PERFORMANCE AUDIT REPORT

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

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

06PA01

Legislative Post Audit Committee

Legislative Division of Post Audit

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May 8, 2006

To: Members, Legislative Post Audit Committee

Senator Les Donovan, Chair	Representative John Edmonds, Vice-Chair
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This report contains the findings, conclusions, and recommendations 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 any legislative committees, individual legislators, or other State officials.

Barbara J. Hinton
Legislative Post Auditor

READER'S GUIDE

Get the Big Picture

Read these Sections and Features:

1. **Executive Summary** - an overview of the questions we asked and the answers we found.
2. **Conclusion** and **Recommendations -** are referenced in the Executive Summary and appear in a box after each question in the report.
3. **Agency Response** - also referenced in the Executive Summary and is the last Appendix.

Helpful Tools for Getting to the Detail

- In most cases, an "**At a Glance**" description of the agency or department appears within the first few pages of the main report.
- **Side Headings** point out key issues and findings.
- **Charts/Tables** may be found throughout the report, and help provide a picture of what we found.
- **Narrative text boxes** can highlight interesting information, or provide detailed examples of problems we found.
- **Appendices** may include additional supporting documentation, along with the audit **Scope Statement** and **Agency Response(s)**.

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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 <u>*services organization*</u>*. 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.

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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.* ....page 17

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 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.* ....page 20

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 <u>between</u> 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.* ....page 21

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.* ....page 22

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.* ....page 24

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.* ....page 24

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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 other state regulators or the National Credit Union Administration. 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.* ....page 27

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* ....page 29

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.

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.* ....page 31

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.

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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.

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

Under State law, any seven residents of Kansas can apply to the Department of Credit Unions for permission to organize a credit union. The law limits credit union membership to groups having a common bond of occupation or association, or living within a well-defined neighborhood, community, or rural district.

The Department examines all State-chartered credit unions to ensure that they are financially stable and in compliance with State and federal laws and regulations. It also grants new charters and mergers, handles consumer complaints, and oversees closures when necessary.

Because credit unions have expanded their range of services in recent years, legislators have expressed an interest in knowing whether the Department is providing adequate oversight of credit unions' expanded services, whether Kansas consumers are adequately protected, and whether the Department has adequate procedures for regulating expansions or mergers of credit unions.

Legislators also have expressed a number of concerns about out-of-State credit unions, such as how many have expanded operations into Kansas, how many Kansas credit unions they've acquired, and what impact those acquisitions have had on the Department's ability to carry out its mission. They also want to know whether the Department has allowed out-of-State credit unions to operate in Kansas without requiring reciprocity agreements allowing Kansas credit unions to operate in other states, and whether Kansas laws or regulations or Department actions may have put Kansas credit unions at a competitive disadvantage.

To address these questions and concerns, this performance audit addresses the following questions:

1. **How have Kansas credit union services changed in recent years, and to what extent have credit unions grown in comparison with other segments of the financial-services industry?**

2. **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?**

3. **Are the Department's actions in relation to credit unions' expanded services consistent with State law?**

4. **Is the Department effectively regulating the influence of out-of-State credit unions?**

To answer these questions, we reviewed State laws governing the powers and duties of the Department of Credit Unions. We also reviewed Department polices, procedures, and regulations related to monitoring, handling complaints, examinations, and enforcement actions to determine whether they conform to statutory requirements and best practices, and how they compare with the Office of the State Bank Commissioner. In addition, we reviewed a sample of credit union examinations and other Department records to determine whether staff were following procedures.

We gathered information from the National Credit Union Administration, Federal Deposit Insurance Corporation, and Kansas Credit Union Association to determine how the number of credit unions in Kansas and nationally has changed in relation to the number of banks and savings and loans. We also used that information to help determine how credit union services have changed over the past 10 years.

Finally, we surveyed all credit union administrators in Kansas to see what they thought about regulation in Kansas and about whether out-of-State credit unions were operating at a competitive advantage in Kansas.

A copy of the scope statement the Legislative Post Audit Committee approved for this audit is included in ***Appendix A***. For reporting purposes, we modified the questions to combine the discussion about how credit union services have changed in recent years with our findings about whether the Department's actions regarding expanded services are consistent with State law. In conducting this audit, we followed applicable government auditing standards set forth by the U.S. Government Accountability Office. The reader should be aware that National Credit Union Administration and Federal Deposit Insurance Corporation data were used throughout the audit. There was no way for us to assess the accuracy of that information.

Our findings begin on page 5, following a brief Overview.

The Department of Credit Unions Was Established in 1968 To Oversee the Safety and Soundness of Kansas Credit Unions

Before the Department was established in 1968, the Office of the State Bank Commissioner regulated credit unions. The Department's primary responsibilities related to the safety and soundness of Kansas-chartered credit unions include the following:

- examining each credit union at least once every 18 months
- reviewing and validating quarterly reports the credit unions submit to the National Credit Union Administration
- approving mergers to ensure the resulting credit union is financially healthy
- investigating complaints against credit unions
- taking enforcement action against credit unions when conditions warrant such an action

To carry out these responsibilities the Department has 13 employees, including nine examiners who work from their homes in various locations throughout the State. The Department is funded primarily by annual fees it charges to all state-chartered credit unions that operate in Kansas.

Unlike Banks and Savings and Loans, Credit Unions Are Not-for-Profit Entities With Limited Membership

Credit unions, banks, and savings and loans are all depository financial institutions. But as ***Figure OV-1*** shows, two primary factors distinguish credit unions from the other financial institutions:

- Credit unions are not-for-profit organizations governed by volunteer boards elected by the credit union members.
- Credit union membership is limited to a specific group of people. Two terms are commonly used to define that membership: "common bond" and "field of membership." Those terms are described below.

Figure OV-1
Comparing Characteristics of Financial Institutions

Characteristics	Credit Unions	Banks	Savings and Loans
Profit Status	Not-for-profit	For-profit	For-profit
Structure of the Financial Institution	Cooperative	Corporation	Corporation
Pays Federal Income Tax	No	Yes	Yes
Issues Capital Stock	No	Yes	Yes
Membership Limited to a Common Bond	Yes	No	No
Receives Deposits From Individuals	Yes	Yes	Yes
Makes Loans	Yes	Yes	Yes
Insuring Agency	National Credit Union Administration (NCUA)	Federal Deposit Insurance Corporation's (FDIC) Bank Insurance Fund (BIF)	Federal Deposit Insurance Corporation's (FDIC) Savings Association Insurance Fund (SAIF)

Source: LPA analysis of FDIC and NCUA data.

- **Common Bond**: the characteristic that distinguishes a particular group of people from the general public. A common bond may be where people live, work, or go to church. Currently a credit union's membership may be based on more than one common bond (e.g., individuals who are educators or individuals who reside in Shawnee County).

- **Field of Membership**: the people who could become members because of the criteria set forth in the common bond. (e.g., the total number of individuals who are educators or who reside in Shawnee County).

Figure OV-2 Regulatory Authority of Kansas-Based Financial Institutions as of June 30, 2005				
Type of Financial Institution	Kansas-Chartered		Federally Chartered	
	Regulator	Number Operating in Kansas	Regulator	Number Operating in Kansas
Credit Unions	Kansas Department of Credit Unions	96	National Credit Union Administration	26
Banks	Office of the State Bank Commissioner	261	Office of the Comptroller of the Currency	93
Savings & Loans	Office of the State Bank Commissioner	0	Office of Thrift Supervision	17
Source: LPA analysis of FDIC and NCUA data.				

Financial institutions can choose to be either federally chartered or State-chartered. The main difference is the regulating authority. For example, federally chartered credit unions are regulated by the National Credit Union Administration, while Kansas-chartered credit unions are regulated by the Department of Credit Unions. ***Figure OV-2*** shows the number of Kansas-based financial institutions operating in the State as of June 2005, and the agency responsible for regulating them.

As of June 2005, 96 Kansas-chartered and 26 federally chartered credit unions were operating in Kansas. All but two of the 96 Kansas-chartered credit unions were what's called "natural person" credit unions—they provide services directly to individuals and businesses. The other two were corporate credit unions, which provide services only to other credit unions, including loans, investments, check collection, wire transfers, and other banking services.

Kansas Department of Credit Unions
AT A GLANCE

Authority: Created by K.S.A. 17-2234. As of June 30, 2005, the Department was responsible for overseeing 94 "natural person" State chartered credit unions and two corporate credit unions.

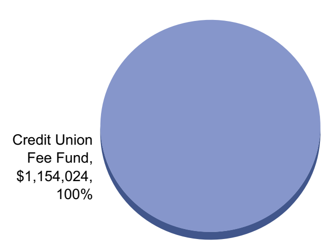
Staffing: The Department has 13 full-time-equivalent staff positions.

Budget: The Department is a fee-funded agency. Fees are assessed to individual credit unions based on the amount of assets each has at the close of each calendar year. In accordance with K.S.A. 75-3170a, 20% of the total revenue collected - up to a maximum of $200,000 - is deposited into the State General Fund. The Department forwards this revenue to reimburse the State General Fund for accounting, auditing, budgeting, legal, payroll, and other services performed on behalf of it by other State agencies which receive appropriations from the State General Fund. For fiscal year 2006, it's estimated the Department will collect almost $1.2 million and spend about $1 million. As shown below, most of the Department's expenditures are for salaries and wages.

