012)**

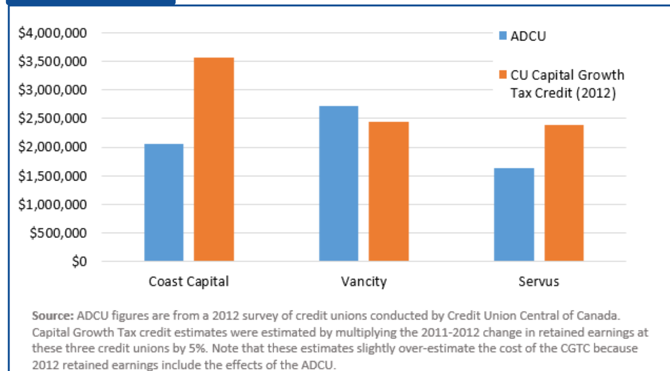
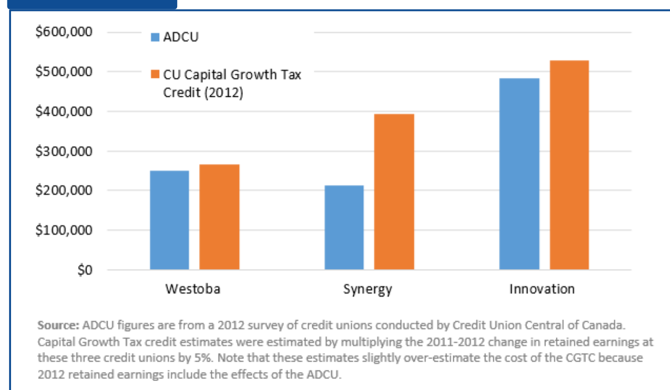
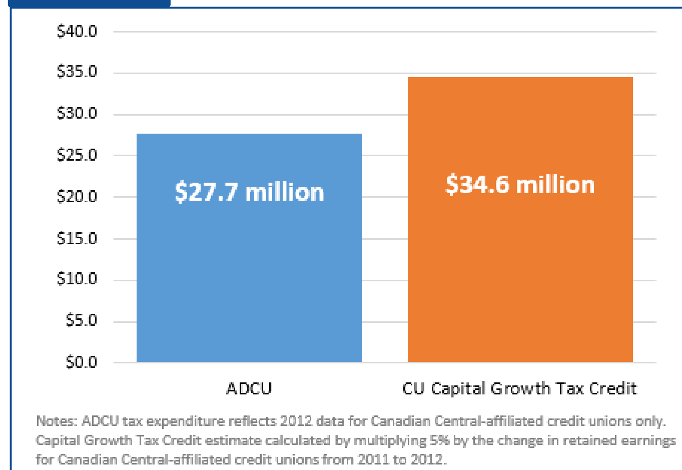


Figure 3 **Tax Savings: ADCU versus CGTC at three mid-sized credit unions (2012)**



If the analysis is extended beyond Canadian Central-affiliated credit unions, the expected tax expenditure associated with the proposed capital growth tax credit increases to $65.9 million versus an ADCU tax expenditure of $42 million in 2012. As we discuss next, the capital growth tax credit has several favourable policy features that help offset this slightly higher tax expenditure cost.

Figure 4 **Estimated expenditures: ADCU versus CGTC**



Notes: ADCU tax expenditure reflects 2012 data for Canadian Central-affiliated credit unions only. Capital Growth Tax Credit estimate calculated by multiplying 5% by the change in retained earnings for Canadian Central-affiliated credit unions from 2011 to 2012.

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section 4

policy advantages of the capital growth tax credit

By aligning the tax credit with the accumulation of retained earnings, widely regarded as the most robust form of capital, the tax credit would be an important source of strength and growth for credit unions and would further several important federal policy objectives.

The capital growth tax credit supports Canada's Economic Action Plan

The federal government has stated in its Economic Action Plan that it is pursuing an economic agenda that supports jobs, growth and prosperity in the economy. Credit unions have been significant contributors to this economic agenda. Since 2006, Canadian Central-affiliated credit unions have increased their lending by a compound annual growth rate of seven per cent a year to more than $136 billion in 2012.

