

# GAO REPORT-07-27 CREDIT UNION MEMBERSHIP AND EXECUTIVE COMPENSATION

December 1, 2006

The Governmental Accountability Office has today released a report, "Credit Union Members and Executive Compensation" which it was requested to undertake by the House Ways and Means Committee following the hearing November 3, 2005 on credit unions tax exempt status. The report focused on: the effect of the Credit Union Membership Access Act on federal credit union membership; NCUA's efforts to expand credit union services to low- and moderate-income individuals; rates offered by credit unions compared with rates offered by banks, as one way to determine how credit unions' tax exemption is passed on to members; and the transparency of credit union board and executive compensation.

While the 65-page report contains important information about credit unions and NCUA, it contains some negative representations, relying in part on the Federal Reserve System's 2004 Survey of Consumer Finance; a data source that the GAO's report repeatedly acknowledges has limitations for the purposes of this study. CUNA will be responding accordingly and address any misleading information in the report. In the meantime, here is a summary which demonstrates the report is certainly not the anti-credit union document that bank trade groups were hoping for. (The summary addresses the recommendations first and then the other sections of the report in order of their appearance.)

## Recommendations

- The report contains two recommendations, both of which are for NCUA; there are no recommendations to Congress or to the IRS.
- The report recommends that NCUA systematically obtain information on the income levels of federal credit union members to allow NCUA to track and monitor the progress of credit unions in serving low and moderate income populations.
- To accomplish this, NCUA should expand its recently completed pilot to monitor member income data by credit union charter types, obtain information on the services lower income individuals use, and monitor progress over time.
- Regarding executive compensation, the report recommends that NCUA take action to ensure information on FCU executive compensation is available to credit union members and the public.

- To achieve this, GAO said NCUA may want to consider options such as requiring FCUs to include information on compensation in call reports or issue rules that would require information to be available at FCU annual meetings.

## **Results in Brief**

- NCUA has taken action to make credit union service available to individuals of modest means but information that directly measures the income levels of credit union members is limited.
- NCUA has established two initiatives to enhance the availability of services – its low income credit union program and allowing certain credit unions to include underserved areas.
- The most recent information from the Fed's Survey of Consumer Finances indicates that credit unions continue to lag behind banks in the percentage of their customers or members that are of lower income households.
- Because of the limitations of the survey, NCUA undertook a pilot to estimate the income level of credit unions members. That pilot, however, had limitations in sample size and NCUA was not able to make statistically valid conclusions in member income by specific charter type or about specific services provided to members of various incomes.
- GAO's analysis of 15 savings and loan products showed that credit unions seem to offer better rates than comparably-sized banks, particularly for consumer loans.
- However, GAO was not fully able to identify how the tax exemption benefits credit unions members.
- CUNA and groups representing state credit unions stated that the IRS has not provided sufficient guidance on what activities are subject to UBIT for state credit unions. The IRS is planning to issue technical advice on this. The practices of providing aggregate returns effectively makes it more difficult for IRS to scrutinize state chartered credit union operations to determine whether they are subject to UBIT, but compliance with the statute should improve after the IRS guidance is issued.
- Unlike most tax exempt organizations, federal credit unions are not required to provide IRS with Form 990s that provide information about executive compensation, among other things. NCUA holds that in most states the shareholders are entitled to inspect corporate minutes and other records but GAO said it is not clear credit unions or their members are aware of these rights.

- The report contains two recommendations to NCUA to track the performance of FCUs in providing service to those of modest means and improve the transparency of credit union executive compensation.
- NCUA was provided with a draft of the report and made comments to GAO on the draft. NCUA said it was inaccurate and inappropriate to measure the success of FCUs in serving those of modest means by reference only to low and moderate income categories associated with the Community Reinvestment Act. NCUA also said that GAO's income categories were inconsistent with definitions used by other regulators for CRA. NCUA further said that the Survey of Consumer Finance was not designed for income comparison between credit union members and bank consumers.
- GAO agrees that the survey was not designed to compare credit union member and bank customer income levels, but it was the best data currently available to undertake such a comparison.

