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Testimony

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# FINANCIAL INSTITUTIONS

## Issues Regarding the Tax- Exempt Status of Credit Unions

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Financial Markets and Community Investments





Highlights of [GAO-06-220T](#), testimony before the Committee on Ways and Means, House of Representatives

## Why GAO Did This Study

Unlike other depository institutions, credit unions are exempt from federal corporate income taxes. Recent legislative and regulatory changes to credit union membership restrictions and allowable products and services have blurred some of the historical distinctions between credit unions and other depository institutions. As a result, some observers have raised questions about whether tax exemption provides credit unions with an advantage over other depository institutions and whether the original basis for tax exemption is still valid.

As part of its continuing oversight of the tax-exempt sector, the House Committee on Ways and Means asked GAO to address (1) the historical basis for the tax-exempt status of credit unions; (2) the arguments for and against taxation, including estimates of potential revenue from eliminating the exemption; (3) the extent to which credit unions offer services distinct from those offered by banks of comparable size, and serve low- and moderate-income individuals; and (4) the extent to which credit unions are required to report information on executive compensation and assessments of their internal controls.

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# FINANCIAL INSTITUTIONS

## Issues Regarding the Tax-Exempt Status of Credit Unions

### What GAO Found

Congress originally granted tax-exempt status to credit unions in 1937 because of their similarity to other mutually owned financial institutions that were tax-exempt at that time. While the other institutions lost their exemption in the Revenue Act of 1951, credit unions specifically remained exempted. The act's legislative history is silent regarding why the tax-exempt status of credit unions was not revoked. More recently, the Credit Union Membership Access Act of 1998 indicates that credit unions continue to be exempt because of their cooperative, not-for-profit structure, which is distinct from other depository institutions, and because credit unions historically have emphasized serving people of modest means.

Arguments for taxing credit unions center on creating a "level playing field" since credit unions now compete more directly with banks. Proponents also point to associated potential revenues, with federal estimates ranging from \$1.2 billion to \$1.6 billion per year. Opponents of taxation argue that credit unions remain distinct—organizationally and operationally—from other financial institutions and taxation would impair their capital levels.

Prior GAO work has found that relatively large credit unions offer many of the same services that same-sized banks offer, while smaller credit unions tend to provide more basic financial services. Limited comprehensive data exist on the income of credit union members. GAO's assessment of Federal Reserve data suggested that credit unions served a slightly lower proportion of low- and moderate-income households than banks, but the lack of comprehensive data prevents definitive conclusions.

Most credit unions are not subject to reporting requirements that provide information on executive compensation or internal controls. Specifically, federal credit unions are not required to file the Internal Revenue Service form that most other tax-exempt entities must file and some states allow credit unions to file on a group basis. Further, credit unions are not subject to internal control reporting requirements applicable to banks and thrifts, an item we identified for Congressional action in 2003.

**Credit Union Industry Size and Assets Distribution, as of December 31, 2004**

Credit union assets	Number of credit unions	Percentage of total assets
\$10 million or less	4,255	2.5
>\$10 million to \$100 million	3,604	18.8
>\$100 million to \$250 million	644	15.8
>\$250 million to \$500 million	266	14.5
>\$500 million to \$1 billion	147	15.5
>\$1 billion	98	32.9

Source: GAO analysis of NCUA Form 5300 data.

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Mr. Chairman Thomas and Members of the Committee:

I am pleased to be here today to discuss issues regarding the tax-exempt status of credit unions. Credit unions are the only type of financial institution currently exempt from federal income taxes.<sup>1</sup> As we have noted in a prior testimony before this Committee, the size of the tax-exempt sector has grown in recent years in both the number and assets of institutions.<sup>2</sup> Today's hearing on issues related to the credit union tax-exempt sector is timely in light of current and projected fiscal imbalances and renewed emphasis on accountability and governance in both the corporate and nonprofit sectors. A comprehensive examination could help determine whether exempt entities such as credit unions are providing services that are commensurate with their favored tax status, and whether an adequate framework exists for ensuring that these entities are meeting the requirements for tax-exempt status. The information that I am providing today is based primarily on prior work completed on the credit union industry and on ongoing work underway for this Committee.<sup>3</sup>

Based on your request, I will discuss:

- the historical basis for the tax-exempt status of credit unions;
- arguments for and against the taxation of credit unions, including estimates of the potential tax revenues from eliminating the tax-exempt status of credit unions;

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<sup>1</sup>Qualified financial institutions can elect to avoid federal corporate income tax as Subchapter S corporations (S-corporations). S-corporation tax status mainly allows small, closely held corporations meeting certain requirements to elect to eliminate corporate-level taxation. S-corporation shareholders are taxed on their portion of the corporation's taxable income, regardless of whether they receive a cash distribution. For more information on S-corporations, see GAO, *Banking Taxation: Implications of Proposed Revisions Governing S-Corporations on Community Banks*, [GAO/GGD-00-159](#) (Washington, D.C.: Jun. 23, 2000).

<sup>2</sup>GAO, *Tax-Exempt Sector: Governance, Transparency, and Oversight Are Critical for Maintaining Public Trust*, [GAO-05-561T](#) (Washington, D.C.: Apr. 20, 2005), and GAO, *Nonprofit, For-Profit, and Government Hospitals: Uncompensated Care and Other Community Benefits*, [GAO-05-743T](#) (Washington, D.C.: May 26, 2005).

<sup>3</sup>GAO, *Credit Unions: Financial Condition Has Improved, but Opportunities Exist to Enhance Oversight and Share Insurance Management*, [GAO-04-91](#) (Washington, D.C.: Oct. 27, 2003) and GAO, *Credit Unions: Reforms for Ensuring Future Soundness*, [GAO/GGD-91-85](#) (Washington, D.C.: Jul. 10, 1991).

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- the extent to which credit unions offer services that are distinct from those offered by banks of comparable size;
  - the extent to which credit unions are serving low- and moderate-income individuals, including relevant programs of the National Credit Union Administration (NCUA) that target these individuals; and
  - the extent to which credit unions are required to report or make public certain information such as executive compensation and assessments of their internal controls for financial reporting.

In summary, we found that:

- The basis for continuing tax exemptions for credit unions, although not often articulated in legislation over the years, appears to be related to the perceived distinctness of credit unions and their service to people of modest means. Congress originally granted tax-exempt status to credit unions in 1937 because of their similarity to other mutually owned financial institutions that were tax exempt at that time. While the other institutions lost their exemption in the Revenue Act of 1951, credit unions specifically retained the exemption. The legislative history on the 1951 act did not articulate a rationale for the continued exemption of credit unions. However, more recent legislation (the Credit Union Membership Access Act of 1998 or CUMAA) states that credit unions are exempt from taxes because “they are member-owned, democratically operated, not-for-profit organizations generally managed by volunteer boards of directors, and because they have the specified mission of meeting the credit and savings needs of consumers, especially persons of modest means.”<sup>4</sup>
- Recently, arguments for taxing credit unions have centered on creating a “level playing field” among financial institutions in terms of taxation, referencing the notable recent growth of the credit union industry to support the idea that credit unions compete more and more directly with banks. Proponents of taxing credit unions also point to the potential revenue associated with repealing the tax exemption. There is also some debate regarding the extent to which credit unions are serving people of modest means, especially in comparison with small banks. In response,

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<sup>4</sup>See Public Law 105-219 (Aug. 7, 1998), 112 STAT. 914. The Federal Credit Union Act of June 26, 1934 refers to “make more available to people of small means credit for provident purposes.” While these statutes have used “small means” and “modest means” to describe the type of people who credit unions might serve, these terms are not defined in the statutes.

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opponents of taxation have argued that credit unions remain distinct—both organizationally and operationally—from other financial institutions, and that taxation would jeopardize the safety and soundness of credit unions by adversely impacting their net worth or capital levels, which are restricted to retained earnings. Opponents also note that other depository institutions do have opportunities for tax relief as S-corporations. Federal estimates of the potential tax revenues fall within a somewhat narrow range—\$1.2 billion to \$1.6 billion annually—while nongovernmental sources have produced higher estimates of up to \$3.1 billion annually.