The capital growth tax credit will strengthen the ability of credit unions to support the economic foundations of their communities. Drawing on historical leverage ratios in the credit union and Desjardins systems, we estimate that the proposed tax credit could support $694 million in additional lending and $851 million in additional aggregate assets (i.e., loans plus other forms of financial assets such as government debt) per year, as shown in the accompanying chart.

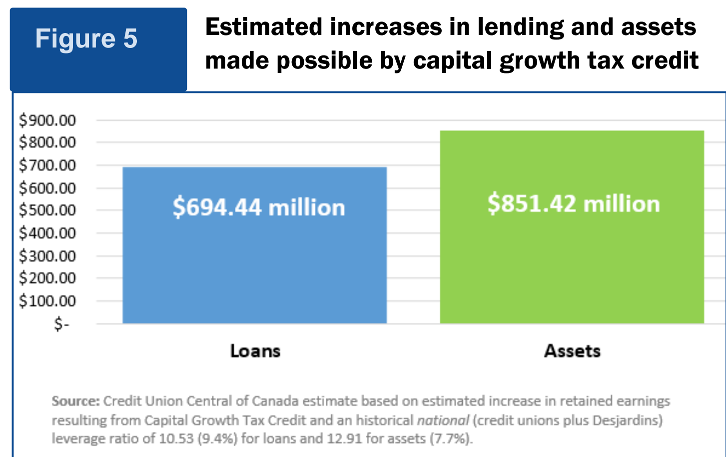


Figure 5 **Estimated increases in lending and assets made possible by capital growth tax credit**

The capital growth tax credit facilitates take-up of the federal credit union option

In early 2014, the federal government proposed several measures to facilitate continuance to the federal level using the new (circa 2010) federal credit union option. Among other things, it proposed to offer temporary transitional support to eligible credit unions through extended deposit insurance, a short-term funding facility and a streamlined process for amalgamating two or more provincial credit unions into one federal credit union.

While the credit union system is grateful for these measures, credit unions contemplating the move to federal jurisdiction face another hurdle in the form of a federal regulatory structure that is not sensitive to co-operative financial structures. For example, as documented in a recent analysis by financial industry expert Michael Andrews, Basel III rules – which the Office of the Superintendent of Financial Institutions (OSFI) has adopted largely wholesale – will likely not recognize co-operative preferred shares as common

equity tier 1 capital (CET1), although these shares may count towards additional Tier 1 or Tier 2 capital.[2] Similarly, OSFI has to date given no indication that it intends to adapt its capital requirements to future federal credit unions despite evidence that co-operative financial institutions are generally less risky than their bank counterparts in part because of their strong focus on residential lending, which generally receives favourable weighting treatment under Basel rules.

By helping credit unions increase their retained earnings, the proposed capital growth tax credit would make it easier for credit unions to make the move to the federal level and thereby satisfy an important federal policy objective.

The capital growth tax credit means more lending for small business

Credit unions are independent financial institutions owned by their members. They serve the financial needs of millions of individual Canadians, they employ over 27,000 Canadians in communities across Canada and they are strong supporters of small business. In the most recent Canadian Financial Independent Business (CFIB) study on small business lending, credit unions ranked fourth – with 11 per cent of SME lending – across all financial institutions, well out of proportion with their 5.9 per cent overall market share. If the SME market shares of credit unions and *caisses populaires* are added together, co-operative financial institutions place second at 18.6%, just behind Royal Bank of Canada again, despite their considerably smaller size. The accompanying table illustrates these numbers.

Table 1: Small business market share	
Royal Bank	18.7%
Scotiabank	17.9%
TD Canada Trust	16.0%
Credit union	**11.0%**
Bank of Montreal	10.1%
CIBC	9.9%
Caisses populaires	**7.6%**
National Bank	2.9%
HSBC	2.3%
ATB Financial	2.0%
Other institutions	1.5%

Source: CFIB data based on a 2012 survey of 12,877 small businesses across Canada. For the purposes of this survey, the CFIB defines small business as those with fewer than 500 employees.

