

# Summary of April 2007 GAO Report on Selected Issues Concerning Banking Activities

In September 2006, Congressman Bernie Sanders of Vermont requested that the Government Accountability Office conduct a study of “(1) selected federal expenditures, policies, and programs that affect the U.S. banking industry and (2) certain banking industry trends.”

In an April 30 letter<sup>1</sup> to now Senator Sanders, the GAO responded with information on:

1. the cost of resolving the savings and loan industry crisis
2. the extent of U.S. banks’ use of Export-Import Bank products
3. federal tax deductions, credits, and other provisions available to banks and thrifts and their use of transactions that the IRS has found to be abusive
4. trends in depository institutions’ profits and income, and
5. trends in executive compensation in the banking industry.

GAO documents a number of federal expenditures and tax breaks that benefit the banking industry. These are to be compared with \$1.4 billion annual value of the credit union tax exemption as estimated by the Treasury Department for 2007. (Footnote 38, page 20)

This document summarizes what GAO reported on each of these topics, provides some additional calculations based directly on GAO’s findings, and in a few cases provides additional data, analysis or interpretation on some of the subjects covered in the GAO report. In all cases, we identify the source of the information.

## **Cost of Resolving the Savings and Loan Industry Crisis.**

### **What GAO Reported.**

GAO reports that its 1996 estimate of \$160.1 billion for the costs of resolving the Federal Savings and Loan Insurance Corporation bailout is equivalent to \$198 billion in 2006 dollars. Of that, \$132.1 billion (\$163.4 billion in 2006 dollars) was

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<sup>1</sup>[http://www.cuna.org/download/gao\\_sanders\\_bank\\_report.pdf](http://www.cuna.org/download/gao_sanders_bank_report.pdf). Page number references in this summary pertain to the GAO letter at this link.

provided from taxpayer funding sources. Additional litigation costs since then have added to \$2.1 billion, for a total of \$165.5 billion of taxpayer expense in 2006 dollars. (Pages 9 – 11) In addition, in 1996 GAO estimated that interest costs associated with funding the debt incurred to cover the crisis will total \$320 billion, to be paid between 1989 and 2029. Of this interest expense, GAO estimates that \$285 billion will be born by the taxpayer. (Footnote 26, page 12)

### **CUNA's Calculations Based on What GAO Reported.**

CUNA estimates that in 2006 dollars, the taxpayer share of the interest expense amounts to approximately \$272 billion. We assumed that the \$285 billion would be paid evenly over forty years from 1989 to 2029, and discounted with an inflation rate of 2.5%.

Therefore, the total costs to the taxpayer of resolving the savings and loan crisis, in 2006 dollars, are:

- Resolution costs born by taxpayers: \$166 billion
- Interest costs born by taxpayers: \$272 billion
- Total FSLIC bailout costs born by taxpayers: \$438 billion

It is worth noting that this total taxpayer cost of the dealing with the savings and loan crisis in 2006 dollars is equivalent to 313 years of the 2007 value of Treasury's estimate of the federal tax exemption of credit unions.

### **Commercial Bank Use of the Export-Import Bank.**

#### **What GAO Reported.**

The Export-Import Bank (Ex-Im Bank) operates as an independent agency of the U.S. government to support financing of the export activities of U.S. companies. They do this by providing the following financing instruments: loan guarantees and direct loans for buyer financing, export credit insurance, and working capital guarantees for pre-export financing.

To the extent the Ex-Im Bank reduces the costs or risks of U.S. banking institutions, it is subsidizing their activities related to financing export activities, which has the public policy objective of creating and maintaining American jobs. The GAO reports that in fiscal year 2005, U.S. lenders accounted for about \$1.8 billion in loan guarantees, \$2.4 billion in export credit insurance, and \$1.1 billion in working capital guarantees, for a total notional level of activity of \$5.3 billion. However, GAO reports that the Ex-Im Bank is unable to determine how much of this activity is due to banking institutions compared to other U.S. lenders. (Pages 14 to 19)