- As the credit union industry has evolved, the historical distinction between credit unions and other depository institutions has continued to blur. The number of credit unions declined between 1992 and 2004, although the total assets of the industry have grown. As of 2004, credit unions with more than \$100 million in assets represented about 13 percent of all credit unions and 79 percent of total assets. The consolidation in numbers and concentration of assets has resulted in two distinct groups of credit unions: a few relatively large institutions providing a wide range of services that resemble those offered by banks of the same size, and a number of smaller credit unions that provide basic financial services. For example, the loan portfolios of larger credit unions tend to hold more mortgage and real estate loans, resembling those of similarly sized banks. Smaller credit unions tend to carry smaller loans such as car loans. Additionally, larger credit unions tend to offer a range of products and services similar to those offered by banks.
- As credit unions have become larger and begun offering a wider variety of services, the issue of whether these institutions are serving households with low and moderate incomes has become a matter for debate. Yet, limited comprehensive data are available on the income of credit union members. In prior work on the credit union industry, our assessment of available data—the Federal Reserve’s 2001 Survey of Consumer Finances and other studies—suggested that credit unions served a slightly lower proportion of households with low and moderate incomes than banks.<sup>5</sup> To NCUA’s credit, it has established programs that are intended for low-income individuals and underserved areas. However, NCUA does not collect comprehensive data such as the overall income of individuals benefiting from these programs to allow definitive conclusions about the membership served.

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<sup>5</sup>[GAO-04-91](#).

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- Most credit unions are not specifically subject to reporting requirements that would disclose information on executive compensation or assessments of internal controls for financial reporting—information that can enhance public confidence in tax-exempt entities. Publicly available financial reports reflect, and support, strong governance and transparency—essential elements in assuring that tax-exempt entities operate with integrity and effectiveness and maintain public trust. For example, public disclosure of revenue and expenses, such as the compensation of officers and directors, enhances transparency. However, most credit unions do not individually file the Internal Revenue Service (IRS) form that would provide such information—Form 990, Return of Organization Exempt from Income Tax—because of exclusions and group filings.<sup>6</sup> Further, as we noted in a 2003 report, credit unions with assets over \$500 million are not subject to internal control reporting requirements applicable to banks and thrifts under the Federal Deposit Insurance Corporation Improvement Act (FDICIA), which are similar to the reporting requirements of public companies affected by the Sarbanes-Oxley Act of 2002.<sup>7</sup> As we suggested in 2003, making credit unions of \$500 million or more subject to the FDICIA internal control reporting requirements would provide a commensurate tool to NCUA and appropriate state regulators to ensure that credit unions establish and maintain internal control structure and procedures for financial reporting purposes.

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## Background

Credit unions have historically occupied a unique niche among financial institutions. Credit unions differ from other depository institutions because they are (1) not-for-profit entities that build capital by retaining earnings (they do not issue capital stock), (2) member-owned cooperatives run by boards elected by the membership, and (3) tax-exempt. Like banks and thrifts, credit unions have either federal or state charters. Federal charters have been available since 1934, when the Federal Credit Union Act was passed. States have their own chartering requirements. As of December 2004, the federal government chartered about 62 percent of the slightly more than 9,000 credit unions and states chartered the remainder. Both federally and state-chartered credit unions are exempt from federal income taxes, with federally chartered and most

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<sup>6</sup>Most tax exempt entities annually must file a Form 990 with the IRS. Form 990 is publicly available and contains various revenue and expense information, including compensation data for officers, directors, trustees, and key employees.

<sup>7</sup>[GAO-04-91](#).

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state-chartered credit unions also exempt from state income and franchise taxes.

Another distinguishing feature of credit unions is that they may serve only an identifiable group of people with a common bond. More specifically, credit union membership may be based on one of three types of common bond: single, multiple, or community. For example, a group of people that share a single characteristic, such as a common profession, could constitute the “field of membership” for a single-bond credit union. Field of membership is used to describe all the individuals and groups, including organizations, which a credit union is permitted to accept for membership.<sup>8</sup> More than one group having a common bond could constitute the membership of a multiple-bond credit union. And, persons or organizations within a well-defined community, neighborhood, or rural district could form a community-bond credit union. Further, credit unions can offer members additional services made available by third-party vendors and by certain profit-making entities with which they are associated, referred to as credit union service organizations (CUSO).<sup>9</sup>

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## Rationale for the Historical Tax Exemption of Credit Unions

The tax-exempt status of credit unions originally was predicated on the similarity of credit unions and mutual financial institutions; however, while Congress did not always cite its reasons for continuing this exemption, recent legislation mentions the cooperative structure and service to persons of modest means as reasons for reaffirming their exempt status.<sup>10</sup> The Revenue Act of 1913 exempted domestic building and loan associations (now called “savings and loans”), and mutual savings

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<sup>8</sup>See [GAO/GGD-91-85](#) for additional background on the history of NCUA and state field of membership regulatory policies.

<sup>9</sup>A CUSO is a corporation, limited liability corporation, or limited partnership that provides services such as insurance, securities, or real estate brokerage, primarily to credit unions or members of affiliated credit unions. Credit unions can invest up to 1 percent of their capital in CUSOs. CUSOs must maintain a separate identity from the credit union. See 12 C.F.R. Part 712 (2003).

<sup>10</sup>Internal Revenue Code section 501(c) describes 28 categories of organizations that are exempt from federal income tax. State credit unions are exempt in a category by themselves under section 501(c)(14)(A). Federal credit unions are exempt under section 501(c)(1). Section 501(c)(1) exempts certain corporations that have been organized under an act of Congress, designated as instrumentalities of the United States, and that are exempt from tax by the Internal Revenue Code or by certain congressional acts.

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banks not having a capital stock represented by shares, from federal income tax.<sup>11</sup> Further, the Revenue Act of 1916 exempted from taxation cooperative banks without capital stock organized and operated for mutual purposes and without profit.<sup>12</sup> However, credit unions were not specifically exempted in either of these acts. Their tax-exempt status was addressed directly for the first time in 1917, when the U.S. Attorney General determined that credit unions closely resembled cooperative (mutual savings) banks and similar institutions that Congress had expressly exempted from taxation in 1913 and 1916.

The Federal Credit Union Act of 1934 authorized the chartering of federal credit unions. The stated purpose of the act was to “establish a further market for securities of the United States and to make more available to people of small means credit for provident purposes through a national system of cooperative credit, thereby helping to stabilize the credit structure of the United States.” The 1934 act did not specifically exempt federal credit unions from taxation. In 1937, the act was amended to exempt federal credit unions from federal tax and limit state taxation to taxes on real and tangible personal property.<sup>13</sup> Two reasons were given for the exemption: (1) that credit unions are mutual or cooperative organizations operated entirely by and for their members; and (2) that taxing credit unions on their shares, much as banks are taxed on their capital shares, places a disproportionate and excessive burden on the credit unions because credit union shares function as deposits.<sup>14</sup>

The Revenue Act of 1951 amended section 101(4) of the 1939 Internal Revenue Code to repeal the tax-exempt status for cooperative banks, savings and loan societies, and mutual savings banks, but it specifically provided for the tax exemption of state-chartered credit unions.<sup>15</sup> While the act’s legislative history contains extensive discussion of the reasons why the tax-exempt status of the other mutual institutions was revoked, it is silent regarding why the tax exempt status of credit unions was not also revoked.

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<sup>11</sup>Public Law 63-16.

<sup>12</sup>Public Law 64-271.

<sup>13</sup>Public Law 416.

<sup>14</sup>H.R. Rep. No. 75-1579, at 2 (1937).

<sup>15</sup>Public Law 80-183.

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The Senate report accompanying the Revenue Act of 1951 stated that the exemption of mutual savings banks was repealed in order to establish parity between competing financial institutions.<sup>16</sup> According to the Senate report, tax-exempt status gave mutual savings banks the advantage of being able to finance growth out of untaxed retained earnings, while competing corporations (commercial banks) paid tax on income retained by the corporation. The report stated that the exempt status of savings and loans was repealed on the same grounds. Moreover, it stated that savings and loan associations were no longer self-contained mutual organizations, for which membership implied significant investments over time, risk of loss, heavy penalties for cancellation of membership or early withdrawal of shares, and in which members invested in anticipation of becoming borrowers at some time. Instead, investing members were simply becoming depositors who received relatively fixed rates of return on deposits that were protected by large surplus accounts, and borrowing members dealt with savings and loans in the same way as other mortgage lending institutions.<sup>17</sup>

More recently (in 1998), CUMAA amended the Federal Credit Union Act to, among other things, allow multiple-bond federal credit unions under certain circumstances (such as a general limitation on the size of each member group to 3,000 members).<sup>18</sup> In addition, CUMAA reaffirmed the federal tax exemption of credit unions, despite contentions that allowing multiple-bond credit unions would permit credit unions to become more like banks. Specifically, the findings section of CUMAA stated:

Credit unions, unlike many other participants in the financial services market, are exempt from Federal and most State taxes because they are member-owned, democratically operated, not-for-profit organizations generally managed by volunteer boards of directors and because they have the specified mission of meeting the credit and savings needs of consumers, especially persons of modest means.