This commitment to small businesses can be illustrated in other ways as well: since 2006, Canadian Central-affiliated credit unions have increased their commercial lending – a significant share of which is likely to small businesses – by a compound annual growth rate of almost 7.9 per cent to almost $38 billion. We can also provide a rough estimate of the expected increase in commercial lending made possible by the capital growth tax credit proposal. Of the $694 million in total additional lending discussed earlier, $175 million would be expected to end up in the form of commercial loans (including agricultural loans).

[2] Mike Andrews, "Credit Union Capital Adequacy: What's New and What's Next?," Filene Research Institute, available at: http://filene.org/research/report/credit-union-capital-adequacy-whats-new-and-whats-next

Credit unions have been particularly active in the agricultural sector, which tends to be made up of small businesses. At the end of 2012, credit unions accounted for 11.1 per cent of all farm debt outstanding (FDO) in Canada outside of Quebec, well above their overall 5.9 per cent market share. In some provinces, like Saskatchewan and Manitoba, credit unions are responsible for even larger market shares, 19.6 per cent and 26.1 per cent of FDO respectively. Since 1997, credit unions have increased their agricultural lending (measured in terms of farm debt) at a steady and sustainable average annual rate of 6.9 per cent – faster than the 2.3 per cent average annual growth rate for agriculture in Canada. The capital growth tax credit proposal will help credit unions deepen this commitment to farmers.

In short, for a growing, improving Canadian economy, credit unions are an important source of financing for small business, including farmers. If the "Economic Action Plan" is to deliver the results that the federal government expects, multiple sources of financing for small business and farmers are needed and a strong tier of smaller community-focused financial institutions will best meet this need.

The capital growth tax credit will promote competition in the financial services industry

The federal government has recognized that there is a need for more competition in the Canadian financial services marketplace. In the 2013 budget, the government announced steps to promote the entry and growth of smaller institutions. This is a long-standing objective of federal government policy and there have been efforts in the past to achieve a greater level of competition in the financial services marketplace. Despite these efforts, the level of concentration in the Canadian financial services market has not been reduced to any material degree during the past few years.

In a recent report on the "too important to fail" problem, the International Monetary Fund (IMF) included a chart, reproduced here as Figure 6, that compared the degree of concentration in Canadian banking with that in other developed countries by looking at the market share of three largest banks in the country. Canada not only had the highest degree of concentration but was the only country of those depicted that saw a steady increase in that concentration over the 2006 to 2012 period.

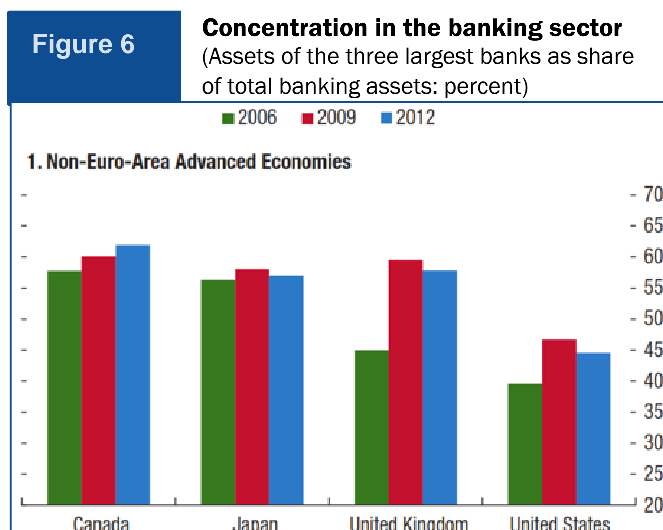


Figure 6 **Concentration in the banking sector** (Assets of the three largest banks as share of total banking assets: percent)

By contrast, during this same period, the credit unions' share of domestic assets fell from 6.6 per cent in 1996 to 5.9 per cent in 2012. By helping balance some of the structural tax

features that favour banks, the CGTC would better equip credit unions to continue offering a strong degree of competition in banking.

The capital growth tax credit will help build local economies

Effective tax policies combined with other regulatory measures are among the most fundamental and effective methods for government to encourage growth in the economy for the benefit of individual Canadians and small business. Credit unions are crucial to the economy in communities right across the country. Credit unions are the only financial institutions in 360 communities and offer crucial services that help to strengthen those communities. The capital growth tax credit is an affordable way to rebalance the tax system to support credit unions and the communities in which they operate.