Estimated FY 2006 Expenditures

Type	Amount	% of Total
Salaries and wages	$801,980	80%
Contractual services	$164,106	16%
Capital outlay	$18,600	2%
Commodities	$16,770	2%
Total Expenses:	**$1,001,456**	**100%**

Sources for Funding for Expenditures



Total Funding: **$1,154,024**

Source: *The Governor's Budget Report*, Vol. 2, FY 2007, and Department financial records.

For the remainder of this report, when we use the term credit union we are referring to natural person credit unions. Also, the data we report don't include data for corporate credit unions unless otherwise indicated.

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

ANSWER IN BRIEF: *Between 1995 and 2005, the total number of financial institutions operating in Kansas (both Kansas-based and those based in other states) has declined by 20%. In both years, credit unions made up about one-fourth of the total financial institutions operating in Kansas. Compared to Kansas-based banks and savings and loans, Kansas-based credit unions' share of total assets, deposits, and loans also hasn't changed much – generally ranging from 5-6% of the total in each of those categories. Finally, Kansas financial institutions haven't grown as fast as financial institutions nationally. These and related findings are described in the sections that follow.*

Since 1995, the Number Of Financial Institutions Operating in Kansas Has Dropped by 20%

In 1995, a total of 648 financial institutions were operating in Kansas. By 2005, that number had dropped to 517. As the left half of ***Figure I-1*** shows, credit unions accounted for about one-fourth of the financial institutions operating in Kansas in both 1995 and 2005.

Figure I-1
Number of Financial Institutions Operating in Kansas
As of June 1995 and 2005

	Institutions					Locations			
	1995		2005		% change 95-05	1995		2005	
Institutions	**#**	**% of Total**	**#**	**% of Total**		**#**	**% of Total**	**#**	**% of Total**
Credit Unions	167 (a)	26%	128	25%	**-23%**	NA (b)		221	13%
Banks	450	69%	367	71%	**-18%**	1,058		1,360	79%
Savings & Loans	31	5%	22	4%	**-29%**	163		145	8%
Total	**648**	**100%**	**517**	**100%**	**-20%**			**1,726**	**100%**

(a) This number is estimated because data weren't available for the number of non-Kansas-based credit unions in 1995. Department officials told us they didn't think there had been any significant change in that number during the past 10 years, so we used the same number (8) that existed in June 2005 for our estimate.
(b) The NCUA didn't collect this information from 1991 to 2002.

Source: LPA analysis of NCUA and FDIC data

The right half of the figure shows the number of separate locations these financial institutions had in Kansas. Data for credit unions weren't available for 1995, but they had 221 locations in Kansas as of June 2005, compared with 1,360 for banks and 145 for savings and loans.

The vast majority of these financial institutions are based in Kansas, but as of June 2005, 26 of them (5%) were based in another state. (Based means the state where the institution reports its home office is located.) For example, Bank of America and US Bank have branches in several Kansas cities, but are based in North Carolina and Ohio, respectively. Eight of the 26 financial institutions based in other states were credit unions.

Type of Institution	1995		2005	
	Number	% of Total	Number	% of Total
CREDIT UNIONS				
Kansas-Chartered	122	77%	94	78%
Federally Chartered	37	23%	26	22%
Subtotal	**159**	**100%**	**120**	**100%**
BANKS				
Kansas-Chartered	322	72%	261	74%
Federally Chartered	127	28%	93	26%
Subtotal	**449**	**100%**	**354**	**100%**
SAVINGS AND LOANS				
Kansas-Chartered	1	4%	0	0%
Federally Chartered	22	96%	17	100%
Subtotal	**23**	**100%**	**17**	**100%**
Total Institutions	**631**	**--**	**491**	**--**

Figure I-2
Number of Kansas-Based Financial Institutions
As of June 1995 and 2005

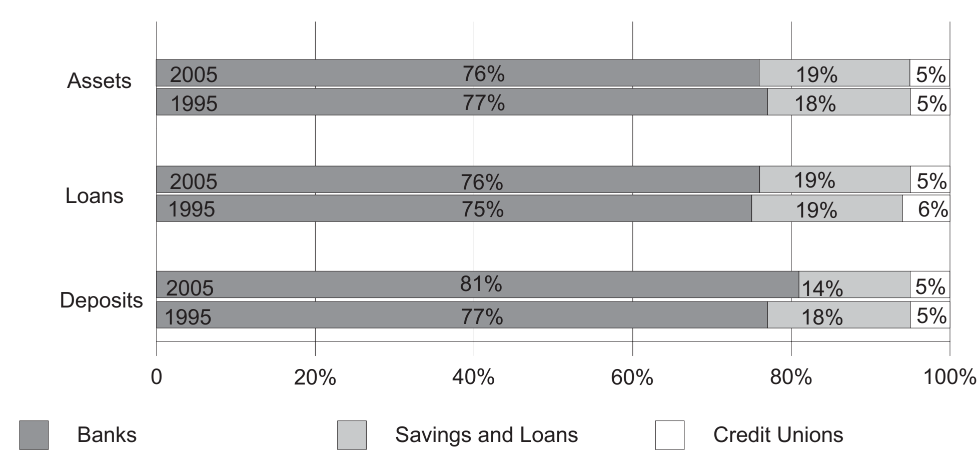
Source: LPA analysis of NCUA and FDIC data

Most Kansas-based credit unions and banks are State-chartered, rather than federally chartered. As shown in ***Figure I-2***, in both years about 75% of all banks and credit unions were State-chartered, while savings and loans primarily were federally chartered.

Kansas-Based Credit Unions' Share of Total Assets, Deposits, And Loans Have Remained Fairly Constant Over the Years

One question raised at the time this audit was approved was whether credit unions had grown in Kansas at the expense of other financial institutions. We weren't able to fully address that issue because non-Kansas-based financial institutions (such as US Bank, Bank of America, Great Plains Federal Credit Union, or CommunityAmerica Credit Union) don't report asset, loan, and deposit information separately for the offices they operate in Kansas. Instead, all data for those institutions is reported under the state in which they are based. As a result, our analysis in this area had to be limited just to Kansas-based institutions.

Figure I-3
Percentage of Loans Assets, and Deposits in Kansas-Based Financial Institutions
December 1995 and December 2005



Source: LPA analysis of NCUA and FDIC data

As ***Figure I-3*** shows, the assets, loans, and deposits Kansas-based credit unions held in both 1995 and 2005 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. As ***Figure I-4*** on the next page shows, Kansas-chartered credit unions' assets grew by 35%, while assets in federally chartered credit unions decreased by 42%. Similarly Kansas-chartered banks' assets grew by 47%, while assets in federally chartered banks decreased by six percent. That same general trend held true for loans and deposits as well. The figure also shows that no State-chartered savings and loans were operating in Kansas near the end of 2005–in fact, none have existed since 1997.

Figure I-5
Comparing Inflation-Adjusted Growth in Assets, Loans, and Deposits in Kansas-Based Institutions to All U.S.-Based Institutions
December 1995- December 2005

Type of Institution	% Growth in		
	Assets	Loans	Deposits
All U.S.-Based Institutions			
Banks	64%	61%	57%
Savings and Loans	40%	59%	13%
Credit Unions	73%	87%	67%
Total Growth	**60%**	**62%**	**49%**
Kansas-Based Institutions			
Banks	20%	45%	12%
Savings and Loans	27%	38%	-17%
Credit Unions	17%	28%	11%
Total Growth	**21%**	**43%**	**7%**

Source: LPA analysis of NCUA and FDIC data.

Kansas-based financial institutions generally haven't grown as fast as financial institutions nationwide. ***Figure I-5*** compares asset, loan, and deposit growth for Kansas-based financial institutions to all banks, credit unions, and savings and loans nationwide. (In reviewing these percentages, the reader should remember that Kansas financial information wasn't available for non-Kansas-based institutions operating in the State. Those include some large institutions, such as US Bank, Bank of America, Great Plains Federal Credit Union, and CommunityAmerica Credit Union. If this information had been available, the growth picture for U.S.-based and Kansas-based institutions may have looked more similar.)

Some items worth noting from the figure:

- Nationwide, credit unions' growth in assets, loans, and deposits outpaced the growth rate for the other financial institutions. From 1995 to 2005, credit unions' assets grew 73%. That compares to 64% for banks and 40% for savings and loans. But nationwide, banks' assets of $9.0 trillion were 13 times higher than credit unions' assets of $692 billion.

- Looking just at Kansas-based institutions, credit unions' didn't increase their assets and loans as much as banks and savings and loans. But credit union deposits grew at a higher percentage than savings and loans and at nearly the same rate as banks. As shown in Figure I-4, Statewide, banks' assets of $48.2 billion were about 16 times higher than credit unions' assets of $3.1 billion.

Figure I-4
Comparing Inflation-Adjusted Change in Assets, Loans, and Deposits of Kansas Based Financial Institutions
December 1995 to December 2005

Type of Institution	Assets (in Billions)			Loans (In Billions)			Deposits (in Billions)		
	1995	2005	Change	1995	2005	Change	1995	2005	Change
CREDIT UNIONS									
Kansas-Chartered Credit Unions	$2.0	$2.7	35%	$1.4	$2.0	43%	$1.8	$2.3	26%
Federally Chartered Credit Unions	$0.6	$0.4	-42%	$0.3	$0.2	-33%	$0.5	$0.3	-41%
Total for Credit Unions	$2.6	$3.1	17%	$1.7	$2.2	28%	$2.3	$2.6	11%
BANKS									
Kansas-Chartered Banks	$19.6	$28.7	47%	$10.3	$19.4	87%	$16.7	$22.7	36%
Federally Chartered Banks	$20.7	$19.5	-6%	$11.4	$12.0	6%	$17.3	$15.4	-11%
Total for Banks	$40.3	$48.2	20%	$21.7	$31.4	45%	$34.0	$38.1	12%
SAVINGS AND LOANS									
Kansas-Chartered Savings and Loans	$0.03	$0.0	-100%	$0.02	$0.0	-100%	$0.03	$0.0	-100%
Federally Chartered Savings and Loans	$9.7	$12.3	28%	$5.6	$7.8	39%	$7.8	$6.4	-17%
Total for Savings and Loans	$9.7	$12.3	27%	$5.6	$7.8	38%	$7.8	$6.4	-17%
TOTAL	$52.6	$63.6	21%	$29.0	$41.4	43%	$44.1	$47.1	7%

Source: LPA analysis of NCUA and FDIC data.