### **NCUA Rules Interpreting CUMAA Appear to Have Fueled Expansion of Community Charter Credit Unions**

- Since the passage of CUMAA, NCUA has approved community charters with increasingly larger geographic fields of members, covering entire cities or multiple counties. Since 2000, community chartered credit unions have nearly tripled their membership and nearly quadrupled their assets. Most new community charter credit unions were multiple common bond credit unions.
- According to NCUA, community charters offer a greater opportunity than single or multiple common bonds to diversify membership, thereby contributing to the institution's economic viability and ability to serve all segments of the community, including those of modest means.
- Changes in NCUA's chartering policies have been triggered by factors such as the continued viability of federal credit unions in a changing economic environment and financial industry developments.

### **NCUA Programs Target Individuals of Low- and Moderate-Income, but Limited Data Preclude an Evaluation of Actual Service to Those Individuals**

- Summary of this section: NCUA has two programs specifically designed to make credit union services more available to persons of low- and moderate-income. First, the Low Income Credit Union (LICU) program assists credit unions with a low-income designation. Second, NCUA has made it easier for federal credit unions to expand their membership into underserved areas. Also, credit unions are increasingly participating in these programs, but the lack of data on income levels of credit union members has made evaluation of these programs difficult. The limited available data suggests that credit

unions lag behind banks in the proportion of members (customers for banks) that are of low- and moderate-income. NCUA's pilot data collection program will begin to provide information to assess the situation, but NCUA's sample is not wide enough to make statistically valid comparisons across charter types.

- Credit unions have a historical emphasis on serving people of “small” or “modest” means.
- Low-income designated credit unions (LICUs) receive certain opportunities that other credit unions do not, including: nonmember deposits, participating in NCUA's Community Development Revolving Loan Fund, access to secondary capital, and a waiver of the limit on member business loans. From 2000 to 2005, the number of LICU's rose from 632 to 1,032.
- From 2000 to 2005, the number of credit unions with NCUA approval to adopt underserved areas rose from 40 to 641, two thirds of which are multiple group credit unions. However, recent changes in NCUA policies in response to a lawsuit by the American Bankers Association may limit the growth of the underserved areas program.
- Despite these two programs, NCUA cannot specifically quantify the extent to which it has increased use of credit union services of individuals of modest means.
- GAO's analysis of the Federal Reserve's 2004 Survey of Consumer Finances (SCF) indicates that credit unions had a lower proportion of members who were of low-and moderate-income than banks had customers in those groups. These results are similar to previous GAO findings from the 2001 Fed Survey.
- GAO used the following definitions: low-income, household income below 50% of national median household income; moderate-income, household income between 50% and 80% of median; middle-income, household income between 80% and 120% of median; and upper-income, household income over 120% of median. GAO estimated that credit union member households are distributed across these four groups as follows: 14% low-income, 17% moderate-income, 20% middle-income, and 49% upper-income. For banks customers, the distribution was: 24%, 16%, 18%, and 41%.
- Lacking a definition of “modest means,” GAO combined the categories of low- and moderate- income “as a proxy for modest means.” They therefore report that 31% of credit union members were of modest means compared with 41% of bank customers.
- Comparing 2001 to 2004 SCF data GAO found an increase in credit union members in the upper-income group and a decline in the low-income group.

Further, the relatively high percentage of credit union members in the moderate- and middle-income categories (37 percent) may reflect that credit union membership is traditionally based on occupational- or employer-based fields of membership.

- NCUA discussed with GAO a number of reasons why the effect of expansions into underserved areas had not yet shown up in the data: most of the expansions are recent, credit unions face a learning curve in serving this market, and many conversions to community charter have been less than five years ago. It was also noted that the SFC data is already two years old.
- As noted in the GAO's 2003 report, limitations in SCF data preclude its use in drawing definitive conclusions about the income characteristics of credit union members. Also, as NCUA and others have noted, credit union members were likely to have higher incomes because credit unions are occupationally based.
- NCUA has conducted a pilot survey to measure income levels of credit union members. The survey involved a sample of 481 federal credit unions, and used data on the addresses of credit union members to estimate member income by means of geo-coding. NCUA also gathered information from credit unions on the type of services they offer members, including services that may be of value to members with lower incomes.
- The National Association of State Credit Union Supervisors, in response to a March 2006 congressional request, has also initiated a data collection effort on state credit unions. In addition to the data being collect by NCUA, the NASCUS effort will gather information on CUSOs and unrelated business income taxes (UBIT).
- The results of neither the NCUA nor NASCUS reports were available at the time of the GAO report.