## **Commercial Bank Use of Tax Deductions and Credits**

### **Specific Tax Breaks for Banks and other Lenders**

#### **What GAO Reported.**

GAO reports on only one tax provision that is exclusive to banks and thrifts: the deduction for excess bad debt reserves, which is available to institutions with less than \$500 million in assets. The estimated revenue loss from this deduction in 2007 is \$10 million. (Pages 20 – 21)

The GAO discusses some additional tax breaks that, although not exclusive to banks, are likely to disproportionately benefit banks as these tax provisions are tied to lending activities. Examples include when banks invest in certain specific activities such as some school improvements and economic development. GAO reports that Treasury estimates the 2007 tax revenue losses for all of these programs at \$2.3 billion. For many of these programs, information is not available on the level of activity by industry. However, in the case of one of these programs, the New Markets Tax Credit (NMTC, which accounts for 35.4% of the \$2.3 billion 2007 revenue loss), banks and other regulated financial institutions made up 38% of total NMTC claimants through 2006 and accounted for the majority of the investment funds. (Page 21)

#### **Additional Calculations Based on What GAO Reported.**

We provide a conservative estimate of the likely bank share of the \$2.3 billion in annual tax revenue loss due to special tax breaks for lending related activities described by GAO. Industry breakdowns are not available for the amount of activity in these tax-preferenced programs except for NMTCs. GAO reports that banks and other regulated financial institutions make up “the majority” of the NMTC investment funds. It seems that a very conservative assumption would be that banks account for between a quarter and a half of the volume of all of these lending activities. We would then estimate that the value of the tax breaks for banks from these programs would range from \$575 million to \$1.15 billion in 2007.

### **Subchapter S Status**

#### **What GAO Reported.**

Banks are significant users of Subchapter S status, which allows them to bypass corporate income taxes. Banks that elect Subchapter S status are not subject to federal income taxes at the corporate level. Instead, their shareholders are taxed at their individual tax rates on their share of the bank’s income. GAO presents an analysis showing that the net effect of electing Subchapter S status is to lower

the total amount of tax for a Sub S bank and its owners by almost 22% compared to what a Subchapter C bank and its owners would pay, or by 9.75% of taxable income. Their analysis assumes that all Subchapter S bank stockholders pay at the top marginal tax rate of 35%. To the extent some bank owners are in lower tax brackets, the revenue loss to the Treasury would be greater than 22% of the banks taxable income.

GAO reports that as of December 2006, 2,356 depository institutions, including 31% of banks, have elected Subchapter S status. The average size of Subchapter S banks is \$175 million, but a couple of S-corporation thrifts have over \$10 billion in assets. (Pages 24 – 26)

### **CUNA's Calculations Based on What GAO Reported.**

Based on FDIC information on the net income of the 2,356 Subchapter S banking institutions mentioned by GAO, and applying their analysis of the Treasury's revenue loss to that data yields an estimate of the 2006 value of the Subchapter S tax break for banking institutions at \$726 million.

The information and analysis reported by GAO allows us to estimate the total annual value of tax preferences enjoyed by the U.S. banking industry. Treasury's number for the value of the bad debt loss provision is \$10 million. We conservatively estimate the tax revenue loss due to special tax breaks for lenders at between \$575 million and \$1.15 billion. The Subchapter S effect amounts to \$726 million.

In total then, the current value of tax preferences for banking institutions is in the range of \$1.3 billion and \$1.9 billion per year.

### **Use of Abusive Tax Shelters by Banks**

#### **What GAO Reported.**

Alarmingly, the GAO further reports that "According to IRS officials, they have found a number of instances in which some banks have participated in tax shelters and transactions that they view as abusive." The GAO provides no estimate of the extent of these practices industry wide, but does report on one case in which a court granted the government's motion for a summary judgment, upholding IRS's disallowance of over \$9 million in deductions by a large bank. (Pages 26 – 27)

## **Recent Developments in Depository Institution Profits**

### **What GAO Reported.**

The GAO reports the following facts regarding profits, or net income, at depository institutions (Pages: 28 – 31)

- Over the past ten years, net income after inflation has increased more than twice as fast at banks and thrifts than at credit unions. The inflation-adjusted annual growth rate for net income was 7% at banks, 8% at thrifts, and 3% at credit unions.
- Measured as return on assets (net income divided by average assets) banks are generally more profitable than thrifts which in turn are more profitable than credit unions. In 2006, GAO reports that the return on assets was 1.27% at banks, 0.96% at thrifts, and 0.81% at credit unions.
- Non-interest income has risen in importance at all depository institutions over the past decade and a half. In 2006, non-interest income accounted for 43% of net operating revenues at banks, 34% at thrifts, and 31% at credit unions.