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

Answer in Brief:

Credit unions can offer a wide variety of financial services directly to their members under current law. In addition, Department regulations allow them to offer many other financial-related services—such as investment counseling, tax preparation, and insurance—indirectly through their credit union services organizations. Over the past 10 years, more credit unions have begun offering basic financial services than ever before, including checking accounts and first mortgage loans. That can happen when smaller credit unions that don't provide such services merge with larger credit unions that do. Credit unions also are making greater use of the Internet and associated technology to deliver their services.

In addition, the Department has liberally interpreted a State law that limits credit unions' memberships only to groups with common occupational or geographic bonds, which has allowed some credit unions to significantly expand the number of people they can serve. We think the Department's practices in this area are not in accordance with the law, and similar provisions have been challenged at the federal level and in several other states. These and other findings are described in the sections that follow.

State Laws and Regulations Govern the Basic Services That Kansas-Chartered Credit Unions Can Offer To Their Members

Under K.S.A. 17-2204, Kansas-chartered credit unions can provide a wide variety of basic financial services. These include the following:

- making loans to members, including mortgage and student loans
- receiving member savings
- providing safe deposit boxes or other safekeeping facilities
- providing negotiable checks, money orders, travelers' checks, or any other money-type instruments or transfer methods

The law also allows credit unions to "exercise such powers, including incidental powers, as shall be necessary or requisite to enable it to carry on effectively the purposes and business for which it is incorporated."

State law doesn't define "incidental powers," and the Department hasn't adopted any policies to define it. As a result, the Department Administrator decides what powers are incidental.

National Credit Union Administration regulations define incidental powers for federally chartered credit unions, and at a very broad level, those services and activities can include the following:

- **certification services**, such as certification of electronic signatures
- **excess capacity services**, including using data processing systems to process information for third parties
- **financial counseling services**, including income tax preparation, estate and retirement planning, and investment counseling
- **finder activities**, including offering third-party products and services to members through the sale of advertising space on the credit union's website
- **loan-related products**, including debt-cancellation or suspension agreements
- **monetary instrument services**, including the sale and exchange of foreign currency or U.S. commemorative coins

Department regulations allow a credit union to provide still more services to its members through a credit union <u>services organization</u>. K.S.A. 17-2204a allows credit unions to invest in and make loans to a credit union services organization, subject to the Department's rules and regulations. It defines a services organization 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.

Regulations the Department promulgated in 1996 (K.A.R. 121-3-1) specify that these services organizations can only engage in services and activities that are "primarily provided to the investing or lending credit union and the lending credit union's members as well as other credit unions and their members." Under permissible services and activities, the regulation spells out the following:

- **financial services**, including financial planning and counseling, retirement and investment counseling, securities brokerage services, income tax preparation, trustee services, and insurance

- **operational services**, including credit and debit card services, internal audits for credit unions, accounting services, data processing, lease or servicing of computer hardware or software, marketing and research services, debt-collection services, and coin and currency services

We compared the services that Kansas and federal regulations allow credit union services organizations to provide, and found that they are very similar.

State law also allows the Department to approve additional services that credit unions can provide on a case-by-case basis. K.S.A. 17-2244 gives the Department the power to issue a special order authorizing any Kansas-chartered credit union "to engage in any activity in which such credit union could engage were they operating as a federally insured credit union..." This clause allows any Kansas-chartered credit union to provide the same service that any federally insured, non-Kansas-chartered credit union provides.

The law specifies that requests to provide such services must be made in writing, and the Department may approve them if they are "reasonably required to preserve and protect the welfare of such an institution and promote the general economy of this state." The law also requires any special orders to be reported to the leadership of the House and Senate.

Department officials told us they recalled receiving only a few requests over the past decade. Most of these requests were received since September 2005. Credit unions sought to charge their members a fee in exchange for allowing them to skip one month's loan payment (i.e., around the Christmas holiday season). Department officials said they approved all these requests. They also reported these special orders to legislative leadership during this audit.

Credit Unions Have Expanded the Services They Offer In a Number Of Ways Over the Past 10 Years

We analyzed data from three major organizations that maintain information about the number and type of services credit unions have offered over the past 10 years—the Kansas Credit Union Association, the Credit Union National Association, and the National Credit Union Administration. Two things should be noted:

- First, no one maintains a comprehensive list of the services credit unions offer their members through their credit union service organizations.
- Second, we didn't consider recent electronic changes—such as Internet banking or Automated Teller Machines (ATMs)—to be a "new" service. They simply represent a new way of delivering the services credit unions historically have offered.

Our review showed that some credit unions had started offering two new savings instruments that were authorized by Congress after 1995—health savings accounts and Roth Individual Retirement Accounts. Also during that period, some credit unions started offering gift cards to their members. All three services are allowable under Kansas law. ***Appendix B*** provides a list of all the services we identified that credit unions provided in 2005.

Mostly, however, we found that more credit unions simply were offering more of the services credit unions historically have been authorized to provide. The ways they've done this are described in the sections that follow.

Some smaller credit unions have expanded the services they provide by merging with larger credit unions. Small credit unions may not have the resources or capabilities to offer services like mortgages or credit cards. However, they can expand into those service areas by merging with a larger credit union.

Our review of five credit union mergers from 2005 showed that, in each case, the surviving credit union was offering services that many of the smaller credit unions that merged with them hadn't offered before—primarily first mortgage loans, credit cards, and money market accounts. Also, they all now have the capability to provide services electronically (i.e., through ATMs and Internet banking). As a result, members of the merged credit unions now have access to an array of services they didn't have access to before.

Our analyses also showed that more Kansas-chartered credit unions have begun offering checking accounts to their members—whether through mergers or because of other business decisions. Information in this area from the National Credit Union Administration is summarized in ***Figure II-1***.

Figure II-1
Comparing the Number and Percent of Kansas-Chartered Credit Unions Providing Basic Financial Services
June 1995 and June 2005

Type of Service	1995		2005		Change in the % of Credit Unions Providing This Service
	Number (out of 122)	% of Total	Number (out of 94)	% of Total	
Checking Account	49	40%	61	65%	25%
Money Market Account	28	23%	30	32%	9%
Savings Account	122	100%	94	100%	0%
First Mortgage Loans	44	36%	43	46%	10%
Credit Cards	36	29%	38	40%	11%
Car Loans	122	100%	94	100%	0%
Business Loans	22	18%	17	18%	0%

Source: LPA analysis of NCUA data.

As ***Figure II-2*** shows, the total loan volume for Kansas-chartered credit unions has nearly doubled over the last 10 years—from about $1.1 billion to more than $2.0 billion. Real estate lending now accounts for a much bigger share of those loans—it's grown from 21% to 31% of total loans. Finally, in a separate analysis we noted that credit unions appeared to be doing more commercial lending in 2005 than they were in 1995.

Figure II-2
Comparison of Kansas-Chartered Credit Unions' Loan Portfolios
As of December 1995 and December 2005 (a)

	1995		2005	
Loan Type	**Amounts**	**% of Total**	**Amounts**	**% of Total**
Real Estate Loans	$230 million	21%	$614 million	31%
Car Loans	$618 million	57%	$1.1 billion	57%
Credit Cards	$44 million	4%	$62 million	3%
Other Secured Loans	$106 million	10%	$117 million	6%
Unsecured Loans	$80 million	8%	$64 million	3%
Total	**$1.1 billion**	**100%**	**$2.0 billion**	**100%**

(a) Not adjusted for inflation.
Source: LPA analysis of NCUA data

Credit unions have expanded the services they could provide their members through the creation of credit union services organizations. These organizations and the types of services they can provide were described earlier in this question. Data available from the National Credit Union Administration showed that five State-chartered credit unions had invested in three service organizations in 1997. By 2005, those figures had grown to 32 Kansas-chartered credit unions investing in 13 active services organizations.

The Administration accumulates very little data about the number and type of services that credit union services organizations in Kansas currently provide. However, data we obtained from the Kansas Credit Union Association showed that, as of December 2005, these services organizations were providing services such as:

- providing automated teller machines
- operating shared branches
- processing credit card transactions
- providing various mortgage services, such as loan applications and payment collection
- selling automobile and accidental death and dismemberment insurance

The Department Performs Limited Reviews of the Types of Services Credit Unions or Their Services Organizations Offer

We reviewed Department policies and interviewed Department officials to find out what they do to ensure that credit unions offer only the services allowed by law and obtain the necessary approvals before beginning to provide certain services. We found the following:

- Department policies don't require examiners to review the services a credit union or its services organization offer during routine examinations. Department officials told us they don't <u>require</u> it because examiners can tell what services a credit union provides through the review of the financial records. Through this review, they'd identify any service that was negatively impacting the safety and soundness of a credit union. An examiner we talked to said he and other examiners do review the services credit unions provide during examinations and assess whether those services are allowed by law. However, he said, the results aren't documented unless those services aren't allowed by law. He also said the last time he found a credit union or its services organization providing unauthorized services was approximately seven years ago.