**Credit Unions Offered Better Rates on Some Products, but the Extent to which the Benefits of Tax-Exempt Status have been Passed to Members Is Unclear**

- GAO's analysis showed that credit unions tended to offer better interest rates than similar sized banks for a variety of products and loans, particularly for consumer loans, but rate data alone cannot be used to determine the extent to which the benefits of tax exemption have been passed on to members.
- The differences among savings rates of comparable sized credit unions and banks tended to get larger as the size of the institutions increased.

- More recently, the gap in rates between larger credit unions and banks closed considerably; in the greater than \$1 billion asset range, the gap was more than 1% in 2001 but about one-half of 1% in 2004. GAO observed similar trends throughout the period on other savings products such as money market accounts and certificates of deposit.
- There may be other reasons for differences in rates besides tax differences. Also, the tax exemption may benefit members in other ways than through loan and deposit rates. Credit unions may charge lower fees than they otherwise would.
- GAO did not identify any comprehensive studies or data sources that addressed differences in fees charged by credit unions and banks on a national basis. Unlike banks, credit unions may, as a result of tax exemption, retain more income to add to reserves or to finance additional services than they would if they were taxed.

**Lack of Guidance and Criteria for Applying UBIT to State Credit Union Activities Makes Determining Compliance with the Requirement Difficult**

- Summary of this section: state chartered CUs are subject to tax on unrelated business income while federal credit unions are specifically exempt. IRS has several ongoing exams of state CUs to determine which of their activities are subject to UBIT. CU trade groups have stated the need for guidance regarding the activities that IRS has determined to be subject to UBIT; IRS has stated that it plans to issue technical advice in 2007 after completing its reviews. The practice of allowing groups to make statewide filings has made it more difficult for IRS to scrutinize the activities of individual institutions. IRS officials asserted that the agency plans to issue technical advice on the application of UBIT to state CU activities, which they said should improve credit union compliance.
- As credit unions have increased the types of products and services that they offer, certain products have resulted in IRS examining whether state credit unions are using their tax-exempt status to conduct business unrelated to their exempt purposes.
- The IRS has been reviewing: the sale of credit life insurance and credit disability insurance; the sale of guaranteed auto protection insurance; the sale of auto warranties; the sale of cancer insurance; the sale of accidental health and dismemberment insurance; ATM fees charged to nonmembers; the sale of health or dental insurance; the market of mutual funds to members; and the marketing of other insurance and financial products.
- The IRS had 50 ongoing exams of state CUs for UBIT purposes as of September 2006.

- Determining the applicability of UBIT to state CUs is a complicated proposition. Neither the IR Code nor IRS rules enumerate the functions of a credit union exempt from 501(c)(14), the section of the code that exempts state credit unions. The exemption is based on structural features, such as mutuality and nonprofit operations, whether it is organized under state law and whether its members share a common bond.
- CUNA and others have stated that IRS has not provided sufficient guidance on which activities are subject to UBIT. According to IRS officials, the agency is planning to issue specific information in the form of Technical Advice Memoranda as a result of its examination of state credit union UBIT activities in the first quarter of 2007. IRS believes the memoranda will more clearly articulate specific activities of state CUs that can be subject to the tax and improve compliance.
- Not-for-profit entities that generate more than \$1,000 in UBIT are required to disclose on Form 990 that they have generated such income and that they have filed an Exempt Organization Business Income Tax Return (Form 990-T) with IRS declaring the income and related UBIT liability.
- An IRS ruling allows some state CUs to file Form 990 on a group wide basis. According to the IRS, the group ruling applies to 34 states and group returns in about 21 of those states have been filed in recent years. Of the 21 states, only 1 has asserted on the Form 990 that UBIT was generated in that state.
- IRS said it would positively be able to verify if an individual credit union declaring unrelated business income in excess of \$1,000 on its Form 990 also filed a Form 990-T.
- However, the IRS does not have a process in place to review group returns to ensure that the credit unions filed the Form 990-T. Thus, IRS cannot systematically determine if credit unions that were included in group returns and generated UBIT properly filed a Form 990-T.
- IRS said that requiring all state credit unions to file an individual Form 990 could enhance the agency's ability to scrutinize the activities of individual credit unions but that it is not clear that the benefits to the IRS and to credit unions would exceed the costs. Credit unions would need to file for recognition of a tax-exempt organization and incur annual costs to prepare and file individual Form 990. IRS said that the TAM the agency plans to issue in early 2007 would improve CU compliance with UBIT filing requirements.

