PERFORMANCE AUDIT REPORT

Regulation of Credit Unions: Reviewing the Department of Credit Unions' Procedures for Ensuring Institutions' Safety, Soundness, and Compliance with the Law

Executive Summary

with Conclusions and Recommendations

A Report to the Legislative Post Audit Committee
By the Legislative Division of Post Audit
State of Kansas
May 2006

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Legislative Post Audit Committee
Legislative Division of Post Audit

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May 15, 2006

To: Members of the Kansas Legislature

This executive summary contains the findings and conclusions, together with a summary of our recommendations and the agency response, from our completed performance audit, *Regulation of Credit Unions: Reviewing the Department of Credit Unions' Procedures for Ensuring Institutions' Safety, Soundness, and Compliance with the Law*.

The report also contains one appendix showing the services that credit unions provide.

The report includes several recommendations which should help make the Department's process for regulating credit unions more consistent and effective. We've also recommended that the Department either enforce the current provisions of State law related to fields of membership, or it should seek to have the law amended. We would be happy to discuss these recommendations or any other items in the report with you at your convenience.

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EXECUTIVE SUMMARY

LEGISLATIVE DIVISION OF POST AUDIT

Overview of the Department of Credit Unions

The Department of Credit Unions was established in 1968 to oversee the safety and soundness of Kansas-chartered credit unions. Unlike banks and savings and loans, credit unions are not-for-profit entities with limited membership. As of June 2005, 96 Kansas-chartered and 26 federally chartered credit unions were operating in Kansas. The main difference between a federal charter and a state charter is the regulating authority; the Department oversees all credit unions that have chosen to have a Kansas charter.

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Question 1: To What Extent Have Credit Unions Grown in Comparison with Other Segments of the Financial-Services Industry?

Since 1995, the number of financial institutions operating in Kansas dropped by 20%. *Between 1995 and 2005, their numbers dropped from 648 to 517. As of June 2005, 26 of these institutions (5%) had home offices located in another state. About 75% of the Kansas-based credit unions and banks were State-chartered; most savings and loans were federally chartered.*

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Kansas-based credit unions' share of total assets, deposits, and loans have remained fairly constant over the years. *In both 1995 and 2005, their assets, loans, and deposits represented about 5-6% of the total held by all Kansas-based financial institutions. Among Kansas-based financial institutions, State-chartered credit unions and banks have grown significantly more than their federally chartered counterparts. Kansas-based financial institutions generally haven't grown as fast as financial institutions nationwide.*

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Question 2: How Have Kansas Credit Union Services Changed in Recent Years, and Are the Department's Actions Related to Expanded Services in Accordance with the Law?

State laws and regulations govern the basic services that Kansas-chartered credit unions can offer to their members. *Under State law, Kansas-chartered credit unions can provide services such as loans, savings accounts, safe deposit boxes, and checking accounts. The law also allows them to provide other services through their "incidental powers," but the Department hasn't adopted any policies to define that term.*

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State law and Department regulations allow credit unions to provide other services to their members—such as financial planning and counseling, income tax preparation, credit and debit card services, and debt-collection services—through a credit union services organization. These entities are defined as "an organization established to provide operational and financial services primarily to credit unions." As of December 2005, 32 Kansas-chartered credit unions had invested in 13 for-profit credit union services organizations.

Finally, State law allows the Department to approve additional services that credit unions can provide on a case-by-case basis. Department officials told us they recalled receiving only a few requests over the past decade. Most of those were received since September 2005, and sought approval to charge members a fee in exchange for allowing them to skip one month's loan payment.

Credit unions have expanded the services they offer in a number of ways over the past 10 years. *Mostly, we found that more credit unions simply were offering more of the services they historically have been authorized to provide, including checking accounts, mortgages, and credit cards. Some smaller credit unions have accomplished this by merging with larger credit unions. Credit unions also have expanded the services they provide through the creation of more credit union services organizations. Department policies don't require examiners to review the services a credit union or its services organizations offer during routine examinations.*

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Credit unions also have expanded who they serve by increasing their "field of membership." *Under State law, credit unions' memberships are limited to "groups...having a common bond of occupation or association or to groups residing within a well-defined neighborhood, community or rural district." The Department's interpretation of credit unions' membership requirements doesn't appear to conform to State law. The Department has interpreted the law to allow:*

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- *the definition of "groups residing within a well-defined neighborhood, community, or rural district" to include residents of the entire State*
- *credit unions to combine groups with occupational bonds and groups with geographic bonds*

In 1998, the U.S. Supreme Court ruled that federal law, which was worded much like Kansas' current law, didn't allow federally chartered credit unions to have multiple common bonds. Federal lawsuits in Utah and Pennsylvania and a state lawsuit in Missouri are currently in process regarding field-of-membership expansions. Current and former Department officials told us no proposals to change Kansas law have been made, primarily because the Department's interpretation hasn't been challenged.