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<sup>16</sup>S. Rep. No. 82-781 (1951).

<sup>17</sup>While both banks and thrifts were subject to federal corporate income tax after 1951, some special provisions served to reduce their tax liability relative to corporations in other industries. Over time, Congress scaled back many of these provisions, including special deductions for additions to bad debt reserves.

<sup>18</sup>Public Law No. 105-219.

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## Arguments for and against Taxation of Credit Unions

At various times, the executive branch has proposed taxing credit unions, generally endorsing the creation of a “level playing field” among financial institutions in which organizations engaged in similar activities would be taxed similarly. Proponents of taxation contend that larger credit unions compete with banks in terms of the services they provide. Proponents also have questioned the extent that credit unions have remained true to their historical mission of providing financial services to persons of modest means. In response, opponents of the taxation of credit unions have argued that credit unions remain distinct organizationally and operationally from other financial institutions, providing their membership with services they would not receive from other institutions. Opponents also have argued that taxation would hinder the ability of credit unions to build capital (which is restricted to retained earnings), jeopardizing their safety and soundness. Finally, opponents have argued that other depository institutions, particularly smaller banks, also have opportunities for tax and regulatory relief such as S-corporation status.<sup>19</sup> Some studies have attempted to quantify potential tax revenue from repealing the tax exemption, with estimates ranging from \$1.2 billion to \$3.1 billion, depending on the fiscal year considered, tax rates used, and other underlying assumptions.

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## Arguments for Taxation

Unlike income retained by most other financial institutions, income retained by credit unions is not taxed until it is distributed to members. Thus, tax exemption allows credit unions to utilize untaxed retained earnings to finance expansion of services. Proponents of taxing credit unions claim that this ability to use untaxed retained earnings provides credit unions with a competitive advantage over banks and thrifts. In 1978, the Carter administration proposed that the tax-exempt status of credit unions be gradually eliminated to mitigate this advantage and establish parity between credit unions and thrift institutions. The administration also argued that the relaxation of rules regarding field of membership criteria, the expansion of credit union powers, and the rising median income of credit union members indicated that credit unions were no longer true mutual institutions serving low-income workers excluded from banking services elsewhere.

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<sup>19</sup>See GAO, *Banking Taxation: Implications of Proposed Revisions Governing S-Corporations on Community Banks*, [GAO-00-159](#) (Washington, D.C.: June 2000).

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In 1984, the Department of the Treasury (Treasury) report to the President included a proposal to repeal the tax exemption of credit unions, which also argued that the exemption gave credit unions a competitive advantage over other financial institutions and its repeal would “eliminate the incentive for credit unions to retain, rather than distribute, current earnings.” In 1985, the Reagan administration proposed taxing credit unions with more than \$5 million in gross assets, but would have maintained the exemption on credit unions with less than \$5 million of gross assets, since it was reasoned that taxing small credit unions would significantly increase the administrative burden for a relatively small revenue increase.<sup>20</sup> Similarly, in the budget for fiscal year 1993 the first Bush administration proposed taxing credit unions with assets of more than \$50 million.

More recent arguments for the taxation of credit unions note the strong growth rates among large credit unions, which tend to offer a wider array of services. As a result, taxation proponents argue that larger credit unions compete with banks in terms of the services they provide and the households to which they provide these services. They question both the extent to which credit unions serve people of modest means and pass on their tax subsidy to members. While limited data are available to evaluate the income of credit union members—which precludes any definitive conclusion—some studies, including one of our own, indicate that credit unions serve a slightly lower proportion of households with low and moderate incomes than banks.<sup>21</sup> We discuss this issue in more detail later in this statement.

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## Arguments against Taxation

Arguments against repealing the tax exemption for credit unions assert that the exemption does not offer competitive advantages and that it is justified by the unique services credit unions offer and by their capital structure. As we reported in 1991, credit unions as organizations are exempt from federal and state income taxes. However, the income that their members receive is taxed. Members who receive dividends on share accounts are taxed on that income, just as depositors at commercial banks are taxed on interest income from savings or checking accounts. If credit unions distribute all income to shareholders and do not retain earnings at

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<sup>20</sup>See the *President's Tax Proposals to the Congress for Fairness, Growth, and Simplicity*, May 1985, 247-248.

<sup>21</sup>[GAO-04-91](#), p.16.

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the entity level, all income will be taxed at the individual level. In this case, credit unions would have little tax advantage relative to taxable mutual financial institutions, whose income is taxed once at either the individual or entity level.

In 2005 and in previous testimonies, trade and industry groups and private individuals presented arguments supporting the tax-exempt status of credit unions, maintaining that tax-exempt status is justified because credit unions provide unique services, such as small loans, financial counseling, and low-cost checking accounts that for-profit financial institutions are unable or unwilling to provide.<sup>22</sup> They stated that taxing credit unions would lead credit unions away from their mutual, nonprofit orientation and structure, leading to reductions in these types of services. They also testified that taxation would hinder credit unions in building reserves, and since credit unions do not have the ability to raise capital through the sale of stock, their safety and soundness would be jeopardized. They argued that while the number of large credit unions has grown over the last 10 years, they hold a relatively small share of overall depository institution assets. Opponents also argued that there is no clear rationale for targeting larger credit unions because, regardless of asset size, larger credit unions retain a distinct organizational structure and must still adhere to limits on their field of membership as sanctioned by Congress. Furthermore, they argued that larger credit unions, relative to smaller credit unions, were more stable and efficient and therefore better able to offer programs targeted to low- and moderate-income households.

Opponents of credit union taxation also have argued that other financial institutions are not without tax privileges and tax relief. Specifically, credit union trade organizations have pointed out that an increasing number of banks have converted to S-corporation status and, thereby, have avoided paying corporate income taxes. In general, U.S. tax law treats corporations and their investors as separate taxable entities. Corporate earnings are taxed first at the corporate level and again at the shareholder level, as dividends if the corporation distributes earnings to shareholders, or as capital gains from the sale of stock. In contrast, the earnings of S-corporations are taxed only once at the shareholder level, whether or not the income is distributed. Corporations that elect Subchapter S status are

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<sup>22</sup>Representatives of the Credit Union National Association, the National Association of Federal Credit Unions, and the Consumer Federation testified before Congress in 1985 as well as in 2005.

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subject to certain restrictions on the number of shareholders and capital structure. For example, an S-corporation may not have more than 75 shareholders, all of whom must be U.S. resident individuals (except for certain trusts and estates) and may issue only one class of stock. Prior to 1996, banks and other depository institutions could not elect S-corporation status. A provision of the Small Business Job Protection Act of 1996 repealed this prohibition.

Like credit unions, mutual thrifts are owned by their depositors and their equity is derived from retained earnings. Mutual thrifts are permitted a tax deduction for amounts paid or credited to their depositors as dividends on their accounts if the amounts may be withdrawn on demand (subject only to the customary notice of intention to withdraw). These dividends are taxed only at the depositor level, whether they represent interest or a return on equity, so that mutual thrifts are taxed only on retained earnings. Further, some farmer's cooperatives are allowed additional tax deductions for dividends on capital stock and distributions to patrons. The earnings of a cooperative generally flow through to the patron and are taxed once at that level. Finally, some other similar entities, like rural electric associations and telephone cooperatives are tax-exempt.<sup>23</sup>

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## Estimates of the Potential Tax Revenues from Taxing Corporations Vary Widely Based on the Source and Underlying Assumptions

Governmental entities have attempted to estimate the potential revenue to the federal government from repealing the tax exemption that ranged from \$1.2 billion to \$1.6 billion on an annualized basis. In a 2001 report, the Department of the Treasury estimated potential revenue between \$1.2 billion and \$1.4 billion annualized over the five year period from 2000-2004, and \$1.4 and \$1.6 billion over the ten-year period from 2000 to 2009, if all credit unions were taxed. More recently, in *Analytical Perspectives, Budget of the United States Government Fiscal Year 2005*, Treasury estimated the potential tax revenue from repealing the credit union tax exemption at \$7.88 billion from fiscal years 2005 through 2009, or \$1.58 billion on average annually.<sup>24</sup> However, according to Treasury officials, the 2005 *Analytical Perspectives* estimate did not account for any behavioral

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<sup>23</sup>There are three categories of cooperatives under the Internal Revenue Code: (1) exempt farmers cooperatives, described in section 521; (2) certain mutual or cooperative entities described in section 501(c)(12), which are exempt from taxation pursuant to section 501(a); and (3) taxable cooperatives, governed by subchapter T of the code (sections 1381-1388).

