



Does the Credit Union Tax Exemption Affect Competition in Local Lending Markets? Evidence from the TCJA

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Why This Matters

- Credit unions have been tax-exempt since 1934
 - Annual cost: ~\$2.8 billion in forgone federal revenue
- Critics argue that the exemption distorts competition
- But does the exemption actually confer a competitive advantage?
 - Hard to test: the exemption is time-invariant





This Paper

- Use the 2017 Tax Cuts and Jobs Act as a natural experiment
 - TCJA cut the C-corp tax rate from 35% to 21%
 - Narrowed the CU-bank tax wedge by 40%
 - Credit unions: unchanged (0% entity-level tax)
- Key findings:
 - C-corp banks passed through the tax cut as lower mortgage rates
 - Credit union rates did not respond (tax advantage already fully priced)
 - However, CU market share declined 5.5 pp in high-C-corp counties
 - Effect concentrated among large CUs in urban markets





The Tax Wedge: Before and After TCJA

- Before TCJA (2014-2016):
 - C-corp banks: 35% entity-level tax
 - S-corp banks: ~39.6% pass-through to shareholders
 - Credit unions: 0% (tax-exempt)
- After TCJA (2018-2019):
 - C-corp banks: 21% entity-level tax (14 pp cut)
 - S-corp banks: ~29.6% (Section 199A QBI deduction)
 - Credit unions: 0% (unchanged)





Research Design

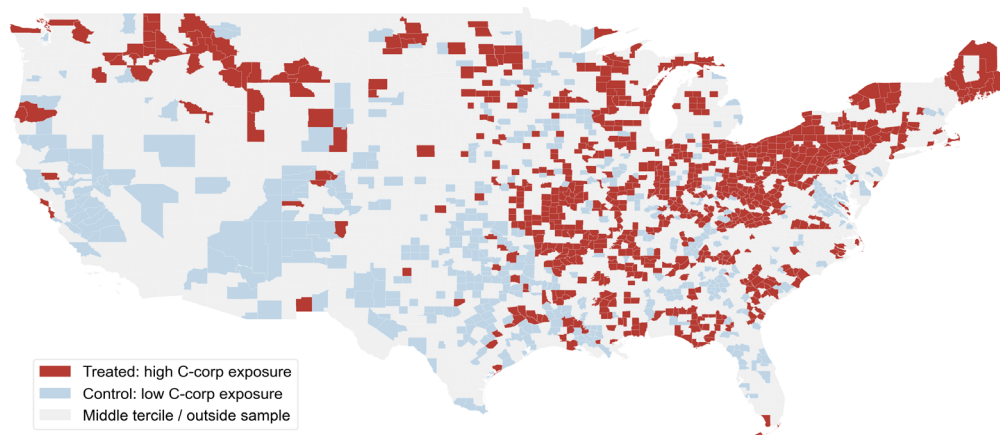
- Treatment: county-level C-corp bank presence (AllCC/All)
 - All C-corp originations / all HMDA originations, averaged 2014-2016
 - Top tercile = treated (high C-corp exposure)
 - Bottom tercile = control (low C-corp exposure)
- Sample: 1,344 counties, 2014-2016 + 2018-2019
 - 2017 excluded (TCJA anticipation effects)
- Our goal: to mortgage markets dominated by C-corps to those with less C-corp presence, before vs. after the tax cut





Treatment Counties Have High Pre-TCJA C-corp Exposure

Top vs bottom terciles of all C-corp share of all HMDA originations



Treatment is based on pre-TCJA all C-corp originations divided by all HMDA originations.