- As mentioned earlier, Department officials told us they've received only a few requests to approve expanded services over the past 10 years. It's not possible for us to know whether credit unions are offering other services that should have been approved without doing a detailed review of the services each one offers. We didn't perform that work.

Credit Unions Also Have Expanded Who They Serve by Increasing Their "Field of Membership"

Under State law (K.S.A. 17-2205), credit unions' memberships "shall be limited to groups...having a common bond of occupation or association or to groups residing within a well-defined neighborhood, community or rural district."

Examples of groups having a common bond of occupation or association could include employees of a specific employer, such as the U.S. Post Office or the City of Topeka, or members with a common occupation, such as teachers. Examples of groups residing within a well-defined neighborhood, community, or rural district could include anyone living in a specific city, county, or other defined geographic area.

The Department's interpretation of credit unions' membership requirements doesn't appear to conform to State law. Even though the law appears to place clear limits on credit unions' memberships (often referred to as their common bonds), the Department has interpreted it very broadly to allow:

- *the definition of "groups residing within a well-defined neighborhood, community, or rural district" to include residents of the entire State*. Department officials told us there are five State-chartered credit unions that anyone in the State can join—Credit Union 1, Golden Plains Credit Union, Hutchinson Credit Union, Kansas Super Chief Credit Union, and Mid American Credit Union. They also said these common bonds were approved in the 1980s. Department policies don't address the size of a geographic area that can make up a common bond. However, National Credit Union Administration policies don't allow a federally chartered credit union to have a community bond that consists of an entire state.

- *credit unions to combine groups with occupational bonds and groups with geographic bonds*. For example, the Boeing Wichita Credit Union originally was formed to serve Boeing employees and their relatives. Over time, the credit union has been allowed to expand its field of membership to add large geographic regions of Kansas as areas and populations it could serve. As a result, the number of people who could join Boeing Wichita Credit Union grew from about 44,000 in 1995 to more than 2 million in 2005. Stated another way, in 2005 about 80% of the State's population was eligible to join the Boeing Wichita Credit Union.

  In sum, the Department has allowed Kansas-chartered credit unions to expand their memberships by having multiple common bonds that include:

  - two or more occupational groups
  - two or more geographic groups
  - a combination of occupational groups and geographic groups

Department officials told us that allowing such diversity minimized the risk a credit union would experience severe financial problems. They cited the upturns and downturns of the aircraft manufacturing industry as an example of the volatile financial environment credit unions could face. They also said that such diversity allows everyone in Kansas to have an opportunity to join a credit union.

Common bond requirements have been challenged at both the federal and state level. In 1982, the National Credit Union Administration began allowing federally chartered credit unions to have multiple common bonds involving two or more occupation or association groups.

In 1998, the U.S. Supreme Court ruled that federal law didn't allow federally chartered credit unions to have multiple common bonds. The wording of that federal law was nearly identical to the wording of Kansas' existing law in this area.

Congress subsequently passed the Credit Union Member Access Act of 1998. It specifically allowed federally chartered credit unions to have multiple common bonds (i.e., serve people from two or more occupational groups), but it didn't allow them to include geographic groups in multiple bonds.

Federal lawsuits in Utah and Pennsylvania and a state lawsuit in Missouri are currently in process regarding field-of-membership expansions. In each case, representatives of bankers' associations brought these challenges. Specific topics included in the lawsuits are:

- approval of a field of membership being an entire telephone area code (involves a state-chartered credit union serving a specified geographic area)
- a credit union without multiple common bonds being able to expand its field of membership to an under-served area (involves a federally chartered credit union)
- the definition of a community bond for three specific credit unions (involves federally chartered credit unions)

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 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

1. To ensure that it is appropriately limiting credit unions' memberships, the Department of Credit Unions should do the following:

   a. Enforce the current provisions of K.S.A. 17-2205 which limit such memberships to "groups...having a common bond of occupation or association or to groups residing within a well-defined neighborhood, community or rural district." The language of this statute wouldn't appear to allow a credit union's membership to include the entire State, nor to allow a credit union to serve a combination of groups with common occupational bonds and groups with geographic bonds. In addition, based on the U.S. Supreme Court's 1998 ruling, Kansas law as written also may not allow credit unions to have multiple common bonds within either an occupational group or a geographic group.

   b. 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, the Department should seek to amend State law accordingly. Such amendments should address the issue of allowing a Statewide common bond, multiple common bonds, or a combination of groups with common occupational bonds and groups with geographic bonds. Unless and until the law is changed, the Department should enforce the provisions of the law as written.

2. To help ensure that credit unions and their service organizations provide only authorized services, the Department should adopt either new polices or Administrative Regulations which clearly define the "incidental powers and services" that Kansas-chartered credit unions have and can provide.

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?

Answer in Brief:

Overall, we found the Department had adequate procedures in this area, and credit union administrators who responded to our survey overwhelmingly thought the Department was doing a good job of ensuring the safety and soundness of credit unions. However, we noted several areas where improvements are needed. In the area of examinations, these include requiring examiners to fill out mandatory conflict-of-interest forms, prohibiting management from being involved in examinations of credit unions where family members are employed, providing guidance about when to make formal recommendations to credit unions, and improving follow up when recommendations aren't implemented.

The Department also needs to provide better guidance to examiners regarding their review of credit unions' quarterly monitoring reports. In the area of enforcement, the Department needs to develop procedures about when to take enforcement actions, and to ensure that such actions are taken when it's warranted. The Department's procedures generally are similar to those used by the State Bank Commissioner, but the Commissioner's Office can levy civil monetary penalties, and requires its staff to do more with the quarterly monitoring reports banks submit. These and related findings are discussed in more detail in the sections that follow.

The Department Has Adopted Federal Regulators' Examination Process and System for Rating Credit Unions' Financial Condition

The National Credit Union Administration has established an extensive examination process for federally chartered credit unions. As part of that process, the Administration has developed a detailed manual outlining the steps its examiners should follow in conducting an exam, including an analysis of areas such as capital adequacy, asset quality, management effectiveness, earnings, and liability/liquidity management.

Like most states, Kansas has adopted this process. Department staff also use the Administration's examination software program, which includes standardized examination questionnaires, spreadsheets, and analyses.

Based on their review of certain financial ratios, examiners develop a "score" that serves as an indicator of each credit union's financial safety and soundness. This score is called a CAMEL rating. Each area reviewed receives a score of 1 to

5, with "1" being the best score. Those individual scores are used to develop a composite rating for each credit union. ***Figure III-1*** describes the CAMEL rating and the individual components within it.

From 1995 through 2004, 15% of all examinations 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.

Figure III-1
Description of Credit Union CAMEL Rating Components

Area	Key Financial Ratio/ Description	Why Important?	NCUA Criteria for a "1" Rating(a)	NCUA Criteria for a "5" Rating(a)
Capital	Ratio of *net worth* to *total assets*	A credit union's capital provides a cushion to absorb losses when the credit union isn't profitable.	Net worth / total asset ratio >7%.	Net worth / total asset ratio <2%.
Asset Quality	1) Ratio of *delinquent loans* to *loans* 2) *Net charge offs / average loans*	Loans are a very large part of most credit union's value (assets). If too many loans aren't being repaid, the losses will exceed the amount of money or revenue the credit union makes. These losses will decrease capital.	Delinquent loans / loans ratio <1.25%. Net charge offs / average loans ratio <0.25%.	Delinquent loans / loans ratio >4.75%. Net charge offs / average loans ratio >1.8%.
Manage-ment	Assessment of business plan-ning, mgmt. of the risk of fraud, & other mgmt. issues	"Management is the most forward-looking indicator of condition, and a key determinant of whether a credit union is able to correctly diagnose and respond to financial stress."	Management must be responsive to changing economic conditions and cope with existing and foreseeable problems.	Management has clearly demonstrated incompetence or self-dealing.
Earnings	Return on average assets	Earnings, or profits, allow a credit union to fund expansion, remain competitive, and replenish or increase capital.	Return on average assets >1%.	Return on average assets <0.2%.
Asset/ **L**iability Manage-ment	Interest rate and liquidity risks	Credit unions must: 1) avoid paying higher interest rates on deposits and investments than they earn on loans while 2) ensuring adequate funds are available to meet present and anticipated cash flow needs (i.e. to make loans, for share withdrawals, and to pay expenses).	Management must demonstrate that it can manage both interest rate and liquidity risks.	The credit union has an unacceptably high exposure to risk. The risk may constitute an imminent threat to the credit union's viability.
Composite Rating	An overall indicator of the credit union's viability	A lower composite rating indicates less confidence in the credit union's future viability.	"...strong performance and risk management practices that consistently provide for safe and sound operations."	"...unsatisfactory performance that is critically deficient and in need of immediate remedial attention."

(a) These financial ratio criteria are for large credit unions (Assets >=$50 Million). Examiners may assign a different rating based on their comprehensive review of the credit union's financial condition.