<sup>24</sup>U.S. Department of the Treasury estimates as published in *Analytical Perspectives: Budget of the United States Government, Fiscal Year 2005*, (Washington, D.C.: 2004).

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changes in response to taxation by credit unions in contrast with estimates from their earlier 2001 study. The Joint Committee on Taxation in a February 2005 Congressional Budget Office report estimated that taxing credit unions with assets greater than \$10 million dollars would potentially raise \$6.5 billion from fiscal years 2006 through 2010, or \$1.3 billion on average annually over that five year period.<sup>25</sup>

Nongovernmental entities have produced estimates that tend to be higher than the estimates generated by government agencies. A study issued by the Tax Foundation, which was funded by the Independent Community Bankers of America, estimated the potential revenue from taxing all insured credit unions to be as high as \$3.1 billion per year when averaged over the 10-year period from 2004 to 2013.<sup>26</sup> Another private study conducted by Chmura Economics & Analytics for the Jefferson Institute for Public Policy estimated the revenue from taxing all credit unions to be \$1.89 billion in 2002, when the same corporate tax rate as banks paid was applied to credit unions (in categories differentiated by asset size).<sup>27</sup> In reviewing these studies, we note that assumptions vary on the tax rates imposed and the response of credit unions to the imposition of taxes (such as distributing higher dividends, lowering loan rates, or increasing deposit rates, which would reduce taxable income and therefore potential tax revenue). However, large credit unions, though small in numbers, are responsible for a disproportionate amount of the potential tax revenue as compared with small credit unions.

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<sup>25</sup> Joint Committee on Taxation estimates as published in the Congressional Budget Office's *Budget Options* (Washington, D.C.: February 2005).

<sup>26</sup> John A. Tatom, *Competitive Advantage: A Study of the Federal Tax Exemption for Credit Unions* (The Tax Foundation: Washington, D.C.: 2005).

<sup>27</sup> Chmura Economics & Analytics, *An Assessment of the Competitive Environment Between Credit Unions and Banks* (Jefferson Institute for Public Policy: Virginia, May 2004).

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## Historical Distinctions between Credit Unions and Other Depository Institutions Have Continued to Blur

Since 1992, credit unions have become less distinct from other depository institutions of similar size, particularly in terms of the products and services offered by larger credit unions. Between 1992 and 2004, the total assets held by federally insured credit unions more than doubled, while the total number of federally insured credit unions declined. As a result of the increase in total assets and the decline in the number of federally insured credit unions, the credit union industry has seen an increase in the average size of its institutions and a slight increase in the concentration of assets. Total assets in federally insured credit unions grew from \$258 billion in 1992 to \$647 billion in 2004, an increase of 150 percent. During this same period the number of federally insured credit unions fell from 12,595 to 9,014. As of the end of 1992, credit unions with more than \$100 million in assets represented 4 percent of all credit unions and 52 percent of total assets; as of the end of 2004, credit unions with more than \$100 million in assets represented about 13 percent of all credit unions and 79 percent of total assets. From 1992 to 2004, the 50 largest credit unions (by asset size) went from holding around 18 percent of industry assets to around 24 percent of industry assets.

This industry consolidation contributed to a widening gap between two distinct groups of federally insured credit unions—larger credit unions, which are relatively few in number and provide a wider range of services, and smaller credit unions, which are greater in number and provide more basic banking services. Figure 1 illustrates institution size and asset distribution in the credit union industry, with institutions classified by asset ranges. As of December 31, 2004, the 2,873 smallest credit unions—those with \$5 million or less in total assets—constituted almost one-third of all credit unions but slightly less than one percent of the industry’s total assets. Conversely, the 98 credit unions with assets over \$1 billion (up to just under \$23 billion) held 33 percent of total industry assets but represented just 1 percent of all credit unions. In our 2003 report, we noted that as of December 31, 2002, 71 credit unions with assets over \$1 billion held 27 percent of total industry assets.

**Figure 1: Credit Union Industry Size and Total Assets Distribution, as of December 31, 2004**

Credit union assets	Number of credit unions	Percentage of total assets
\$5 million or less	2,873	0.9
>\$5 million to \$10 million	1,382	1.6
>\$10 million to \$100 million	3,604	18.89
>\$100 million to \$250 million	644	15.8
>\$250 million to \$500 million	266	14.5
>\$500 million to \$1 billion	147	15.5
>\$1 billion	98	32.9

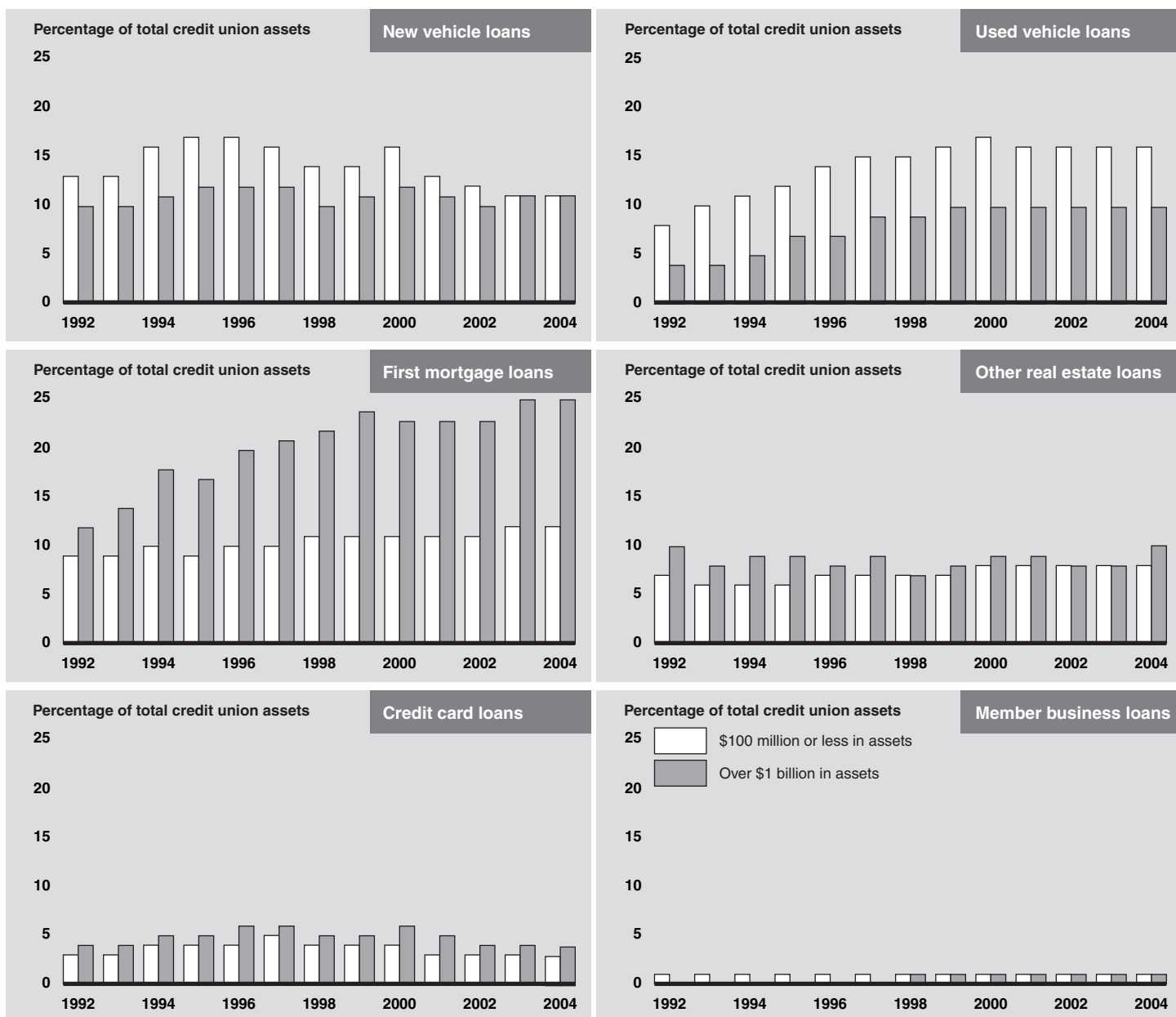
Source: GAO analysis of NCUA Form 5300 data.

Note: This figure depicts credit union industry distribution in terms of the number of federally insured credit unions in a particular asset size category and the percentage of industry assets that are held by credit unions in that category.

