March 28, 2018

BY EMAIL

The Honorable Orrin G. Hatch
Chairman
U.S. Senate Committee on Finance
219 Dirksen Senate Office Building
Washington, DC 20510-6200

Dear Chairman Hatch:

I am writing in response to your January 31, 2018 letter examining the need for continuing the tax exemption for credit unions in light of their evolved nature and expanded fields of membership. The federal tax exemption referred to in your letter is provided to federal credit unions under section 122 of the Federal Credit Union Act (the FCUA).[1] Matters of taxation reside with Congress and are beyond the purview of the National Credit Union Administration (the NCUA). Accordingly, we have focused our response on the effects the elimination of the federal tax exemption could have on the safety and soundness of the National Credit Union Share Insurance Fund (the Share Insurance Fund or the Fund) and the credit union system.

Congress has entrusted the NCUA with protecting the Share Insurance Fund and maintaining a safe and sound credit union system for credit unions and their members. The NCUA is responsible for the regulation and supervision of 5,573 federally insured credit unions with more than 111 million member-owners and more than $1.3 trillion in assets across all states and U.S. territories.[2] Through its examination and supervision program, the NCUA protects the safety and soundness of the credit union system by mitigating risks to the Share Insurance Fund. Backed by the full faith and credit of the United States, the Fund provides members of a federally insured credit union with at least $250,000 of insurance per individual depositor.

[1] 12 U.S.C. 1768 ("The Federal credit unions organized hereunder, their property, their franchises, capital, reserves, surpluses, and other funds, and their income shall be exempt from all taxation now or hereafter imposed by the United States or by any State, Territorial, or local taxing authority; except that any real property and any tangible personal property of such Federal credit unions shall be subject to Federal, State, Territorial, and local taxation to the same extent as other similar property is taxed. Nothing herein contained shall prevent holdings in any Federal credit union organized hereunder from being included in the valuation of the personal property of the owners or holders thereof in assessing taxes imposed by authority of the State or political subdivision thereof in which the Federal credit union is located; but the duty or burden of collecting or enforcing the payment of such a tax shall not be imposed upon any such Federal credit union and the tax shall not exceed the rate of taxes imposed upon holdings in domestic credit unions.").

[2] Information compiled from call report data collected by the NCUA from federally insured credit unions as of September 30, 2017. The total number of member-owners was determined by adding together the total number of persons with member accounts at each federally insured credit union.

As part of its own due diligence, the NCUA has performed a careful analysis of what, if any, impact eliminating the current federal tax exemption would have on the credit union system and the safety and soundness of the Share Insurance Fund. The analysis revealed that, without also eliminating the field of membership restrictions, member business lending restrictions, investment capital restrictions, investment authority restrictions, and other restrictions imposed under the FCUA, eliminating the tax exemption would almost certainly create a safety and soundness issue for the Fund that could ultimately fall to U.S. taxpayers. In other words, a safety and soundness issue would most likely arise if credit unions are not offered a level playing field with other taxed depository institutions, including an option to make something akin to an S corporation election for purposes of taxation. Credit unions would need an appropriate transition period to incorporate any such changes into their business models so as to serve their members in a seamless manner.

As you state in your letter, Congress reaffirmed its support for the credit union tax exemption in 1998 when it passed the Credit Union Membership Access Act (CUMAA). Specifically, under § 2(4) of CUMAA, Congress 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. [3]

The stringent structural limitations Congress placed on credit unions under the FCUA distinguish credit unions from other for-profit participants in the financial services marketplace, and were, in the eyes of Congress at that time, what made the federal tax exemption appropriate.

You are correct in pointing out that the NCUA, consistent with the requirements of the FCUA and the spirit of the President's Executive Order on regulatory relief,[4] has broadened its field-of-membership regulations, and its member business lending regulations, and has permitted credit unions to use limited forms of alternative capital under certain circumstances. As Congress reiterated in 1998, the FCUA defines the business for which credit unions are incorporated—to promote thrift among members and to create sources of credit for provident or productive purposes.[5] The NCUA has endeavored to consistently construe the authority of federal credit unions in a manner that affords them reasonable flexibility—under the FCUA—to provide for the needs of their members, while also remaining true to the mission of meeting the credit and savings needs of consumers, especially persons of modest means, and protecting the safety and soundness of the Share Insurance Fund.