Source: NCUA Letter to Credit Unions, 00-CU-08

Department officials told us that one primary reason for this difference was that Kansas had more smaller credit unions than other states (55% of Kansas credit unions have less than $10 million in assets, compared to 46% nationwide), and that smaller credit unions tended to get lower CAMEL scores. Our review of two key financial ratios—delinquency and earnings—supported this notion. As of June 2005:

- 2.5% of loan amounts in small credit unions were delinquent, on average, compared with only 1.1% of loans in large credit unions
- small credit unions had an average return on assets of -0.2%, compared with large credit unions' average return of 0.5%

For the Most Part, the Department Has and Follows Adequate Procedures To Ensure the Safety and Soundness of Credit Unions

A good regulatory program for financial institutions generally will include the following components:

- **Examining the financial condition of the institution on a periodic basis.** In Kansas, credit unions are required by law to be examined at least once every 18 months. In addition, the Department investigates complaints from the public about the institution's operations.

- **Monitoring the condition of the institution between examinations to ensure there is no significant deterioration in the institution's financial condition**. In Kansas, Department staff monitor the financial condition of credit unions by reviewing the quarterly reports they submit to the National Credit Union Administration. Staff also review monthly reports submitted by credit unions that have been designated to submit such reports because of their poor CAMEL rating.

- **Allowing credit unions to voluntarily address the problems identified**. In Kansas, if the Department's examinations, complaint investigations, or monitoring efforts disclose potential problems with a credit union's financial operations or conditions, the Department can make recommendations to the credit union about how and when to address them.

- **Taking enforcement actions against institutions that don't meet standards or comply with the law**. In Kansas, the Department has the authority to fine credit unions for failure to file reports, issue cease and desist orders, or remove officers or directors if a credit union fails to comply with requirements of law or Department directives. In extreme cases, the Department can put the credit union into conservatorship or liquidate it.

We reviewed the Department's policies and assessed staff's adherence to those policies for each of these areas. Our findings are presented in the sections that follow.

FINDINGS RELATED TO EXAMINATIONS

The Department Is Examining Credit Unions On a Timely Basis, But Needs To Address Issues Related to Examiner Independence And Follow-Up Actions

Our review of the Department's procedures and practices related to examinations of credit unions showed the following:

- Department staff appear to be following the Department's examination procedures. Our review of 10 examinations conducted during calendar years 2004 or 2005 showed that examination forms were being completed as required, the Department was scheduling on-site examinations to ensure that credit union officials would be available, and it was obtaining information for examiners to review before the on-site examination began.

- Department staff are conducting examinations on a timely basis. Our reviews showed that all Kansas-chartered credit unions were examined within 18 months of their previous exams, as required (80% were re-examined within 14 months). Three of five states we surveyed have the same requirements as Kansas in this area; the other two states require an examination once every 24 months.

We noted four areas related to examinations where the Department either lacks procedures, staff didn't follow established procedures, or staff failed to take timely action. Those are described below:

- **Department examiners haven't completed required conflict-of-interest forms**. The Department's ethics policy requires each examiner to disclose any potential conflicts of interest at least once a year. None of the Department's examiners have completed a disclosure form in the past five years, and four had never completed a disclosure form.

- **Department procedures don't prohibit Department staff from reviewing and approving examination reports for credit unions where their family members are employed**. We found that a former senior agency official was involved in the review process for two different examinations of a credit union managed by a member of his immediate family. These examination reports were issued in 1999 and 2000.

- **The Department could improve its guidance to examiners about when to make a formal recommendation to credit union management**. The Department relies on examiners' experience and their consultations with other senior staff in deciding whether to make a recommendation to address a problem identified during an examination. Written guidance could help ensure that different examiners treat issues consistently, and that issues worthy of a recommendation are addressed properly.

- **Primarily because of a vacancy in a key management position, Department officials didn't adequately follow-up on recommendations that credit unions failed to implement**. In reviewing a list of 64 recommendations Department examiners had made during calendar year 2005, we noted that Department officials hadn't reviewed and determined whether the credit union had implemented 19 of these recommendations until more than 90 days after they were supposed to have been implemented. In 17 cases, credit unions hadn't submitted documentation that they'd complied with the Department's recommendation by the required completion date (these items were 6 to 152 days late). In nine cases, Department officials didn't review documentation from the credit unions about the corrective actions they'd taken until more than 60 days after it came in.

Most of this occurred during the 5-month period when the Administrator's position was vacant, and the only other central office management staff person—who normally kept track of recommendations—was serving as acting Administrator.

We also noted most of the outstanding recommendations the Department tracked required credit unions to take one-time actions—such as developing a new policy. It seldom tracked recommendations that require the credit union to take monthly or other on-going actions—such as actively pursuing delinquent loans, or reporting the credit union's net worth to the Board each month. Although the Department often requires these credit unions to start submitting monthly reports on their financial condition for its review, keeping a centralized list of all outstanding recommendations — whether they require one-time or on-going action—would give the Department better information to manage its activities.

FINDINGS RELATED TO COMPLAINTS

The Department Receives Very Few Complaints, and It Has and Follows Adequate Procedures for Handling Them

The Department's procedures for handling complaints appeared to be thorough. The Department investigates only written complaints. Those investigations are expected to be completed within seven working days of receipt, and reports are expected to be submitted to the complainant within seven working days after the investigation is completed.

The Department receives very few complaints each year; in calendar year 2005, it received only 13 written complaints. Credit union customers complained about such things as being denied a loan, being overcharged for late fees, unauthorized withdrawals being made from an account, and a credit union had paid checks the customer had placed a stop payment order on. Our review of each complaint showed they were handled promptly and completely.

FINDINGS RELATED TO MONITORING BETWEEN EXAMS

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. Department staff are supposed to review these reports to determine whether they are accurate, and if not, to ensure that corrections are made.

The National Credit Union Administration then runs various analyses to identify risk factors, and passes that information on 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.

The Department could improve its guidance to examiners regarding the monitoring process. This area is described below:

- **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**. The Department doesn't have any written guidance on what the field examiners' review of quarterly risk reports should include, or what information should be provided to management regarding the financial condition of any credit unions.

FINDINGS RELATED TO ENFORCEMENT ACTIONS

The Department Lacks Adequate Guidance for When an Enforcement Action Should Be Taken

Department examiners can issue recommendations to address problems they identify during an examination or as part of a complaint investigation or monitoring review. For example, if an examiner finds a credit union's ratio of delinquent loans to total loans is too high, he or she may recommend that the credit union discontinue making high risk loans or more aggressively pursue loans that are currently delinquent.

If a credit union doesn't follow those recommendations, the Department will try to enter into a voluntary Letter of Understanding and Agreement with the credit union. This letter essentially is a contract between the Department and the credit union's board members, who agree to take specified actions to remedy the problems.

If the credit union doesn't adhere to the provisions of the Letter of Understanding and Agreement, or if the problems identified during an examination or investigation warrant it, the Department has a graduated system of enforcement actions available to it. Those actions include issuing cease and desist orders, taking charge of a credit union (conservatorship), and liquidating a credit union. In addition, the Department can levy fines against credit unions that fail to submit required reports.

Since 2003, the Department has entered into three Letters of Understanding and Agreement with Kansas-chartered credit unions, and has taken one enforcement action. That action occurred in March 2006, when the Department issued a cease and desist order and took charge of the Lawrence-based Credit Union Group. More information about this latest action is provided below.

Recently the Department Administrator Issued a Cease and Desist Order Against a Lawrence-Based Credit Union

In March 2006, the Department issued a cease and desist order against Credit Union Group Credit Union in Lawrence. This enforcement action removed the officers of the credit union and placed the credit union into a conservatorship with the National Credit Union Administration (NCUA). For the time being, NCUA staff will manage the credit union in an attempt to improve its financial condition.

This enforcement action was issued because a recent examination of the credit union identified serious problems. According to the cease and desist order, the examination's findings included the following:

- Credit Union Group management staff had falsely reported its December 31, 2005, financial status to NCUA. Specifically, the credit union reported that $3 million in loans had been sold since September 30; however, that sale hadn't occurred. (By claiming that assets were sold, a credit union would understate its assets, and thus overstate its net worth ratio. This is one of the areas assessed in determining a credit union's CAMEL rating.)
- An officer of Credit Union Group took out a $106,000 land loan without authorization. Lending money to an officer of a credit union without authorization is known as self-dealing, and is an unsound business practice. In addition, the loan was to be used to purchase land; however, the Credit Union Group's loan policies don't allow land loans.
- The Credit Union Group invested more in its credit union services organization(CUSO) than is allowed by State law. Kansas law allows a credit union to invest up to two percent of its unimpaired shares, reserves, and undivided earnings in its CUSO. The Credit Union Group had invested more than four percent of these amounts in its CUSO.
- The Credit Union Group loaned money to its CUSO knowing that CUSO would use the money to buy real estate. This action isn't clearly authorized by Kansas Administrative Regulations.

Through the cease and desist order, Department staff concluded that some of these actions could cause Credit Union Group to lose its federal deposit insurance. The cease and desist order identified this action as a violation of Kansas law because State law requires credit unions to maintain such insurance.

We identified two areas where the Department either lacks adequate procedures or Department staff didn't take timely actions. Those are described below:

- **The Department has no written guidance on when a Letter of Understanding and Agreement should be used, or when an enforcement action should be taken**. Such guidance can help ensure that enforcement actions are being taken when needed, and are being applied on a uniform and consistent basis. (As an example, the Bank Commissioner has policies that describe when the most common types of enforcement action will be used, and the implications of their use.)
- **In one case where a Letter of Understanding and Agreement had been issued, the Department's actions weren't adequate to ensure that serious problems were corrected promptly**. In this case, examiners found the following condition four years in a row: "Loans continue to be made in direct violation of credit union

> loan policy and sound lending practices." During that time, the credit union failed to change its lending practices, as Department examiners had recommended, and also had a deteriorating CAMEL score. The Department didn't enter into a Letter of Understanding and Agreement with this credit union until after the fourth instance—in June 2004.