As credit unions' assets have grown in recent years, credit unions have generally shifted to larger loans such as mortgages. Between 1992 and 2004, the amount of first mortgage loans held grew from \$29 billion to \$130 billion, while that of new vehicle loans increased from \$29 billion to \$71 billion and that of used vehicle loans increased from \$17 billion to \$85 billion. In terms of the relative importance of different loan types, we compared the growth in the amounts of various loan types relative to credit unions' assets over the same period. Amounts held in first mortgage loans grew from around 11 percent of assets in 1992 to around 20 percent of assets in 2004, while amounts held in used vehicle loans grew from just under 7 percent to slightly more than 13 percent.

As shown in figure 2, larger credit unions generally held relatively larger loans (e.g., first mortgage loans) than smaller credit unions, which generally held relatively more small loans (e.g., used vehicle loans). Since 1992, the amount of first mortgage loans held relative to assets has more than doubled for credit unions with over \$1 billion in assets, from around 12 percent to over 25 percent of assets, while it has grown less than 40 percent for credit unions with less than \$100 million in assets, from around 9 percent to slightly more than 12 percent of assets.

**Figure 2: Loan Types as a Percentage of Total Assets, Smallest versus Largest Credit Unions, 1992-2004**



Source: GAO analysis of NCUA Form 5300 data.

The discrepancy between smaller and larger credit unions is more apparent through an analysis of more recently collected data on more sophisticated product and service offerings, such as the availability of

automatic teller machines (ATM) and electronic banking (see table 1). While less than half of the smallest credit unions offered ATMs and one-third offered transactional websites, nearly all larger credit unions offered these services.

**Table 1: Credit Union Size and Offerings of More Sophisticated Services, as of December 31, 2004**

Asset range	Number	Group assets (billions)	Percentage of institutions offering the following services						
			Financial services through the Internet	Financial services through audio response or phone	ATMs	Electronic applications for new loans	Website		
							Informational	Interactive	Transactional
\$10 million or less	7,859	\$138	37.8	44.3	47.0	25.3	16.0	4.0	32.9
Greater than \$100 millions to \$250 million	644	\$102	94.7	97.4	95.0	82.1	3.7	2.2	92.2
Greater than \$250 to \$500 million	266	\$94	98.5	98.5	96.6	89.8	0.8	1.5	97.0
Greater than \$500 million to \$1 billion	147	\$100	98.0	98.0	98.0	92.5	2.0	1.4	95.9
Greater than \$1 billion	98	\$213	98.0	98.0	98.0	95.9	1.0	2.0	96.9
<b>Total</b>	<b>9,014</b>	<b>\$647</b>	<b>51.2</b>	<b>51.2</b>	<b>53.3</b>	<b>33.1</b>	<b>14.3</b>	<b>3.7</b>	<b>40.7</b>

Source: GAO analysis of NCUA Form 5300 data.

Note: Data are based on all federally insured credit unions filing call reports.

Despite the growth in credit union assets over recent years, the credit union industry remains much smaller than the banking industry, with credit unions representing around 6 percent of total assets of both

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industries.<sup>28</sup> For example, at the end of 2004, the largest credit union had nearly \$23 billion in assets, while the largest bank, with \$967 billion in assets, was larger than the entire credit union industry combined.

Although credit unions are on average much smaller than banks, larger credit unions and banks of comparable size tend to offer the same products and services (see fig. 3).<sup>29</sup> In particular, nearly all banks and larger credit unions reported holding first mortgage loans, while a majority of the smaller credit unions did not.

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<sup>28</sup> Credit union assets grew from \$438 billion at year-end 2000 to \$647 billion at year-end 2004—an increase of 48 percent—while banking industry assets grew from \$7.5 trillion at year-end 2000 to \$10.1 trillion at year-end 2004—an increase of 35 percent. Credit unions represented 6.0 percent of the combined assets of the banking and credit union industries as of December 31, 2004, versus 5.6 percent as of December 31, 2000.

<sup>29</sup> Given the disproportionate size of the banking industry relative to the credit union industry—the average credit union had \$72 million in assets versus \$1.1 billion in assets for the average bank at year-end 2004—we developed peer groups by asset size to mitigate the effects of this discrepancy. We constructed five peer groups in terms of institution size as measured by total assets, reported as of December 31, 2004. We further refined the sample of FDIC-insured institutions to exclude those banks and thrifts we determined had emphases in credit card or mortgage loans. The largest bank included in our analyses had total assets of nearly \$23 billion at year-end 2004, and the average bank in this peer group sample had \$359 million in assets.

**Figure 3: Percentages of Credit Unions and Banks Holding Various Loans, by Institution Size, as of December 31, 2004**

Institution assets range	Number	Assets (dollars in billions)	Percentage of institutions with the loan type									
			First mortgage		Junior mortgage and home equity		Credit card		Other consumer		Agricultural and business	
\$100 million or less	7,859	\$138	<div></div>	46.5%	<div></div>	56.6%	<div></div>	45.4%	<div></div>	99.8%	<div></div>	13.1%
	3,604	186	<div></div>	96.3	<div></div>	74.8	<div></div>	14.1	<div></div>	97.4	<div></div>	96.2
Greater than \$100 million, but less than or equal to \$250 million	644	102	<div></div>	97.4	<div></div>	97.8	<div></div>	85.1	<div></div>	100.0	<div></div>	48.1
	2,169	343	<div></div>	98.7	<div></div>	95.1	<div></div>	30.3	<div></div>	98.9	<div></div>	97.9
Greater than \$250 million, but less than or equal to \$500 million	266	94	<div></div>	98.9	<div></div>	98.5	<div></div>	86.1	<div></div>	100.0	<div></div>	62.8
	973	343	<div></div>	98.3	<div></div>	97.0	<div></div>	36.6	<div></div>	98.3	<div></div>	97.8
Greater than \$500 million, but less than or equal to \$1 billion	147	101	<div></div>	99.3	<div></div>	98.6	<div></div>	90.5	<div></div>	100.0	<div></div>	66.7
	467	323	<div></div>	97.9	<div></div>	96.8	<div></div>	34.7	<div></div>	97.9	<div></div>	97.2
Greater than \$1 billion	98	213	<div></div>	100.0	<div></div>	100.0	<div></div>	92.9	<div></div>	100.0	<div></div>	79.6
	426	1,549	<div></div>	96.7	<div></div>	95.1	<div></div>	39.9	<div></div>	97.2	<div></div>	96.5
Total	9,014	647	<div></div>	53.1	<div></div>	62.0	<div></div>	50.7	<div></div>	99.9	<div></div>	18.7
	7,639	2,744	<div></div>	97.4	<div></div>	85.9	<div></div>	24.3	<div></div>	97.9	<div></div>	97.0

 Credit unions  
 Banks

Source: GAO analysis of NCUA and FDIC call report data.

Notes: Data are based on all federally insured credit unions, banks, and thrifts filing call reports. We excluded insured U.S. branches of foreign-chartered institutions and banks that we determined had emphases in credit card or mortgage loans. Credit union data on other consumer loans may include member business and agricultural loans. Agricultural and business loans for credit unions include both member business loans and participation in nonmember loans.

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## The Extent to Which Credit Unions Serve Persons of Modest Means Is Not Definitely Known because of Limited Data and Lack of Indicators

While credit union fields of membership have expanded, the extent to which they serve people or communities of low or moderate incomes is not definitively known. In 1998, CUMAA affirmed preexisting NCUA policies that had allowed credit unions to expand their field of membership and include underserved areas.<sup>30</sup> After the legislation was passed, NCUA revised its regulations to enable credit unions to serve larger communities or geographic areas. As they have become larger and begun offering a wider variety of services, questions have been raised about whether credit unions are more likely than banks to serve households with low and moderate incomes. However, limited comprehensive data are available to evaluate the income of credit union members. Our assessment of available data—the Federal Reserve’s 2001 Survey of Consumer Finances (SCF) and other studies—provided some indication that, compared with banks, credit unions served a slightly lower proportion of households with low and moderate incomes. Although NCUA has undertaken initiatives to enhance the availability of financial services to individuals of modest means, as of October 15, 2005, it had not implemented our 2003 recommendation to develop indicators to evaluate the progress credit unions made in reaching the underserved.