### **CUNA's Interpretation of What GAO Reported.**

Although the GAO does not opine on the meaning of the net income differences among the various types of depository institution, we offer the following interpretations:

- Banks are very, very profitable, with high and growing profits levels. This certainly puts the lie to the bankers' contention that the existence of credit unions is putting a damper on successful bank operations. If bankers are not content with the very strong profit performance of the past decade, one wonders if anything could satisfy them.
- The difference between bank and credit union profitability over the past decade is strong evidence of the real difference between for-profit banks and not-for-profit credit unions. After retaining sufficient earnings for safety and soundness purposes, credit unions eschew excess earnings by offering members lower loan rates and fees, and higher rates on deposits.

### **Additional Information Gathered by CUNA.**

Some have suggested that the overall strong profit performance of the banking industry masks the much weaker performance of smaller, community banks. FDIC data on banks by size show this is certainly not the case (see table below). Over the past five years, smaller banks have enjoyed only slightly lower profits than their larger bank brethren. The average return on assets over the period was 1.35% at large banks, 1.22% at smaller banks, and 0.93% at credit unions.

## Financial Institution Net Income

### As a percent of Average Assets

	<u>2002</u>	<u>2003</u>	<u>2004</u>	<u>2005</u>	<u>2006</u>
Large Banks (\$1 billion+)	1.35%	1.43%	1.31%	1.33%	1.35%
Community Banks (< \$1 Billion)	1.21%	1.20%	1.23%	1.26%	1.20%
Credit Unions	1.06%	0.98%	0.92%	0.85%	0.82%

Source: FDIC and NCUA data

### Executive Compensation in the Banking Industry

#### **What GAO Reported.**

GAO reports that “Publicly available information on executive compensation in the banking industry is limited.” They simply report that studies suggest that compensation for bank executives has increased, especially for CEOs. (Pages 32 – 34)