Department officials told us no action was needed before then because the credit union's solvency wasn't threatened during the earlier years. Even if that were true in the earlier years, as of March 2006 the credit union still hadn't addressed all of these problems, and Department officials still hadn't taken any enforcement actions to bring this credit union into compliance with requirements and sound practices.

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 regarding the operations and effectiveness of the Department. We received 65 responses, for a response rate of 70%. As shown in ***Figure III-2***, survey respondents indicated they were very pleased with the Department's oversight activities, overall.

Figure III-2
Percentage of Respondents Answering Favorably To Questions about The Department's Effectiveness at Regulating Kansas-Chartered Credit Unions

Survey Questions Asked About the ...	% Who Responded Favorably:
Thoroughness of examinations	98%
Effectiveness of the Department's regulatory program	97%
Consistency of the Department when examining credit unions	86%
Fairness of the Department when examining credit unions	85%

Source: LPA survey of credit union managers

In addition, 97% of the survey respondents indicated the Department's examinations were appropriate and reflected what's required by State law and regulation.

The Department's Oversight Procedures Are Similar to Those of The State Bank Commissioner's Office

As part of our evaluation of the Department, we compared its procedures to those of the State Bank Commissioner's Office. We found their procedures to be similar in many areas. For example, both agencies require examinations to be conducted once every 18 months, and both use the CAMEL rating system to assess the safety and soundness of the financial institutions they regulate. They also have many of the same enforcement actions. We did identify a few differences. For example, the Department expects complaint investigations to be completed much sooner than the Bank Commissioner's Office–about seven working days and 30 working days, respectively.

We also identified two areas where the Bank Commissioner's procedures and practices appeared to provide better regulatory oversight of financial institutions:

- 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. These reports allow management staff to determine whether potential financial problems have become real problems. Staff can then decide whether to push forward their next examination date, take an enforcement action, or continue routine monitoring. Department examiners don't submit written evaluations of potentially at-risk credit unions to the Department's administrators.

- 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. State law gives the Bank Commissioner the power to levy civil monetary penalties if a bank engages in unsafe or unsound practices, or violates the State banking code. Although the Department can fine credit unions for submitting a report late, it can't levy civil monetary penalties like the Bank Commissioner can.

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

1. To help ensure that the Department of Credit Union's process for examining credit unions treats credit unions consistently and operates in an effective manner, the Department should do the following:

   a. enforce its policy requiring examiners to complete conflict-of-interest forms annually.

   b. revise its procedures to prohibit management staff from reviewing and approving examination reports of credit unions where family members are employed.

   c. develop written guidance for examiners concerning when to make a formal recommendation to credit union management.

   d. evaluate whether the current process of tracking only the progress of certain recommendations could be improved by tracking all recommendations.

   e. develop procedures that outline the actions the Department will take when credit unions don't submit required documentation of corrective action by the due date.

2. To help ensure that the Department's process for monitoring credit unions between examinations provides staff with meaningful information about a credit union's financial condition, the Department should develop written procedures that describe the tasks examiners should perform when reviewing a credit union's quarterly report, and what information the examiners should report to Department management.

3. To help ensure that the Department's process for taking enforcement actions treats credit unions consistently and operates in an effective manner, the Department should develop written guidance outlining the general parameters for when Letters of Understanding and Agreement or other enforcement actions will be taken.

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

Answer in Brief:

Between 1998 and 2005, eight Kansas-chartered credit unions merged with six out-of-State credit unions. The CommunityAmerica Credit Union based in Missouri was involved in three of those mergers, and acquired about $222 million in assets formerly held by Kansas-based credit unions. Overall, the Department appears to have exercised reasonable oversight of mergers involving credit unions from other states. Kansas' merger requirements are similar to those of other states and for Kansas banks. Kansas doesn't have reciprocity agreements with other states, but officials in the industry told us there's no need for such agreements. It didn't appear that out-of-State credit unions operating in Kansas have a significant competitive advantage over Kansas-based credit unions, and nearly all the credit union managers we surveyed thought the Department was doing enough to ensure that Kansas-chartered credit unions don't operate at a competitive disadvantage. These and other findings are described in the sections that follow.

Between 1998 and 2005, Eight Kansas-Chartered Credit Unions Merged With Six Out-of-State Credit Unions

Federally chartered credit unions don't need the Department's permission to begin operating in Kansas, but state-chartered credit unions do. A state-chartered credit union from another state can come into Kansas in these ways:

- **rescind its charter from another state and become a Kansas-chartered credit union**. Any credit union that did that would be regulated by the Department.
- **merge with—or purchase the assets of—an existing Kansas credit union**. If the out-of-State credit union were the "surviving" credit union, it might have one or more branches in Kansas but would continue to be regulated by officials from its state of charter.
- **receive approval to operate a branch in Kansas but still maintain its out-of-State charter**. The Department has the authority to allow an out-of-State credit union to begin operating in Kansas without switching its charter or merging with or purchasing an existing credit union. In this case, the credit union would continue to be regulated by officials from its state of charter.

Since 1996, no out-of-State credit union has switched its charter to Kansas, and the Department has given only one out-of-State credit union permission to operate in Kansas without switching its charter or merging with an existing credit union. That happened in 1997. However, since 1998 out-of-State credit unions have acquired eight Kansas-chartered credit unions through mergers. That information is summarized in ***Figure IV-1*** on the next page.

Figure IV-1 Kansas-Chartered Credit Unions That Merged With Out-of-State Credit Unions 1998-2005					
This Kansas-Chartered Credit Union....	**....merged with this Out-of-State Credit Union...**	**...which was chartered in...**	**...on this date...**	**Total Assets of KS Credit Union When Merger Occurred (in millions)**	**Annual Fee Paid to the Department in Last Year of Kansas Charter**
Top Gas	ONEOK Employees Federal	Oklahoma	April 1998	$1.1	$1,666
Community America	Members America Credit Union (which took the name of CommunityAmerica)	Missouri	August 1998	$156.4	$45,861
Santa Fe	CommunityAmerica	Missouri	Sept. 1999	$56.9	$19,561
EDUCOM	66 Federal Credit Union	Oklahoma	January 2002	$5.0	$4,235
Electrical Workers	Communication Federal	Oklahoma	Dec. 2002	$3.4	$3,187
Wecoe	CommunityAmerica	Missouri	Dec. 2002	$8.4	$5,356
Church of God	America's Christian Credit Union	California	June 2005	$4.6	$3,762
Wichita Eagle	Knight Ridder	Florida	October 2005	$4.2	$2,745
Total	--	--	--	**$240.0**	**$86,373**
Source: Kansas Department of Credit Unions records and National Credit Union Administration data					

As the figure shows, 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. It's the largest of the six out-of-State credit unions involved in Kansas mergers. As described on the next page, CommunityAmerica operated six branches in Kansas as of December 2005, and had total assets (not just Kansas-based) of about $1.5 billion.

Among other things, these mergers had the following impacts:

- The oversight of about $240 million of assets was transferred from the Department to other state regulators or the National Credit Union Administration. Although these mergers occurred at different times, the $240 million represents about 9% of the $2.7 billion in total assets held by Kansas-chartered credit unions as of December 2005.

- The Department lost about $86,000 in fees paid by these credit unions. Because the Department is a fee-funded agency, it had to adjust its fee schedule to spread the loss among the remaining credit unions.

As of December 2005, Eight Credit Unions Based in Other States Were Operating in Kansas

Of these, four were federally chartered and four were state-chartered. ***Figure IV-2*** presents summary information about these out-of-State credit unions. As the figure shows, these eight credit unions' total assets were $3.8 billion as of December 2005. Kansas-chartered credit unions had total assets of $2.7 billion on that date.

Figure IV-2
Credit Unions Chartered in Other States That Also Operate In Kansas

Name of Credit Union	Year Began Operating in Kansas	Home State	Number of Branches in Kansas June 2005	Total Assets December 2005 (a)
State-Chartered				
CommunityAmerica	1998	Missouri	6	$1.5 billion
Corporate America Family	1997	Ilinois	2	$622 million
America's Christian	2005	California	1	$190 million
Knight Ridder	2005	Florida	1	$17 million
Subtotal	**--**	**4 States**	**10 branches**	**$2.3 billion**
Federally Chartered				
66 Federal	2002	Oklahoma	1	$377 million
Great Plains Federal (b)	1996	Missouri	7	$223 million
Communication Federal	2002	Oklahoma	2	$382 million
Farmers Insurance Group Federal	1980	California	2	$563 million
Subtotal	**--**	**3 States**	**12 branches**	**$1.5 billion**
Total		**5 States**	**22 branches**	**$3.8 billion**

(a) This amount represents total assets of the credit union, and not the amount held by Kansas branches.
(b) This credit union began operating as a federally chartered, Kansas-based credit union in 1950. In 1996, it changed its home state from Kansas to Missouri.

Source: LPA analysis of NCUA data

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. State law (K.S.A. 17-2228(e)) says that "This section shall be construed, whenever possible, to permit a credit union chartered under any other act to merge with one chartered under this act..."