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## Credit Unions Can Serve More People and Larger Areas because CUMAA Permitted NCUA to Continue Preexisting Policies That Expanded Field of Membership

In 1998, the Supreme Court ruled against NCUA’s practice of permitting federally chartered credit unions based on multiple bonds.<sup>31</sup> Subsequently, Congress passed CUMAA, which specifically permits multiple-bond credit unions. The act permits these credit unions to retain their current membership and authorizes their future formation.<sup>32</sup> Figure 4 provides additional information on the percent and assets of federally chartered credit unions by bond type. While multiple-bond credit unions have constituted on average slightly under 50 percent of all credit unions since 2000, they tend to be larger than the other two types of credit union bonds

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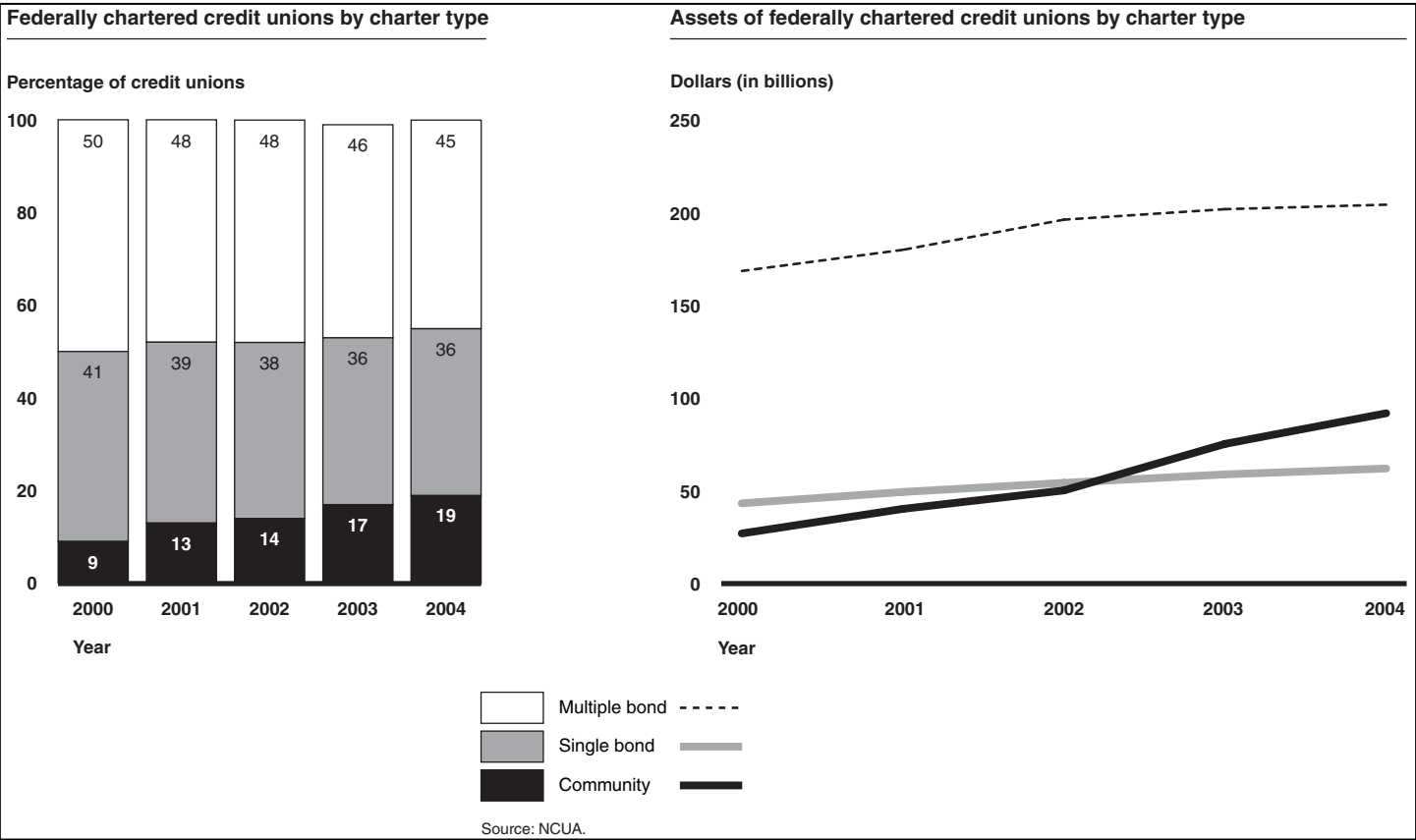
<sup>30</sup>The Federal Credit Union Act defines an “underserved area” as a local community, neighborhood, or rural district that is an “investment area” as defined by the Community Development Banking and Financial Institutions Act of 1994. An investment area includes locations experiencing poverty, low income, or unemployment.

<sup>31</sup>*National Credit Union Administration v. First National Bank & Trust Company*. 522 U.S. 479 (1998).

<sup>32</sup>See 12 U.S.C. § 1759(b), (d), as amended.

in terms of asset size.<sup>33</sup> For example, at year-end 2004, multiple bond credit unions made up 45 percent of the total number of federal credit unions but represented 57 percent of federal credit union assets.

Figure 4: Percent and Assets of Federally Chartered Credit Unions, by Bond, 2000–2004



Note: NCUA provided revised data for the year 2000 from that previously provided for our 2003 report.

In addition to permitting multiple-bond credit unions, CUMAA further qualifies the definition of community bond. The act adds the word “local” to the preexisting requirement that community-based credit unions serve a

<sup>33</sup>With the exception of the statistics provided for multiple-bond credit unions for 1996, NCUA cannot provide us data on federal chartering trends before 2000. However, NCUA was able to report that by 1996, about half of all federally chartered credit unions were multiple-bond credit unions.

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“well-defined community, neighborhood or rural district,” but provides no guidance on how “local” or any other part of this requirement should be defined.<sup>34</sup> However, after the passage of CUMAA, NCUA revised its regulations to make it easier for credit unions to serve increasingly larger areas (e.g., entire cities or counties). As a result, NCUA approved a community-based charter application in July 2005 covering Los Angeles County with a potential membership of 9.6 million.

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### Limited Comprehensive Data Are Available to Evaluate Income of Credit Union Members

While it has been generally accepted that credit unions historically have emphasized service to people with modest means; currently, there are no comprehensive data on the income characteristics of credit union members, particularly those who actually receive loans and other services. Industry groups and consumer advocates have debated which economic groups benefit from credit union services, especially in light of the credit unions’ exemption from federal income taxes. As stated in our 1991 report, and still true, none of the common-bond criteria available to federally chartered credit unions refer to the economic status of their members or potential members.

Information on the extent to which credit unions are lending and providing services to households with various incomes is scarce because NCUA, industry trade groups, and most states (with the exception of Massachusetts and Connecticut) have not collected specific information describing the income of credit union members who obtain loans or benefit from other credit union services.<sup>35</sup> Credit unions—even those serving geographic areas—are not subject to the federal Community Reinvestment Act (CRA), which requires banking regulators to examine and rate banks and thrifts on lending and service to low- and moderate-

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<sup>34</sup>Pub. L. No. 105-219 § 101. See 12 U.S.C. § 1759(c)(2), as amended.

<sup>35</sup>The Credit Union National Association, a trade association, collects information about the characteristics (for example, income, race, and age) of credit union members but not specifically the income levels of members who actually receive mortgage and consumer loans or use other services. Also, Massachusetts and Connecticut collect information on the distribution of credit union lending by household income and the availability of services because their state-chartered credit unions are subject to examinations similar to those of federally regulated institutions. Massachusetts established its examination procedures in 1982 and Connecticut in 2001.

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income neighborhoods in their assessment area.<sup>36</sup> Consequently, NCUA and most state regulators do not require credit unions to maintain data on the extent to which loans and other services are being provided to households with various incomes.

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### Federal Reserve Board Data Suggest That Credit Unions Serve a Slightly Lower Proportion of Low- and Moderate-Income Households Than Do Banks

Our prior work, which included an analysis of data from the Federal Reserve Board's 2001 SCF, suggested that credit unions overall served a lower percentage of households of modest means (low- and moderate-income households combined) than banks.<sup>37</sup> More specifically, while credit unions served a slightly higher percentage of moderate-income households than banks, they served a much lower percentage of low-income households. We combined the SCF data into two main groups—households that primarily and only used credit unions versus households that primarily and only used banks.<sup>38</sup> As shown in figure 5, this analysis indicated that about 36 percent of households that primarily and only used credit unions had low or moderate incomes, compared to 42 percent of households that used banks. Moreover, our analysis suggested that a greater percentage of households that primarily and only used credit unions were in the middle and upper income grouping than the proportion of households that primarily and only used banks.