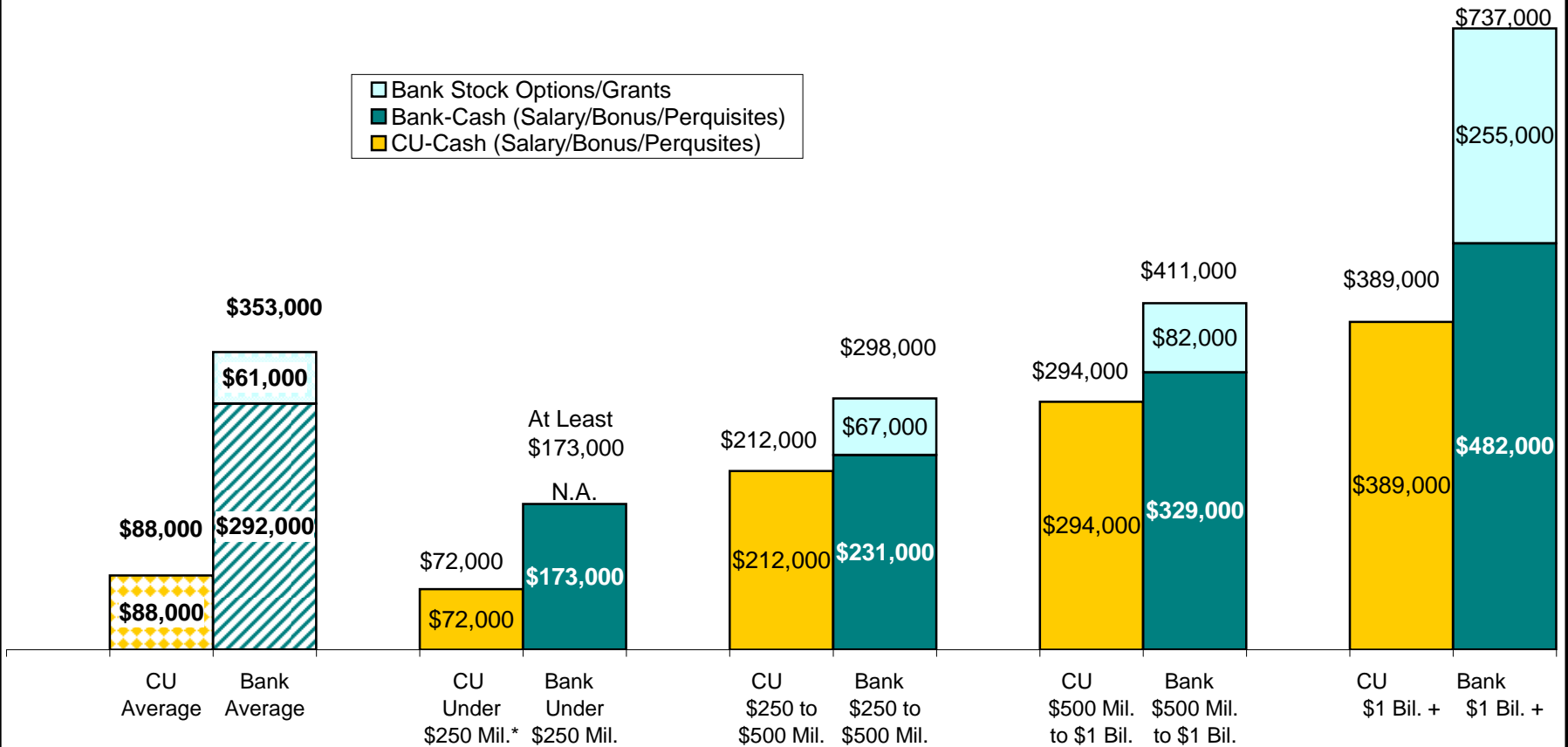
GAO further discusses legislative and regulatory limits on executive compensation at insured depository institutions for safety and soundness reasons. Both the Office of the Comptroller of the Currency and the Office of Thrift Supervision have issued formal orders or directives regarding executive compensation. FDIC has addressed compensation through both formal and informal actions. Neither the Federal Reserve nor the National Credit Union Administration has taken formal actions on executive compensation.

#### **Additional Data Compiled by CUNA.**

Although executive compensation data is not readily “publicly” available, there are a number of sources of private and public data on executive compensation. Based on these sources, we estimate that in 2006 average credit union CEO total compensation was \$88,000 and average bank CEO total compensation was \$353,000. The disparity is also evident even when considering like-sized institutions. For example, for institutions with less than \$250 million in assets, the credit union CEO average total compensation is \$72,000 compared to at least \$173,000 at banks. At the other end of the spectrum, at institutions with over \$1 billion in assets, the credit union CEO average compensation was \$389,000 compared to \$737,000 for bank CEOs. The attached chart provides more information and the sources of this data.

Prepared by Bill Hampel, Chief Economist  
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June 2007

## 2006 Average CEO Total Compensation At Credit Unions and Banks



**Bank data sources:** Cash compensation data is from the Delves Group's 2005 Bank Cash Compensation Survey and stock grant/option values from SEC form def 14a filings. Data for stock grant/option amounts is not available for banks with assets below \$250 million. Because CEOs of these smaller banks do indeed receive stock-based compensation, we are understating total compensation both for smaller banks, and for banks overall. Because credit unions are member-owned cooperatives without stock, credit union CEOs receive no stock grants or options.

**Credit union data sources:** CUNA's 2006-2007 CEO Total Compensation Survey and CUNA's 2006 Complete Credit Union Staff Salary Survey. \* Note: Credit union survey data is limited to credit unions with \$1 million or more in assets. At mid-year 2006, 874 credit unions (10% of all credit unions) reported \$1 million or less in assets. The credit union average "overall" and for institutions "under \$250 million" would be lower if CEO compensation at these institutions were included in the analysis.