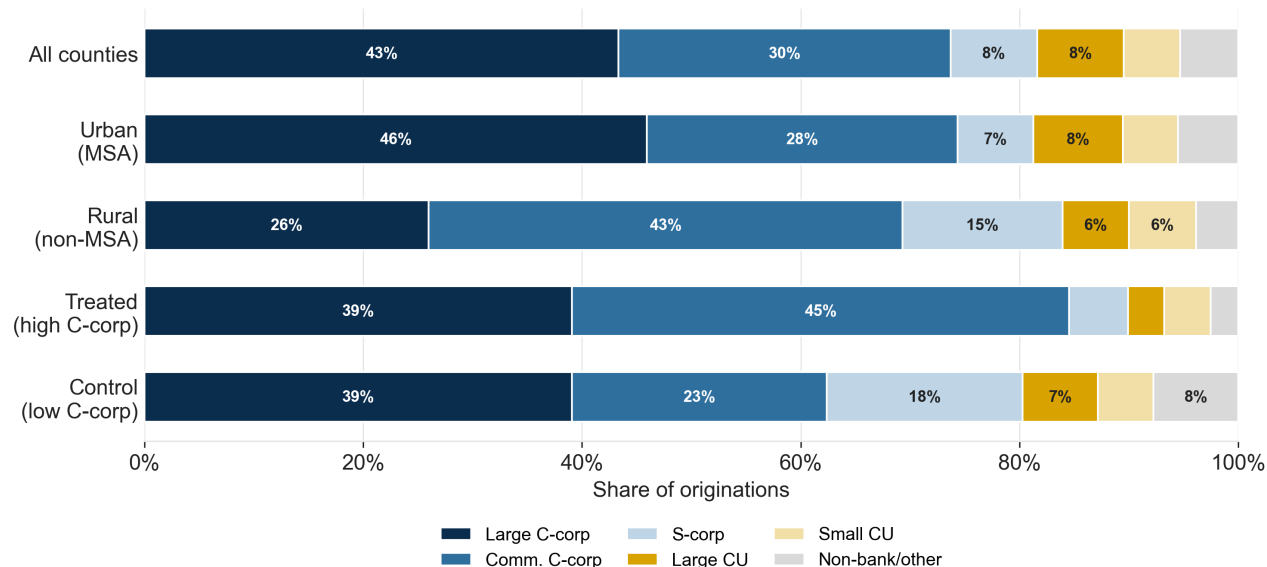
Data

- HMDA: Loan-level mortgage originations (all lenders from 2014-2019)
 - Conventional first-lien purchase mortgages
- RateWatch: Monthly posted 30-year fixed mortgage rates
- FFIEC Call Reports: Bank tax status (C-corp vs S-corp)
- NCUA FOICU: Credit union characteristics





Who Competes in Local Mortgage Markets?





The Pre-TCJA Rate Gap: Only 3 Basis Points

- Before the TCJA, CU and bank mortgage rates were nearly identical
 - CU mean: 4.24% Bank mean: 4.24% Gap: ~3 bps
- The tax advantage was already fully capitalized into CU pricing
 - CUs didn't offer visibly lower rates
 - The exemption made them competitive, not cheaper
- Implication: CUs had no pricing cushion to absorb
 - When banks cut rates, CUs couldn't match them