Most of the stringent structural limitations Congress originally placed on federal credit unions back in 1934 remain in place today. Federal credit unions continue to be member-owned, democratically operated, not-for-profit organizations that are managed by boards of directors that consist mostly of volunteers, and work primarily to meet the credit and savings needs of

[3] Pub. L. 105–219, § 2(4), 112 Stat. 913, 914 (1998) (codified at 12 U.S.C.A. 1751 note).
[4] E.O. 13777 (Feb 24, 2017) ("It is the policy of the United States to alleviate unnecessary regulatory burdens placed on the American people.").
[5] 12 U.S.C. 1752(1); Public Law No. 105-219, 112 Stat. 913, § 2 (1998).

consumers of modest means. Federal credit unions also continue to be subject to firm restrictions on their abilities to expand their fields of membership, access capital markets, make business loans, set competitive loan-maturity dates, and purchase and hold investments. The regulatory adjustments the NCUA has made over the years have not changed, in any material way, the major statutory limitations that Congress cited in 1998 to justify its continued support for the credit union tax exemption.[6]

Your letter included six specific questions, which we have answered below:

1. How does the NCUA examine associations that form a part of a credit union's field of membership to verify that they promote a meaningful affinity and bond among members, and to ensure that they don't exist solely to expand a credit union's field of membership?

The NCUA defines what qualifies as a valid association in Appendix B to Part 701 of the NCUA's Rules and Regulations, commonly referred to as the NCUA's *Chartering and Field of Membership Manual*.[7] In 2015, the NCUA updated the agency's policies to ensure that members of associational groups, in our contemporary operating environment, continue to share a meaningful affinity and bond. One significant change was to add a provision that disqualifies an associational group if its sole purpose is to expand a credit union's field of membership. On the application form, credit union officials must attest that the associational groups they desire to serve were not formed solely to promote credit union service.

During the pre-exam planning phase of a federal credit union examination, examiners review a report identifying new associational groups added to the credit union's field of membership to assess any heightened risk. Similarly, for recently approved community charter conversions or expansions, examiners assess credit union officials' good faith efforts to comply with the terms of the business and marketing plans they submitted to the NCUA. Such reviews generally occur at each examination and continue for a period of three years. Examiners also review and document any voluntary acquisitions of other credit unions during their pre-exam planning phase.

The NCUA evaluates associational groups by applying a totality-of-the-circumstances test, which considers the following eight factors:

1. Whether the association provides opportunities for members to participate in the furtherance of the goals of the association;

2. Whether the association maintains a membership list;

3. Whether the association sponsors other activities;

4. Whether the association's membership eligibility requirements are authoritative;

5. Whether members pay dues;

[6] *See* Pub. L. 105–219, § 2(4), 112 Stat. 913, 914 (1998) (codified at 12 U.S.C.A. 1751 note).
[7] 12 CFR Part 701, Appendix B.

6. Whether the members have voting rights—to meet this requirement, a member need not vote directly for an officer, but may vote for a delegate who in turn represents the member's interests;

7. The frequency of meetings; and

8. Separateness—the NCUA reviews if there is corporate separateness between the group and the federal credit union. The group and the federal credit union must operate in a way that demonstrates the separate corporate existence of each entity. Specifically, a federal credit union and an associational group's business transactions, accounts, and corporate records may not be commingled.

No single factor is determinative of membership eligibility for an associational group; rather, the totality of the circumstances controls over any individual factor in the test.

2. What data does the NCUA retain on associational charters that have been rejected for not meeting the NCUA's associational common bond policies?