## **Alternatives Exist To Improve the Transparency of Credit Union Executive and Director Compensation**

- Summary of this section: Federal credit union executive compensation is not transparent. FCUs are not required to file reports, including IRS Form 990 required for most other tax-exempt organizations that would provide information on executive and director compensation. NCUA legal opinions have stated that member access to CU records is generally a matter of state law but that federal CU members have inspection rights similar to those enjoyed by a shared holder in a corporation. GAO could not determine to what extent credit union and credit union members were aware of this information. GAO identified a number of credit union and bank executive compensation surveys, but data and methodological limitations precluded GAO from making direct comparisons of executive compensation. NCUA has collected executive compensation information for federal credit unions as part of its efforts to assess who credit unions serve.
- The issue of transparency and disclosure of executive compensation has become an important topic. Credit union members bear some similarity to public company shareholders in that they are owners and vote for board of directors who are entrusted to oversee executive compensation.
- The importance of disclosure of executive and director compensation was illustrated in recent changes adopted by SEC in July 2006 to increase transparency and disclosure by public companies and reflect the increasing focus on corporate governance.
- In contrast, credit union executive compensation is not transparent as credit unions are not required to file publicly available reports such as the IRS Form 990 that provides executive compensation data. Some members of the public rely on Form 990 as the primary or sole source of information about an organization and most tax-exempt organizations with gross receipts normally more than \$25,000 are required to file the Form 990 annually. IRS also uses these forms to select organizations for exams.
- In 1988, the IRS determined that federal CUs are not required to annually file Form 990 because of their status as tax exemption instrumentalities under 501(c) of the IR Code.
- Boards of directors of credit unions receive limited compensation because directors serve in nonpaid positions. Credit union board members may be reimbursed for mileage; insurance; and travel expense. In contrast, bank directors may receive fees such as an annual retainer for serving on the board, profit sharing, professional fees and other bonuses. About half of the banks that responded to a survey on this issue indicated their fees were based strictly on attendance.

- According to NCUA, executive compensation is assessed during the credit union's examination. Examiners review compensation in instances of safety or soundness concerns such as compensation arrangements that significantly exceeded compensation paid to persons with similar responsibilities in credit unions of similar size and in similar locations. NCUA also stated that since it has not found a system wide abuse, it has not considered it necessary to collect data on executive compensation.
- NCUA's guidance on compensation is consistent with other financial regulators.
- NCUA legal opinions state that member access to credit union records is a matter of state law and that members have inspection rights similar to those of corporate shareholders.
- However, it is unclear to what extent federal credit union members are aware of a member's right to inspect records.
- GAO could not identify any surveys or studies that directly compared credit union executive compensation with compensation by similarly sized banks. A few credit union and bank trade group surveys do address this issue for their industry.
- The survey information was not useful as it did not provide detailed information and was self-reported.
- NCUA has collected CU compensation data on CEOs, CFOs and COOs from Form 1099 and Form W-2, which enables NCUA to project industry averages.
- The NCUA effort provides a snapshot of compensation for a single year, 2005, and it is unclear whether NCUA will conduct future reviews of this issue.
- NCUA said it was considering amending the call reports to include compensation and benefit data for senior executive officers.

## **Conclusions**

- Since the passage of CUMAA and subsequent changes to NCUA rules that permitted credit unions to serve large areas and enlarged fields of membership, community chartered credit unions have grown in number and size. As a result, the common bonds of occupation or employment that traditionally existed between credit union members have been attenuated, blurring one of the historical distinctions between credit unions and other depository institutions.