Conclusion. *For a variety of reasons over the past 10 years, more Kansas-chartered credit unions have started offering their members more of the traditional financial services they've historically been authorized*

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to provide—such as checking accounts, first mortgage loans, and credit cards. Because of the Department's liberal interpretation of State law, some of those credit unions also have significantly increased the number of members they serve. Based on our reading of Kansas law, and on the U.S. Supreme Court's interpretation that a federal law almost identical to Kansas' law didn't allow credit unions' membership to be expanded in the ways the Department has allowed, we think the Department's current practice isn't in conformance with State law.

Recommendations. *We recommended that the Department either enforce the provisions of State law related to credit unions' field of membership, or if the Department thinks it's important to the safety and security of credit unions to allow their fields of membership to be expanded in the ways it has allowed them to expand over the years, it should seek to have State law amended accordingly. We also recommended that the Department adopt either new polices or administrative regulations which clearly define the "incidental powers and services" that Kansas-chartered credit unions have and can provide.*

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Question 3: Does the Department of Credit Unions Have Adequate Procedures for Ensuring the Safety and Soundness of Credit Unions, and How Do They Compare to Oversight Procedures for Other Financial Institutions?

The Department has adopted federal regulators' examination process and system for rating credit unions' financial condition. *Like most other states, Kansas has adopted the National Credit Union Administration's process for examining credit unions. Through this process, examiners develop a CAMEL rating score (from 1 to 5, with 1 being the best) that serves as an indicator of each credit union's financial safety and soundness. Scores for individual areas are used to develop a composite rating. From 1995 through 2004, 15% of exams of Kansas-chartered credit unions resulted in a CAMEL composite rating of "1," while less than four percent received a composite rating of 4 or 5. Nationally, 20% of all examinations of federally insured credit unions resulted in a "1" rating for this period, and less than three percent received a rating of 4 or 5.*

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For the most part, we found the Department has and follows adequate procedures to ensure the safety and soundness of credit unions, but some improvements are needed.

The Department is examining credit unions on a timely basis, but needs to address issues related to examiner independence and follow-up actions. *Department examiners haven't completed the required conflict-of-interest form for the past five years. Department procedures also don't prohibit its staff from reviewing and approving examination reports for credit unions where their family members are employed, and we found one such instance where a Department manager was involved in*

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the review process. The Department also could improve its guidance to examiners about when to make a formal recommendation to credit union management. And primarily because of a vacancy in a key management position during 2005, Department officials didn't adequately follow-up on recommendations that credit unions failed to implement. However, we did note that all 13 written complaints the Department received in 2005 were handled promptly and completely.

Staff's review of quarterly financial reports can be more complete. *Credit unions are required to submit quarterly financial reports to the Department and the National Credit Union Administration. After Kansas examiners verify the accuracy of these reports, the National Credit Union Administration runs various analyses to identify risk factors, and passes that information to the Department. These analyses allow the Administration and the Department to monitor credit unions' financial condition between exams, and to identify those whose condition may be deteriorating significantly. Department procedures don't describe what examiners should be looking for when reviewing a credit union's quarterly report, or what information they should report to management.*

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The Department lacks adequate guidance for when an enforcement action should be taken. *We identified two areas of concern. First, the Department has no written guidance on when it should enter into voluntary Letters of Understanding and Agreement with credit unions that don't follow its recommendations, or when an enforcement action should be taken. Second, in one case where a Letter of Understanding and Agreement was issued, the Department's actions weren't adequate to ensure that serious problems were corrected promptly.*

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Managers of credit unions we surveyed were satisfied with the Department's actions related to credit unions. *We surveyed 93 managers of Kansas-chartered credit unions and received 65 responses, a response rate of 70%. Most survey respondents indicated they were very pleased with the Department's oversight activities. For example, 97% indicated they thought the Department was effective at ensuring the safety and soundness of Kansas credit unions.*