The NCUA has an internal electronic correspondence tracking system, which is used to maintain records on applications the agency receives for credit unions interested in serving associational groups. The agency has processed 1,890 requests to serve associational groups since the updated rule concerning associational groups became effective in 2015. The actions taken on these requests are as follows:

Decision	**Number**	**Percentage**
Approved	1,504	79.58%
Denied	3	0.16%
Withdrawn	26	1.38%
Deferred	179	9.47%
Quality Control/Pending	178	9.41%
Totals	**1,890**	**100.00%**

The low denial rate is due to credit unions understanding and submitting compliant packages coupled with the NCUA's practice to assist credit unions in achieving their objectives in compliance with the FCUA and the agency's regulatory parameters. Instead of outright denial, the NCUA typically defers action on requests the agency cannot approve and, to the extent reasonably possible, offers alternative solutions consistent with the FCUA and the agency's regulatory framework.

The 2015 rule provided automatic recognition for the following types of associational groups:

1. Alumni associations;
2. Religious organizations, including churches or groups of related churches;
3. Electric cooperatives;

4. Homeowner associations;
5. Labor unions;
6. Scouting groups;
7. Parent teacher associations organized at the local level to serve a single school district;
8. Chamber of commerce groups (members only and not employees of members);
9. Athletic booster clubs whose members have voting rights;
10. Fraternal organizations or civic groups with a mission of community service whose members have voting rights;
11. Organizations having a mission based on preserving or furthering the culture of a particular national or ethnic origin; and
12. Organizations promoting social interaction or educational initiatives among persons sharing a common occupational profession.

While the adoption of automatic recognition of certain associational groups significantly reduced the regulatory burden for credit unions, the NCUA has retained regulatory oversight for all requests to serve other types of associations.

3. What data does the NCUA retain on community charters that have been rejected for having too broad of a geographic field of membership?

As with other types of applications, the NCUA tracks internally the status of requests for community charter conversions and expansions. It is difficult, however, to pinpoint a precise number of applications rejected as a result of their fields of membership being too broad. The following factors contribute to the difficulty associated with answering this question:

1. The NCUA's tracking system does not distinguish between denials based on the geographic area requested as opposed to other reasons, such as safety and soundness.

2. NCUA staff often work with applicants before receiving a request to ensure the proposed service area meets the NCUA's regulatory requirements. If an area does not qualify, the agency often recommends using an alternative area to meet the NCUA's regulatory requirements. Agency efforts to provide timely information to credit unions reduces the number of applications the agency would otherwise receive for areas outside of the NCUA's regulatory parameters.

3. If an area is too broad based on safety and soundness considerations stemming from a credit union's inability to serve the entire area, the agency often will typically recommend an area that is more consistent with the credit union's resources. This practice also reduces the number of applications the NCUA outright denies because an area is too broad.

Through its rulemaking process, the NCUA has worked to establish reasonable parameters that ensure the size of community service areas consistent with both the letter and spirit of the FCUA. Federal credit unions may undertake to avoid such limitations by simply converting to a state charter. Many states' field-of-membership laws allow for the mixing and matching of communities and select employee groups for state-chartered credit unions. State-chartered credit

unions can avail themselves of these flexible field-of-membership requirements to allow themselves to adhere to the individual state's geography and communities. Moreover, most states have signed agreements on interstate branching, which help facilitate and streamline the process for interstate branching of state-chartered credit unions, and assist state-chartered credit unions in serving members across state lines.

4. What recommendations does the NCUA make and what policies do they enforce regarding credit unions offering services outside of their tax-exempt purpose?

The NCUA examines and supervises federally insured credit unions to ensure they are complying with the FCUA and other applicable laws and regulations, and operating in a safe and sound manner.

The services and activities federal credit unions are authorized to offer and engage in are derived directly from the authorities and limitations specified under the FCUA. Any regulatory relief or expansion of authority provided to federal credit unions must be consistent with the letter and spirit of the FCUA and the authority provided to the NCUA Board under the Act. The services and activities that federally insured, state-chartered credit unions are authorized to offer and engage in are primarily derived from applicable state statutes and regulations.[8] Such laws may be narrower or broader than those applicable to federal credit unions.