- But credit unions do retain distinctions in terms of structure and governance, and they retain their tax-exempt status.
- One perceived rationale for the CU tax exemption expressed by Congress is the notion that credit unions serve individuals of small means. Yet it is difficult to determine to what extent credit unions actually serve such individuals.
- NCUA has established programs to expand service to this group, but their newness, combined with the absence of long-term systematic collection of data on the income of credit union members, currently precludes an assessment of their effectiveness and overall industry performance.
- However, limited data from the Fed's SCF suggest that both in 2001 and 2004, credit unions had a smaller portion of low and moderate income customers than banks.
- NCUA officials noted that it may be too soon for data to fully reflect NCUA initiatives and activities and that growth in community CUs will allow credit unions to draw members from more diverse populations.
- NCUA has taken steps to identify the income levels of credit union members but several limitations on NCUA's efforts will make it difficult to fully assess to the extent to which credit unions have been serving low and moderate income populations.
- The data will not stratify information by charter types or identify specific services that members have been using.
- Obtaining more detailed information on income and service would help NCUA track the performance of credit unions and help monitor progress over time.
- This information would provide Congress and the public with clear evidence that as CUMAA notes, credit unions are accomplishing their specified mission of meeting the credit and savings needs of consumers, especially those of modest means.
- While laudable, NCUA's efforts are currently confined to a pilot project. The value and utility of the information collected would be greatly enhanced if NCUA were to move beyond a pilot and continue the data collection effort.
- State CUs have increased the amount of UBIT paid to the IRS but determining which credit union activities are subject to UBIT is difficult. IRS's guidance in 2007 will help compliance.
- The transparency of executive compensation is an important issue. Credit union executive compensation is not transparent due to the lack of

information available to the public. Increased public opportunity to review executive salary information would promote greater accountability.

- NCUA could require all federally insured credit unions to include compensation and benefit data for senior executive officers on call reports. Or, NCUA could require FCUs to disclose or make available credit union records, such as senior executive salary information, to members during annual meetings.

### **NCUA's Response**

(Consistent with GAO practice, NCUA was permitted to comment in writing on GAO's draft. The final GAO report addresses NCUA's comments, as well as GAO's observations on NCUA's comments.)

- NCUA said GAO's recommendations are consistent with those of NCUA in its own report on its pilot study on federal credit union member income levels and officials' compensation.
- However, NCUA expressed concerns with important aspects of the report. Any meaningful comparison between credit unions and other financial institutions should include an in-depth assessment of their differences, NCUA said. NCUA said the substantive differences are who credit unions may serve and how they operate and provide services.
- GAO said it agrees that there are important structural and governance differences between credit unions and other depository institutions. GAO added, though, that statistically reliable data on credit union members by charter type and field of membership were not available at the time of its review. GAO said it was encouraged by NCUA's pilot to obtain information on federal credit union members' income levels and that the value of this effort would be greatly enhanced if NCUA were to continue. Specifically, NCUA should provide benchmark data; obtain data on the extent services are being used by members' income category; expand the data collection to allow results to be projectable by charter type; and conduct the study on a periodic basis.
- NCUA said it was inaccurate and inappropriate to measure the success of federal credit union in serving persons of modest means referencing only the low-and moderate income categories associated with the Community Reinvestment Act. NCUA said there was legal and historical evidence that the term "modest means" is intended to include a broader range of individuals. GAO said that because neither Congress nor NCUA has defined "modest means" GAO used the group consisting of low-and moderate income households as a proxy for persons of modest means for purposes of its report.

This approach allowed GAO to use the definitions established for CRA and included in the 2001 and 2004 Fed SCFs.

- NCUA pointed out that GAO's income category benchmarks were inconsistent with specific definitions of CRA. GAO responded that because the most comprehensive data available is the Fed's SCF, GAO used national median income measures for its income categories whereas the categories for CRA are based on more local measures.
- NCUA raised concerns about the reliability of conclusions reached using the Fed's SCF as it was not designed for reliable income comparisons between credit unions members. GAO agreed that the SCF was not designed for that purpose but that it provides the best data currently available to undertake such a comparison. GAO said its report notes the limitations in SCF data that preclude drawing definition conclusions about the income characteristics of credit unions members.