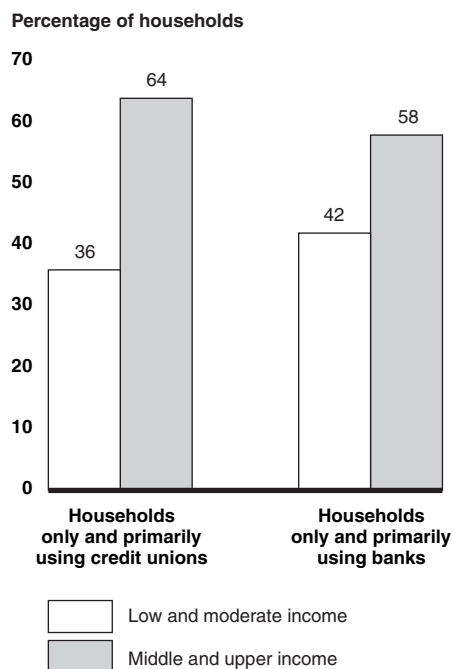
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<sup>36</sup>CRA requires federal bank and thrift regulators to encourage depository institutions under their jurisdiction to help meet the credit needs of the local communities, including low- and moderate-income areas, in which they are chartered, consistent with safe and sound operations. See 12 U.S.C. §§ 2901, 2903, and 2906 (2000). Federal bank and thrift regulators conduct CRA examinations to evaluate the services that depository institutions provide to low- and moderate-income neighborhoods. However, CRA provides for enforcement only when regulators evaluate an institution's application for a merger or new branch, requiring that the agencies take an institution's record of meeting the credit needs of its community into account.

<sup>37</sup>The SCF is an interview survey of U.S. households conducted by the Federal Reserve Board that includes questions about household income and specifically asks whether households use credit unions or banks. It is conducted every 3 years and is intended to provide detailed information on the balance sheet, pension, income, and other demographic characteristics of U.S. households, and their use of financial institutions.

<sup>38</sup>See [GAO-04-91](#), pages 19-23, for a more detailed discussion of our analysis and limitations of the SCF data.

**Figure 5: Income Characteristics of Households Using Credit Unions versus Banks, and Low and Moderate Income versus Middle and High Income**

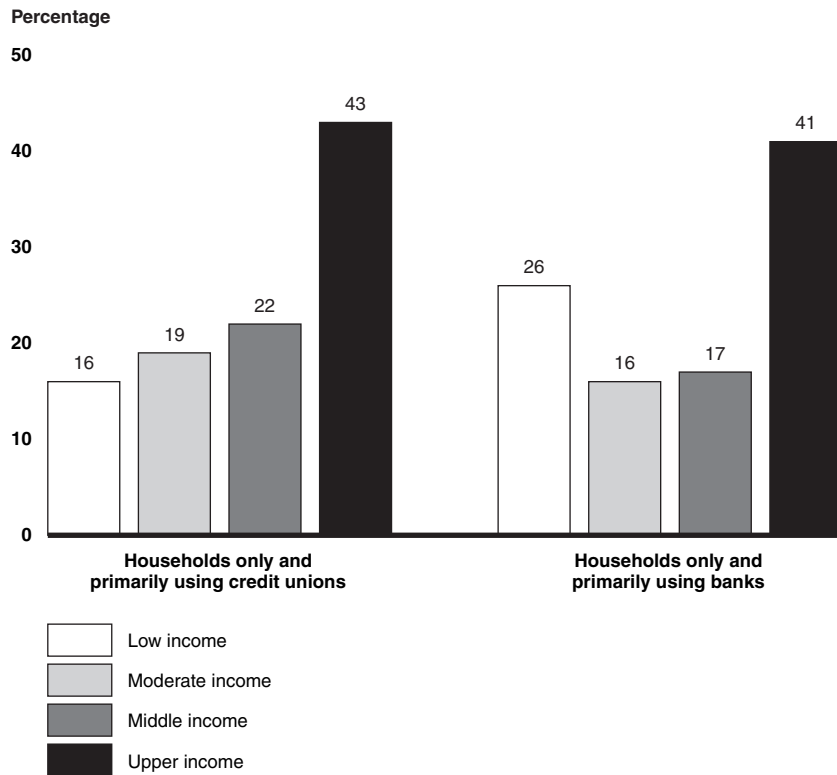


Source: 2001 SCF.

Note: We used the same income categories as used by federal regulators in their CRA examinations.

We also looked at each of the four income categories separately. As shown in figure 6, this analysis suggested that the percentage of households in the low-income category that used credit unions only and primarily (16 percent) was lower than the percentage of these households that used banks (26 percent). In contrast, more moderate- and middle-income households were likely to use credit unions only and primarily (41 percent) than banks (33 percent). Given that credit union membership traditionally has been tied to occupational- or employer-based fields of membership, that higher percentages of moderate- and middle-income households using credit unions is not surprising.

**Figure 6: Income Characteristics of Households Using Credit Unions versus Banks, by Four Income Categories**



Source: 2001 SCF.

Note: We found no statistical difference in the percent of upper-income households when the “primarily and only” using credit union group and the “primarily and only” using bank group were compared.

We also attempted to further explore the income distribution of credit unions members by separately analyzing households that only used credit unions or banks from those that primarily used credit unions or banks. However, the results were ambiguous and difficult to interpret, due to the characteristics of the households in the SCF database. For example, because such a high percent of the U.S. population only uses banks (62 percent), the data obtained from the SCF is particularly useful for describing characteristics of bank users but much less precise for describing smaller population groups, such as those that only used credit unions (8 percent).

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Other relatively recent studies—notably, by the Credit Union National Association and the Woodstock Institute—generally concluded that credit unions served a somewhat higher-income population. The studies also noted that the higher income levels could be due to the full-time employment status of credit union members.<sup>39</sup> Officials from NCUA and the Federal Reserve Board also noted that credit union members were likely to have higher incomes than nonmembers because credit unions are occupationally based. A National Federation of Community Development Credit Unions representative noted that because credit union membership is largely based on employment, relatively few credit unions are located in low-income communities.<sup>40</sup> However, without additional research, especially on the extent to which credit unions with a community base serve all their potential members, it is difficult to know whether the relative importance of full-time employment is the primary explanatory factor.

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### NCUA Has Established Initiatives That Target Low-Income Individuals and Underserved Areas

NCUA recently has established two initiatives to further enhance the availability of financial services to individuals of modest means: the low-income credit union program and expansion into underserved areas. According to NCUA, its Low Income Credit Unions (LICU) program is designed to assist credit unions whose members are of modest means in obtaining technical and financial services. LICUs grew in number from more than 600 in 2000 to nearly 1,000 by the end of 2004. To obtain a low-income designation from NCUA, an existing credit union must establish that a majority of its members meet the low-income definition.<sup>41</sup> According to NCUA, credit unions that meet this criterion are presumed to be serving predominantly low-income members. Also, newly chartered credit unions

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<sup>39</sup> Credit Union National Association 2002 National Member Survey and Woodstock Institute, *Rhetoric and Reality: An Analysis of Mainstream Credit Unions' Record of Serving Low Income People* (February 2002).

<sup>40</sup> The National Federation of Community Development Credit Unions represents and provides, among other things, financial, technical assistance, and human resources to about 215 community development credit unions for the purpose of reaching low-income consumers.

<sup>41</sup> Section 701.34 of NCUA's Rules and Regulations defines the term "low-income members" as those members who (1) make less than 80 percent of the average for all wage earners as established by the Bureau of Labor Statistics or (2) whose annual household income falls at or below 80 percent of the median household income for the nation as established by the Census Bureau. The term "low-income members" also includes members who are full- or part-time students in a college, university, high school, or vocational school.

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can receive low-income designation based on the income characteristics of potential members.