The FCUA specifically exempts federal credit unions from taxation by the United States or by any state or local taxing authority, except real and personal property taxes.[9] Unlike federal credit unions, the Act does not exempt federally insured, state-chartered credit unions from taxation. Certain federally insured, state-chartered credit unions are, however, exempted from federal income tax under § 501(c)(14)(A) of the Internal Revenue Code. Section 501(c)(14)(A) of the Internal Revenue Code provides that a state credit union without capital stock organized and operated for mutual purposes without profit is exempt from federal income taxes.[10]

Please note that some services and activities typically attributed to credit unions are actually provided by state-chartered entities called credit union service organizations. More commonly known as CUSOs, these are corporate entities owned by federally chartered or federally insured, state-chartered credit unions that provide a number of services to credit unions, including loan underwriting, payment services, and back-office functions like human resources and payroll, among others. The FCUA permits federal credit unions to organize, invest in, and lend to credit union service organizations. These organizations, however, are not subject to NCUA examination, and are not exempted from federal taxation under the FCUA.

In section 2 of CUMAA, Congress found the following:

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[8] Some provisions of Title II—Insurance—of the FCUA and the NCUA's Regulations limit the activity of federally insured, state-chartered credit unions. Congress has chosen to impose certain limitations on all federally insured credit unions. The NCUA's regulatory limitations applicable to all federally insured credit unions are to achieve the purpose of Title II of the FCUA.

[9] 12 U.S.C. 1768.

[10] At this time, there does not appear to be an established definition of "capital stock" used by the IRS.

> (1) The American credit union movement began as a cooperative effort to serve the productive and provident credit needs of individuals of modest means.
>
> (2) Credit unions continue to fulfill this public purpose, and current members and membership groups should not face divestiture from the financial services institution of their choice as a result of recent court action.
>
> (3) To promote thrift and credit extension, a meaningful affinity and bond among members, manifested by a commonality of routine interaction, shared and related work experiences, interests, or activities, or the maintenance of an otherwise well-understood sense of cohesion or identity is essential to the fulfillment of the public mission of credit unions.
>
> (4) 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.
>
> (5) Improved credit union safety and soundness provisions will enhance the public benefit that citizens receive from these cooperative financial services institutions.[11]

Allowing federal credit unions to operate with the full authority provided in the FCUA is consistent with safety and soundness and Congress' intent. Conversely, the extent to which state-chartered credit unions choose to engage in—and state legislatures allow—services and activities beyond their tax-exempt purpose dictates whether they are subject to the federal unrelated business income tax.[12]

5. What data does NCUA collect on executive compensation at credit unions?

The NCUA's quarterly Call Report has an entry for compensation, which includes all compensation at a credit union, including executive compensation.[13] Consistent with the requirements applicable to similarly situated privately held banks, the NCUA does not require credit unions to separately report additional information on their executive compensation arrangements.[14] The NCUA, however, does assesses executive compensation during examinations to ensure credit unions' compensation programs follow applicable regulations and do not threaten their safety and soundness.

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[11] Pub. L. 105–219, § 2, 112 Stat. 913, 914 (1998) (codified at 12 U.S.C.A. 1751 note).
[12] *See, e.g.*, IRS Memorandum, *Interim Guidance on Applicability of Unrelated Business Income Tax (UBIT) to State Chartered Credit Unions Described in IRC § 501(c)(14)(A)* (March 24, 2015) available at https://www.irs.gov/pub/foia/ig/spder/TEGE-04-0315-0007%20Applicability%20of%20UBIT%20to%20State%20Chartered%20Credit%20Unions%5B1%5D.pdf.
[13] This is account code 210 on the current version of the call report, NCUA Form 5300.
[14] There are some limits on compensation in the NCUA Regulations, such as 12 CFR §§ 701.19, and 701.21.