The capital growth tax credit enhances stability and is fiscally responsible

By design, the value of the proposed capital growth tax credit will increase as the economy moves through the economic cycle towards its peak because of increased lending and profitability. This feature has two policy benefits.   First, it helps credit unions generate increased retained earnings – and capital – ahead of a downturn or recession, when loans are most likely to go into default and erode capital values. In that sense, it works similarly to the Basel III counter-cyclical capital buffer. Second, and consequently, the tax expenditure associated with the tax credit will reach its zenith in periods of strong economic growth when the budget balance is likely to be in surplus.

conclusion

Until recently, the federal tax system provided a sort of "rough and ready equilibrium" whereby structural factors that favoured large shareholder-owned banks – such as the capital gains tax exemption and GST/HST rules – were offset by the additional deduction for credit unions (ADCU). The elimination of the ADCU upset that equilibrium, or competitive balance.

The ADCU also recognized that as locally-based co-operative financial institutions, credit unions depend on retained earnings for their capital far more than large national joint-stock owned banks. The elimination of the ADCU went against the grain of almost 40 years of public policy recognizing that the tax system should recognize that credit unions are different and that they matter.

To help restore balance, Canadian Central on behalf of the Canadian credit union system, is proposing a new tax credit, called the capital growth tax credit, which would be set at five per cent of the increase in a credit union's previous year's retained earnings. This proposal has several favourable policy features, including supporting additional economic growth through additional lending to individuals and small businesses, providing an important incentive to continue into the federal regime, supporting credit unions in providing a viable competitive alternative to the dominant banking sector, and helping generate a capital buffer that matches features of the Basel III framework and which is sustainable from a fiscal perspective.

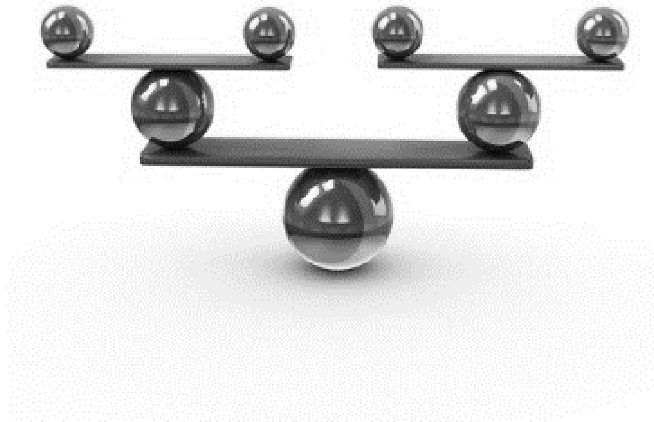
As co-operatives, credit unions believe that the availability of a wide variety of corporate forms helps to strengthen the economy and society. No one type of business structure is ideally suited to all aims or outcomes. The recent financial crisis produced some evidence of this. While globally many banks retrenched and reconsidered their lending activities, credit unions tended to increase lending to small businesses, start-ups and households. They did all this despite a challenging environment of record low interest rates. But it is precisely because credit unions are a different kind of entity – member owned, community focused financial co-operatives with a mandate to serve their communities that credit unions responded in this way.

The point is that Canadians benefit from the diversity of players in the financial services sector. It makes good sense that governments understand the differences between banks and credit unions and be prepared to make accommodations to ensure that forms can be different, yet still able to compete fairly and satisfy the public purpose.

about us

Credit Union Central of Canada (Canadian Central) is the national trade association for the Canadian credit union system. Canada's credit unions are vital competitors in the financial services industry. Canadian Central represents five regional Centrals and one Federation representing 320 credit unions with more than $$162.7 billion in assets and serving over 5.3 million members, outside of Quebec. For more information about Canada's credit union system and Canadian Central visit www.cucentral.ca.

For the ninth consecutive year, Canadians ranked credit unions first in overall Customer Service Excellence, among all financial institutions, surpassing all Canadian banks in Ipsos® 2013 Best Banking Awards. Credit unions also took sole honours in the Values My Business and Branch Service Excellence categories. Credit unions tied for first among all financial institutions for Financial Planning and Advice and Telephone Banking Excellence.



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