Credit unions that receive a low-income designation from NCUA are measured against the same standards of safety and soundness as other credit unions. However, NCUA grants benefits that other credit unions do not have, including:

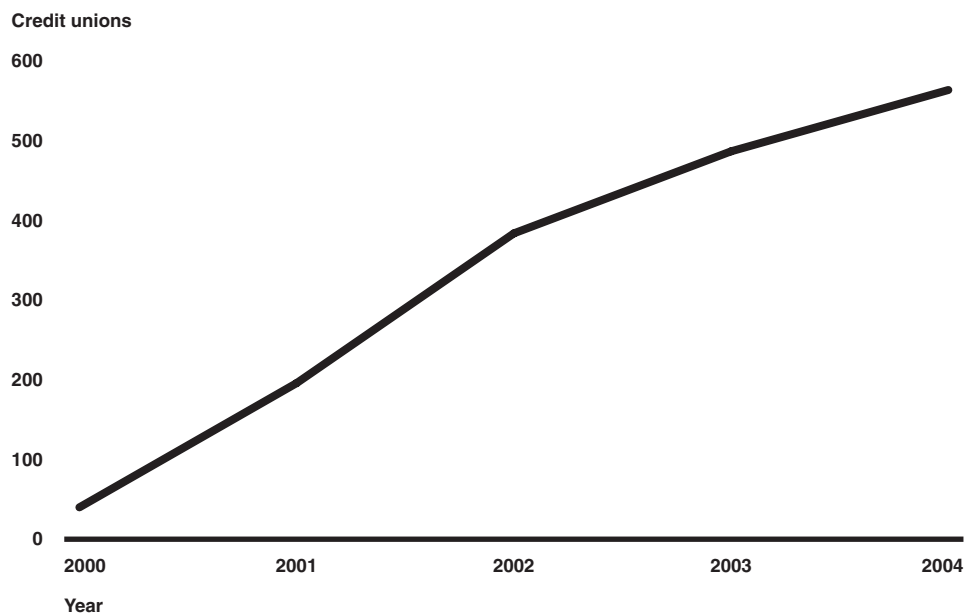
- greater authority to accept deposits from nonmembers such as voluntary health and welfare organizations;
- access to low-interest loans, deposits, and technical assistance through participation in NCUA's Community Development Revolving Loan Fund;
- ability to offer uninsured secondary capital accounts and include these accounts in the credit union's net worth for the purposes of meeting its regulatory capital requirements;<sup>42</sup> and
- a waiver of the aggregate loan limit for member business loans.

NCUA has stated that one of its goals is to encourage the expansion of membership and make quality credit union services available to all eligible persons. It has done so in part by allowing credit unions to expand into underserved areas in recent years, from 40 in 2000 to 564 in 2004 (see fig. 7).

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<sup>42</sup>A "secondary capital instrument" is either unsecured debt or debt that has a lower priority than that of another debt on the same asset. These subordinated debt instruments are not backed or guaranteed by the federal share insurance fund.

**Figure 7: Credit Union Expansions into Underserved Areas, 2000–2004**



Source: NCUA.

CUMAA and NCUA's Interpretive Ruling and Policy Statement (IRPS) 03-1, the Chartering and Field of Membership Manual, allows credit unions to include in their fields of membership, without regard to location, communities in underserved areas. The Federal Credit Union Act defines an underserved area as a local community, neighborhood, or rural district that is an "investment area" as defined by the Community Development Banking and Financial Institutions Act of 1994—that is, experiencing poverty, low income, or unemployment.<sup>43</sup> In order to expand into an underserved area, credit unions must receive approval from NCUA by demonstrating that a community qualifies as an investment area. Credit unions must also provide a business plan describing how the underserved community will be served. Finally, although the underserved and LICU initiatives are intended to help serve the underserved, NCUA does not collect data such as overall income levels of individuals using specific credit union products.

<sup>43</sup>Quoted from NCUA Chartering and Field Membership Manual, March 2003, p.3-4 & 3-5.

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## NCUA Has Not Fully Implemented Our Recommendation to Develop Indicators to Evaluate Credit Union Progress in Reaching the Underserved

Although NCUA has targeted underserved individuals and areas, in our 2003 report on credit unions we found that NCUA had data on potential—but not actual—membership of low- and moderate-income individuals in underserved areas adopted by credit unions. We recommended that NCUA use tangible indicators, other than potential membership, to determine whether credit unions have provided greater access to credit union services in underserved areas.<sup>44</sup>

As of October 15, 2005, NCUA had not adopted any indicators. According to NCUA, it has established a working group to study credit union success in reaching people of modest means. NCUA indicated that the working group was exploring meaningful measures of success for this objective, determining how to best quantify the measures with available or readily obtainable data. The working group has also been evaluating the impact of other regulations, such as the Privacy of Consumer Financial Information, on the collection and use of such data. According to NCUA officials, as of October 15, 2005, the working group had not issued its report or recommendations.

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## Credit Unions Lack Transparency on Executive Compensation and Larger Credit Unions Do Not Have to Report on Effectiveness of Internal Controls

Most credit unions are not subject to IRS and other federal reporting requirements that would disclose information such as executive compensation and assessments of internal controls for financial reporting—information that can enhance public confidence in tax-exempt entities. Public availability of key financial information (that is, transparency) can provide incentives for ethical and effective operations as well as support oversight of the tax-exempt entities. At the same time, the disclosure of such information helps to achieve and maintain public trust.

Recognizing the importance of transparency for tax-exempt entities, Congress made returns of the IRS Form 990 (Return of Organizations Exempt from Income Tax) into publicly available documents. Since tax exemptions are granted to entities so that they can carry out particular missions or activities that Congress judges to be of special value, the public availability of Form 990 promotes public oversight. Most tax-exempt organizations, other than private foundations with gross receipts of \$25,000 or more, are required to file Form 990 annually. The form contains information on an organization's income, expenditures, and

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<sup>44</sup>GAO-04-91, p. 83.

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“activities” including compensation information for officers, directors, trustees, and key employees. IRS also uses these forms to select organizations for examination.

However, most credit unions do not individually file Form 990. In 2002 and 2003, credit unions filed 1,435 and 1,389 Form 990s, respectively. On August 23, 1988, IRS issued a determination that annually filing Form 990 was not required for federal credit unions because of their status as tax-exempt organizations under section 501(c)(1) of the Internal Revenue Code. Depending on the state, some state-chartered credit unions file through a group filing process. For these states, IRS receives only the names and addresses of individual credit unions. As a result, scrutiny of the compensation of credit union executives and other key personnel is difficult. As you are aware, we have ongoing work in this and other areas, and we hope to provide you with additional information on the compensation of credit union executives and officials as part of this follow-up work.

As noted in our 2003 report, the Federal Credit Union Act, as amended, requires credit unions with assets over \$500 million to obtain an annual independent audit of financial statements by an independent certified public accountant. But, unlike banks and thrifts, these credit unions are not required to report on the effectiveness of their internal controls for financial reporting. Under FDICIA and its implementing regulations, banks and thrifts with assets over \$500 million are required to prepare an annual management report that contains:

- a statement of management’s responsibility for preparing the institution’s annual financial statements, for establishing and maintaining an adequate internal control structure and procedures for financial reporting, and for complying with designated laws and regulations relating to safety and soundness; and
- management’s assessment of the effectiveness of the institution’s internal control structure and procedures for financial reporting as of the end of the fiscal year and the institution’s compliance with the designated safety and soundness laws and regulations during the fiscal year.<sup>45</sup>

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<sup>45</sup> 12 U.S.C. § 1831m; 12 C.F.R. Part 363 (2003).

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Additionally, the institution's independent accountants are required to attest to management's assertions concerning the effectiveness of the institution's internal control structure and procedures for financial reporting. The institution's management report and the accountant's attestation report must be filed with the institution's primary federal regulator and any appropriate state depository institution supervisor, and must be available for public inspection.

The reports, with their assessments and attestations on internal controls, allow depository institution regulators to gain increased assurance about the reliability of financial reporting. Also as we stated in our 2003 report, the extension of the internal control reporting requirement to credit unions with assets over \$500 million could provide NCUA with an additional tool to assess the reliability of internal controls over financial reporting.

Moreover, bank and thrift reporting requirements under FDICIA are similar to the public company reporting requirements in the Sarbanes-Oxley Act of 2002. Under Sarbanes-Oxley, public companies are required to establish and maintain adequate internal control structures and procedures for financial reporting; the company's auditor is also required to attest to, and report on, the assessment made by company management on the effectiveness of internal controls. As a result of FDICIA and the Sarbanes-Oxley Act, reports on management's assessment of the effectiveness of internal controls over financial reporting and the independent auditor's attestation on management's assessment have become normal business practice for financial institutions and businesses.

In a letter dated October 2003, NCUA's Chairman stated that while the Sarbanes-Oxley Act does not apply specifically to federal credit unions, certain provisions may be appropriate to consider for some federal credit unions. Federal credit unions are encouraged (but not required) to consider the guidance provided and are urged to periodically review their policies and procedures as they relate to matters of corporate governance and auditing.

Mr. Chairman, this concludes my prepared statement. I would be pleased to respond to any questions you or other Members of the committee may have.

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## Contact and Acknowledgments

For further information regarding this testimony, please contact Richard Hillman at (202 512-8678) or [hillmanr@gao.gov](mailto:hillmanr@gao.gov). Individuals making key contributions to this testimony include Janet Fong, May Lee, John Lord, Harry Medina, Jasmine Persaud, Barbara Roesmann, and Richard Vagnoni.

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