In looking at whether the Department was effectively regulating the influence of out-of-State credit unions, we focused on four areas:

- the Department's enforcement of statutory requirements pertaining to mergers
- whether Kansas' merger requirements were similar to those of other states and of the Office of the State Bank Commissioner
- whether out-of-State credit unions' home states had reciprocity agreements allowing Kansas credit unions to operate in their states
- as described in the next section, we also looked at whether out-of-State credit unions operating in Kansas have a competitive advantage over Kansas-based credit unions

Figure IV-3 Required Steps for Credit Unions To Take When Merging		
Actions required by the credit unions that want to merge...	**Actions required by the Department when 2 or more Kansas-based credit unions are merging...**	**Actions required by the Department when an out-of-State credit union merges with an in-State one...**
The boards of directors of both credit unions must approve the merger agreement.	The Department reviews the merger documents, and approves them if the boards of directors have approved the merger and everything appears to be in order. It directs both credit unions to hold a membership vote.	Same
The boards of directors of both credit unions must notify their members of a membership vote to approve the proposed merger.	The Department reviews documentation submitted by the credit unions to ensure proper notice was given.	The Department only reviews the documentation submitted by the Kansas-chartered credit union.
Each merger agreement must be approved by the credit union's members present at a special meeting specifically held to vote on the merger. (Majority for a merger agreement and 3/4 for a buy-sell agreement.)	If all requirements have been met, and there's no apparent reason to disapprove the merger, the **Department has final approval** over the merger.	If the out-of-State credit union is the surviving credit union, **final approval rests with the regulatory agency in the out-of-State credit union's chartering state**.

The Department generally followed statutory requirements related to allowing credit unions to merge. As outlined in State law, the basic steps involved in a merger are shown in ***Figure IV-3***.

We reviewed the Department's actions related to a sample of five mergers that were approved in 2005. Three of them involved only Kansas-chartered credit unions, and two involved a Kansas-chartered credit union merging into an out-of-State credit union.

We checked to see whether required documents were submitted, and whether Department staff performed the necessary reviews to allow each merger to proceed. We identified one problem with the Department's review of merger proposals:

- **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 submitte**d. Information in the financial statements lets the Department assess whether the credit unions' financial conditions should lead to a successful merger. Although these documents were in the file, there was no indication that staff had reviewed or analyzed them. The former Department Administrator should have performed these reviews and he told us that any analyses he made should have been included in the Department's files. We didn't find evidence of such in the Department's files.

Kansas' merger requirements for credit unions are similar to those for other states and for Kansas banks. We compared Kansas' merger requirements to those used by the five other states that also have a credit union operating in Kansas. All these states have set up a similar merger system to that used by Kansas.

We also found that the Department and the Office of the State Bank Commissioner have similar merger requirements. Like credit unions, banks must submit a merger agreement, receive a majority vote from shareholders in favor of the merger, and publicize the impending merger. The Bank Commissioner also has final approval over the merger.

The only significant difference we saw: banks must pay a $1,000 merger application fee, whereas credit unions pay no application fee.

Kansas doesn't have reciprocity agreements with other states, but it appears there's no need for such agreements. A reciprocity agreement would allow a credit union chartered in one state to begin operating in another state provided the reverse also was allowed.

According to regulatory officials from the five other states we contacted, Oklahoma, California and Florida have no reciprocity agreements, Illinois law requires reciprocity be given by states whose credit unions have begun operating in Illinois, and Missouri had signed at least one reciprocity agreement with another state.

However, these officials told us they weren't aware of any laws that would completely preclude a Kansas-chartered credit union from operating in their states. In addition, as discussed below, their states have signed the NASCUS Interstate Branching Agreement and this agreement recognizes that credit unions will operate in states besides their home state. These two factors negate the need for a reciprocity agreement. Department and Kansas Credit Union Association officials also said they weren't aware of any Kansas-chartered credit unions that had applied to operate in other states.

Currently, There Doesn't Seem To Be a Significant Competitive Advantage For Out-of-State Credit Unions That Operate in Kansas

To determine whether out-of-State credit unions appeared to have a competitive advantage when operating within Kansas, we reviewed regulatory oversight practices, the taxes and fees that Kansas-chartered and Missouri-chartered credit unions pay, and credit unions' ability to provide services to their members.

In Kansas and other states, responsibility for regulating out-of-state credit unions lies with the state the credit union is chartered in. Kansas law provides that credit unions chartered in Kansas shall be subject to the exclusive supervision of the Department of Credit Unions. However, the Department doesn't have regulatory authority over credit unions chartered by another state; that responsibility falls to the chartering state.

This practice has been adopted by most states. That's because Kansas and most other states have signed the National Association of State Credit Union Supervisors (NASCUS) Interstate Branching Agreement. This 1998 agreement says that regulatory authority over a credit union—and responsibility for conducting the safety and soundness examination of that credit union—lies with the state of charter. The agreement still gives the state where the credit union is located the right to take part in the safety and soundness examination or to receive a copy of the completed report.

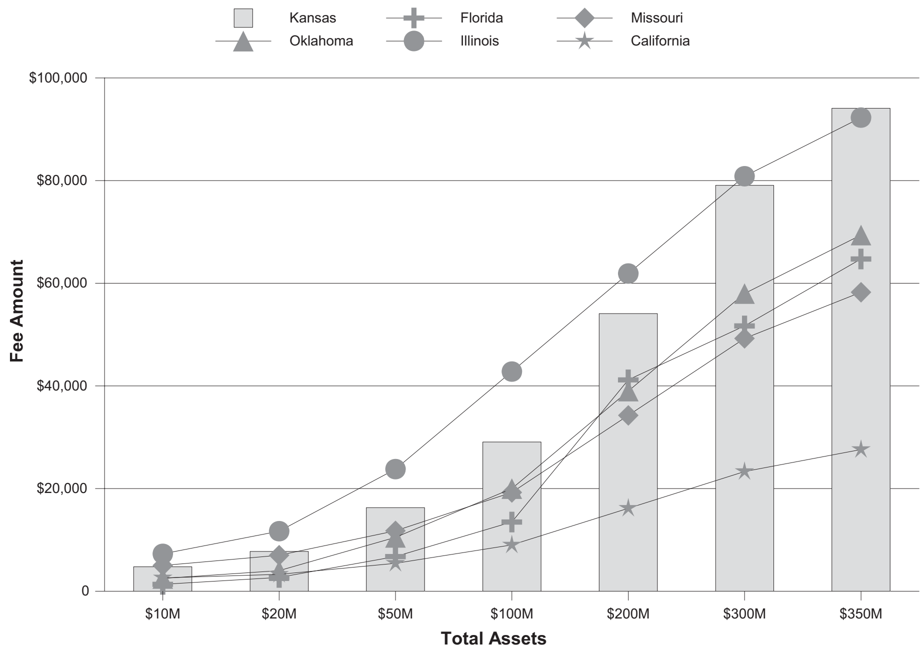
The 2005 Legislature gave the Department additional authority related to out-of-State credit unions. House Bill 2099 gave the Department the power to conduct its own safety and soundness examination of out-of-State credit unions operating in Kansas; however, the Department still wouldn't have any enforcement powers over those credit unions. Department officials told us they don't have any plans to start completing safety and soundness examinations, and will continue to defer that responsibility to the chartering state.

Most states have similar systems for regulating credit unions. Our comparison of Kansas' general credit union oversight practices and requirements to those used in five other states identified no significant differences. For example, all states reviewed use the National Credit Union Administration's examination guidelines when determining the safety and soundness of credit unions, examinations are statutorily required every 18-24 months, and in general the same enforcement actions are available.

Kansas-chartered credit unions can seek permission to provide any services that a federally insured out-of-State credit union operating in Kansas can provide. As discussed in Question 2, a parity provision in State law allows credit unions to ask the Department for permission to provide the same services that any federally insured credit union offers. For example, Missouri credit unions allow their members to skip a loan payment for a nominal fee. Although Kansas law doesn't allow this, a Kansas-chartered credit union can ask the Department to allow it to offer that service because other federally-insured credit unions provide this service.

Kansas-chartered credit unions have had to pay higher regulatory fees than their out-of-State counterparts operating in Kansas. The fees that regulatory agencies assess are based on credit unions' total assets; the more assets a credit union has, the higher its fee. We compared Kansas' fee structure to those of five states.

Figure IV-4
Comparison of Fees Paid by Kansas-Chartered and Other State-Chartered Credit Unions in Their Home States
As of December 2005



Source: LPA analysis of Kansas and other states' fee structures.

As ***Figure IV-4*** shows, Kansas' regulatory fees are fairly similar to those states for credit unions with assets of less than $20 million (which includes 71% of Kansas-chartered credit unions). For larger credit unions, however, Kansas' fees are among the highest. (National Credit Union Administration data show that as of December 31, 2005, Kansas had only one credit union with assets exceeding $330 million.)

Department officials suggested that one reason Kansas fees may be higher is because they have to be set at a level to cover the regulatory costs the Department incurs plus an additional 20% (up to $200,000) to cover the costs of central services the Department of Administration provides to State agencies. They told us some states–including Missouri–don't impose charges on their regulatory agencies for central service costs, and therefore those states can assess lower fees. Of the states in our sample, we noted at least two that do assess a fee for central services. Oklahoma charges 20% and Florida charges 7%. Neither of these states had a cap on the amount of money that goes for central services.

Beginning in fiscal year 2006, however, House Bill 2099 required out-of-State credit unions to pay annual fees to the Department according to a Kansas-developed fee schedule. As a result, out-of-State credit unions operating in Kansas now pay a fee in their home state based on their total assets, plus a partial fee to Kansas based on the amount of assets they report as Kansas-based. To-date in 2006, Department officials told us they've collected almost $56,000 in fees from credit unions chartered in other states.