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The Department's oversight procedures are similar to those of the State Bank Commissioner's Office. *However, we identified two areas where the Bank Commissioner's procedures and practices appeared to provide better regulatory oversight of financial institutions. First, the Bank Commissioner's procedures for reviewing quarterly risk reports provided by the Federal Deposit Insurance Corporation, require staff to submit short written evaluations of all potentially at-risk banks to management. Second, the Bank Commissioner has the authority to levy a civil monetary penalty of up to $1,000 per day when financial institutions fail to take required actions.*

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Conclusion. *In general, we found that the Department of Credit Unions has reasonable procedures in place for ensuring the safety and* *soundness of credit unions. The vast majority of credit union managers we surveyed also were satisfied with the Department's actions. Still, the improvements we've identified should provide even greater assurance that the Department's regulatory efforts are consistent and effective.*

***Recommendations**. We recommended that the Department take several steps to help ensure that its process for examining credit unions treats them consistently and operates in an effective manner. These include having examiners complete conflict-of-interest forms annually, and developing procedures outlining the steps the Department will take when credit unions don't submit required documentation of corrective action by the due date. We also recommended that the Department develop polices to address such issues as providing better guidance to examiners regarding their quarterly reviews of credit unions' reports, and when Letters of Understanding and Agreement or other enforcement actions will be taken.*

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Question 4: Is the Department Effectively Regulating the Influence of Out-of-State Credit Unions?

Between 1998 and 2005, eight Kansas-chartered credit unions merged with six out-of-State credit unions. *As a result of these mergers, about $240 million of assets were transferred away from the Department's oversight to regulators in these out-of-State credit unions' home states. CommunityAmerica Credit Union of Missouri was involved in 3 of the 8 mergers, and acquired about $222 million in assets formerly held by Kansas-based credit unions.*

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The Department appears to have exercised reasonable oversight over mergers involving credit unions from other states. *Nothing in State law would preclude an out-of-State credit union from operating in Kansas. Through our testwork, we found the Department generally followed statutory requirements related to allowing credit unions to merge. However, we couldn't tell from the documentation in the files whether or to what extent Department staff had reviewed merging credit unions' financial statements and the other documents they'd submitted. In addition, we found that Kansas' merger requirements for credit unions are similar to those for other states and for Kansas banks. Kansas doesn't have reciprocity agreements with other states, but it appears there's no need for such agreements.*

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Currently, there doesn't seem to be a significant competitive advantage for out-of-State credit unions that operate in Kansas. *In Kansas and other states, responsibility for regulating out-of-state credit unions lies with the state the credit union is chartered in. Most states have similar systems for regulating credit unions, and Kansas-chartered credit unions can seek permission to provide any services that a federally insured out-of-State credit union can provide.*

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The one area we saw where there could be a competitive advantage: Kansas-chartered credit unions have had to pay higher regulatory fees than their out-of-State counterparts operating in Kansas. That may have changed somewhat with the passage of House Bill 2099; beginning in fiscal year 2006, out-of-State credit unions also must pay annual fees to the Department. We also noted that credit unions chartered in Missouri have to pay a franchise tax, while Kansas-chartered credit unions don't have to pay that tax.

Conclusion. *Based on our reviews, and given its limited statutory responsibility related to mergers, we didn't see anything to suggest that the Department wasn't effectively regulating the influence of out-of-State credit unions. The only issue we identified related to providing better documentation of the actions Department staff took when reviewing merger documents. Although out-of-State credit unions operating in Kansas have paid lower regulatory fees, the 2005 Legislature required them to pay partial fees to Kansas on top of the regulatory fees they pay to their home states.* ....page 34

Recommendation. *We recommended that Department staff document their review of merger documents.* ....page 34

In its response, the Department indicated that it generally agreed with the findings and conclusions of this report.

This audit was conducted by Joe Lawhon, Levi Bowles, Lisa Hoopes, and Ivan Williams. Leo Hafner was the audit manager. If you need any additional information about the audit's findings, please contact Joe at the Division's offices. Our address is: Legislative Division of Post Audit, 800 SW Jackson Street, Suite 1200, Topeka, Kansas 66612. You also may call us at (785) 296-3792, or contact us via the Internet at LPA@lpa.state.ks.us.