The NCUA's *Examiner's Guide* sets forth the expectations for this review. NCUA examiners are required to review employees' compensation, including executive compensation, for reasonableness. Examiners are also required to ensure that the credit union's board of directors perform an annual review of all compensation arrangements and employment contracts for senior management personnel, and that the reviews are documented in board meeting minutes.[15] The *Examiner's Guide* also provides numerous examples of compensation practices that may be unsafe or unsound. In addition, §§ 701.19 and 701.21 of the NCUA's regulations set regulatory limits on the compensation and benefits credit unions may provide to their employees.[16]

Taken together, the NCUA's regulations and exam policies help ensure that any compensation practices that could pose a threat to a credit union's safety and soundness are identified and addressed quickly.

6. How has the NCUA considered the issue of public disclosure of executive compensation since the GAO recommendation in 2006?

The NCUA has taken several actions that demonstrate its ongoing commitment to ensuring that credit union executives fulfill their fiduciary duties to credit union members. First, in 2010, the NCUA amended its corporate credit union rule to require corporate credit unions (corporates) to disclose executive compensation as follows:

1. Corporate credit unions with 41 or more employees must disclose compensation paid to the top five most highly paid individuals;

2. Corporate credit unions with between 30 and 41 full time employees must disclose the compensation paid to the four most highly paid employees;

3. Corporate credit unions with 30 or fewer full time employees must disclose compensation paid to the three most highly paid individuals; and

4. If the chief executive officer of a corporate credit union is not already included among the most highly compensated employees, the corporate credit union must also disclose the CEO's compensation.[17]

In 2011, the NCUA also adopted a regulation to prohibit most golden-parachute arrangements, that is, payments made to an institution-affiliated party that are contingent on the termination of that person's employment and received when a federally insured credit union is in troubled condition.[18] Similarly, the NCUA, along with five other agencies, proposed joint regulations to implement incentive compensation provisions of the Dodd-Frank Act in 2011, and again in 2016. The proposal would prohibit incentive-based compensation arrangements that encourage

[15] NCUA Examiner's Guide, p. 7-22, available at https://www.ncua.gov/Legal/GuidesEtc/ExaminerGuide/Chapter07.pdf.
[16] 12 CFR §§ 701.19, and 701.21.
[17] 12 C.F.R. § 704.19(a).
[18] 12 C.F.R. Part 750.

inappropriate risks, and would require additional disclosures of compensation arrangements to regulators. At this time, the agencies are reviewing the 2016 incentive-based compensation proposal. I believe, however, that the issue of incentive-based compensation can still be addressed adequately through interagency guidance issued jointly by the agencies involved in the rule making.

In the context of voluntary mergers or business combinations, the NCUA recently proposed to update the disclosures a merging federal credit union must make available to its members. The proposal would require notice be sent to all members listing payments or increases in compensation paid to officials of the merging credit union as a result of the business combination.[19] The NCUA Board hopes to finalize a version of the proposal later this year.

These actions demonstrate the NCUA's commitment to ensuring the safety and soundness of credit union executive compensation practices and remind credit union executives that they are stewards of the credit union's net worth, which belongs to all members.

In summary, we believe that eliminating the credit union tax exemption, without also eliminating the statutory restrictions on credit unions, would almost certainly have a detrimental effect on the credit union system and increase losses to the Share Insurance Fund, which could ultimately fall to U.S. taxpayers. Moreover, we believe the regulatory changes and allowances you reference in your letter are all consistent with the requirements of the FCUA and the spirit of the President's Executive Order on regulatory relief.

Thank you for the opportunity to provide the NCUA's perspective on these important issues. The NCUA will continue to execute its duties as a prudential regulator to maintain the safety and soundness of the Share Insurance Fund while also ensuring compliance with all laws we are charged to enforce.

Please let me know if I can be of further assistance.

Sincerely,

J. Mark McWatters
Chairman

[19] 82 Fed. Reg. 26605, 26606 (June 8, 2017).