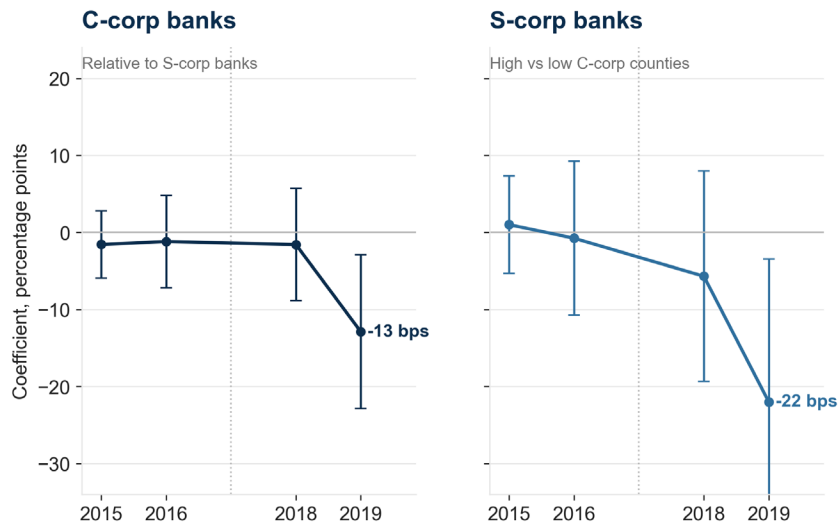


Findings





C-Corp Banks Cut Rates After TCJA

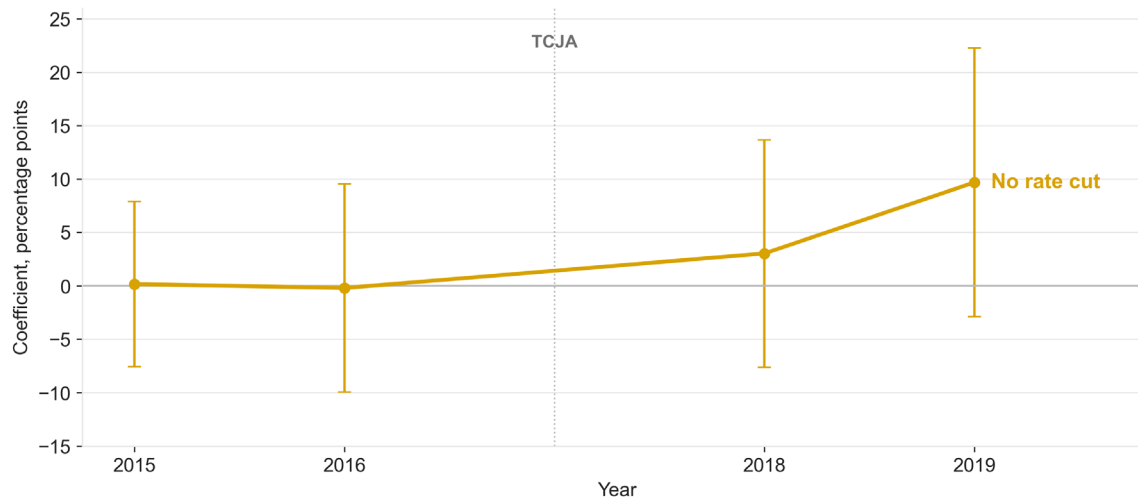


- C-corp banks reduced 30yr fixed rates by 13 bps relative to S-corp banks by 2019.
On a \$250K mortgage: ~\$335/year in interest savings.





Credit Union Rates Did Not Respond





Main Result: CU Market Share Declined

- CU share of depository originations fell 5.5 pp in treated counties
 - Post x Treated = -0.055 ($p < 0.01$)
- But CU originations actually grew (+11.4%)
 - Banks expanded lending faster than CUs
 - Relative displacement, not absolute decline
- Interpretation:
 - Banks passed through tax savings as lower mortgage rates
 - Borrowers shifted toward banks offering better mortgage rates
 - CUs couldn't match because the tax advantage was already priced in





Which Credit Unions Lost Market Share?

- Large CUs (>\$1B assets): -9.3 pp ($p < 0.01$)
 - Operate at national scale, set rates centrally
 - Compete directly with banks for conventional borrowers
- Small CUs (<\$1B assets): -3.5 pp ($p < 0.01$)
 - Serve defined membership groups
 - Compete on relationship banking, not price





Where Did CU Share Decline?

- Urban (MSA) counties: -8.4 pp ($p < 0.01$)
 - More lenders, more product standardization
 - Borrowers are more rate-sensitive
- Rural (non-MSA) counties: -3.0 pp ($p < 0.01$)
 - Thinner competition, relationship lending
 - CUs partially insulated from rate-based pressure
- **The competitive effect is strongest where mortgage lending is most commoditized and rate-sensitive**





Policy Implications

- What the tax exemption does:
 - Sustains a narrow (~3 bps) competitive advantage
 - Enables large CUs to compete head-on with banks
 - Does not appear to generate a visible rate discount for borrowers
- What the TCJA showed:
 - When the tax wedge narrows, CUs lose relative ground
 - But CU lending doesn't decline in absolute terms
 - The competitive effect is a reallocation, not a contraction
- For merger review:
 - CU weight should depend on institution size and market type





Conclusion

- The credit union tax exemption sustains a narrow but competitively meaningful pricing advantage
- This advantage is sensitive to changes in the corporate tax code
- The exemption appears to enable CU competition with banks rather than distorting the market in CUs' favor