We compared the amount of fees that Community America Credit Union would pay to Kansas and Missouri under several different scenarios, using its December 2005 asset figure. Before the passage of House Bill 2099, Community America would have paid about $230,000 in fees to Missouri and nothing to Kansas. With the passage of House Bill 2099, Community America would have paid the same amount to Missouri and an additional $46,000 to Kansas. If Community America was based in and only operated in Kansas, it would have paid total fees of $382,000 to Kansas. This analysis shows that Community America pays about $106,000 less in fees because it's chartered in Missouri and not Kansas. We also noted that Community America is a Missouri-chartered credit union, but its Internet website lists its home office as located in Lenexa, Kansas.

Figure IV-5
State and Local Taxes Paid by Credit Unions Chartered in Kansas and Missouri

Type of Tax	Kansas-Chartered Credit Unions	Missouri-Chartered Credit Unions
State Franchise or Privilege Taxes	No	Yes
State and Local Property Taxes	Yes	Yes
State and Local Sales Taxes	Yes	Yes

Source: LPA review of tax laws and interviews of tax administration officials.

We also compared the taxes credit unions operating in Kansas and Missouri pay, and summarized that information in ***Figure IV-5***. As the figure shows, Kansas-chartered credit unions don't have to pay State franchise or privilege taxes, while Missouri-chartered credit unions do—they have to pay a 7% franchise tax on income.

We couldn't calculate the total amount of taxes that credit unions might pay because of all the variations in tax rates. But this information doesn't suggest that Kansas' tax structure causes Kansas-chartered credit unions to operate at a competitive disadvantage.

Finally, 97% of the Kansas credit union managers who responded to our survey indicated the Department does enough to ensure that they don't operate at a competitive disadvantage when compared to out-of-State credit unions.

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.

Recommendation

To provide greater assurance that Department staff properly review merger agreements and supporting materials, the Department should require that the scope and nature of those reviews be documented. Depending on the materials reviewed, this could range from initialing documents to including in the file the results of any financial analyses performed.

APPENDIX A
Scope Statement

This appendix contains the scope statement approved by the Legislative Post Audit Committee for this audit on December 14, 2004. The audit was requested by Representative Ray Cox and Senator Ruth Teichman.

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

State law says that Aany seven persons, residents of the state of Kansas, may apply to the administrator of the credit union department for permission to organize a credit union, " and that Acredit union organizations shall be 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 of Credit Unions examines all state-chartered credit unions to ensure that they are financially stable and in compliance with State and federal laws and regulations. The Department also grants new charters and mergers, handles consumer complaints, and provides liquidation procedures when necessary. The credit union administrator is appointed by the Governor, with Senate confirmation, and serves a four-year term. A separate, seven-member Credit Union Council, appointed by the Governor, serves as an advisor to the credit union administrator. The Department is funded by fees from each State-chartered credit union.

In recent years, credit unions reportedly have expanded their range of services, spurred in part by regulatory changes and the advent of online services. Legislators have expressed an interest in knowing whether the Department of Credit Unions is providing adequate oversight of credit unions' expanded services consistent with the Department's current statutory authority, whether Kansas consumers are adequately protected, and whether the Department has adequate procedures for regulating expansions or mergers of credit unions.

Other legislative concerns have been raised about whether the Department has allowed out-of-State credit unions to operate branches in Kansas without reciprocity agreements allowing Kansas credit unions to operate in those states; the number of these out-of-State branches, the extent to which they have acquired Kansas credit unions, the impact these acquisitions may have on the Department's ability to carry out its mission; and whether State laws or regulations or Department actions may put Kansas-based credit unions at a competitive disadvantage or encourage those acquisitions. A performance audit in this area would address the following questions:

1. How have Kansas credit union services changed in recent years, and to what extent have credit unions grown in comparison with other segments of the financial-services industry? To answer this question, we would review relevant literature and interview industry and regulatory officials to determine how and why credit unions have broadened their service offerings in recent years, and how those changes have affected credit unions' share of the financial-services business. We would attempt to describe this growth in terms of the number of institutions or facilities, the percentage increase of total deposits over the past few years, how those increases compare to other financial institutions, or other available measures.

2. 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? To answer this question, we would review the Department's written procedures and interview officials and staff to determine what the Department does to oversee and regulate the various services offered by Kansas credit unions. We would compare those procedures to those employed by the Banking Department and Securities Commissioner, and conclude whether the credit union procedures are similar to or more or less stringent than those governing other financial institutions. We would examine how the Department governs the merger of credit unions, or deals with requests for new charters or branches, including any provisions for public input. We also would examine what the Department does to ensure that credit unions' memberships comply with the Acommon bond" provision of Kansas law. We would review the Department's recent regulatory activities for a sample of credit unions to determine whether the Department follows its procedures. We also would review any recent enforcement actions to determine whether they appeared to be appropriate, timely, and effective. We would perform other test work as required.

3. Are the Department's actions in relation to credit unions' expanded services consistent with State law? To answer this question, we would review Department records for a sample of recent actions, particularly those related to approvals of new or expanded credit union financial services. We would review applicable State law, and determine whether the Department's approvals or other actions were within the scope of its authority.

4. Is the Department effectively regulating the influence of out-of-State credit unions? To answer this question, we would review applicable laws and regulations, Department policies and procedures, and other relevant records, and interview or survey Department staff and credit union officials as needed. We would attempt to determine which states the Department has allowed to operate branch credit unions in Kansas and why, whether those states have reciprocity agreements with Kansas, how many out-of-State credit unions are operating branches in Kansas, how many branches have been opened and where, and how many Kansas-based credit unions these out-of-State branches have acquired. If possible, we would try to determine the amount of Kansas membership assets these merged credit unions now control. We would determine the requirements, authority, and restrictions placed on in-State and out-of-State credit unions, and whether those requirements seem to treat out-of-State credit unions more favorably or give them any advantage over Kansas-based credit unions. If we identify any significant inequities, we would try to determine whether they've resulted in a significant financial impact to the State, and to identify what changes may be needed to help level the playing field for Kansas credit unions. In addition, for a sample of acquisitions we would determine what actions the Department took-either directly or indirectly-that could have affected the merger decision, and assess whether those actions appeared to be reasonable and appropriate. We would perform other analyses and testwork as needed.

Estimated completion time: 12-14 weeks, depending on the availability of data.

APPENDIX B

Services That Credit Unions in Kansas Are Providing

During this audit, we reviewed State law and regulation to find out what services credit unions are authorized to provide and reviewed National Credit Union Administration data to find out what services credit unions actually are providing. The table below summarizes the services credit unions provide and their authority to provide those services.

Types of Services	Services Kansas Credit Unions Currently Offer	What gives credit unions the power to offer this service?
Loan Services		
Business Loans	Agricultural Related Business Loans	Statutory Powers[a]
	Construction & Development Loans	Statutory Powers[a]
	Unsecured Business Loans	Statutory Powers[a]
Real Estate Loans	First Mortgage Loans	Statutory Powers[a]
	Business Real Estate Loans	Statutory Powers[a]
	Other Closed-End Real Estate Loans	Statutory Powers[a]
	Open-End Real Estate Loans	Statutory Powers[a]
Vehicle Loans	Used Vehicle Loans	Statutory Powers[a]
	New Vehicle Loans	Statutory Powers[a]
	Plane/Boat/Rv Loans	Statutory Powers[a]
Other Loan Types	Credit Cards	Statutory Powers[a]
	Participation Loans	Statutory Powers[a]
	Student Loans	Statutory Powers[a]
	Indirect Loans	Statutory Powers[a]
	Lines of Credit	Statutory Powers[a]
	Unsecured Loans	Statutory Powers[a]
Deposit Services		
Long Term Deposits	Money Market Accounts	Statutory Powers[a]
	U.S. Savings Bonds	Statutory Powers[a]
	Certificates of Deposts (CD)	Statutory Powers[a]
	IRA/Keogh Accounts	Statutory Powers[a]
Short Term Deposits	Business Checking	Statutory Powers[a]
	Personal Checking	Statutory Powers[a]
	Gift Cards	Statutory Powers[a]
	Savings Accounts	Statutory Powers[a]
	Health Savings Accounts	Statutory Powers[a]

Use of Electronic Methods		
Account Access	Account Aggregation	Incidental Powers[b]
	Electronic Statements	Incidental Powers[b]
	Computer Home Banking	Incidental Powers[b]
	Online Check Viewing	Incidental Powers[b]
	Electronic Signature Authentication	Incidental Powers[b]
	Phone Based-Audio Response	Incidental Powers[b]
Money Transfer	Automated Clearing House for Electronic Transfers	Incidental Powers[b]
	Automated Teller Machine Access	Incidental Powers[b]
	Electronic Bill Payment	Incidental Powers[b]
Application	Online Loan Applications	Incidental Powers[b]
	Online Member Applications	Incidental Powers[b]
Brokerage, Insurance, and Financial Planning		
Counseling Services	Credit Counseling	Incidental/CUSO[b][c]
	Business Planning Assistance	Incidental/CUSO[b][c]
	Member Education Seminars	Incidental/CUSO[b][c]
Brokerage Services	Securities Brokerage	CUSO Powers[c]
	Formal Financial Planning	CUSO Powers[c]
	Trust Services	Statutory Powers[a]
Insurance	Auto Insurance	CUSO Powers[c]
	Health Insurance	CUSO Powers[c]
	Home Owners Insurance	CUSO Powers[c]
	Life Insurance	CUSO Powers[c]
	Annuities	CUSO Powers[c]
	Loan Protection Insurance	CUSO Powers[c]
Other Services		
Monetary Services	Check Cashing	Statutory Powers[a]
	Cashiers Checks	Statutory Powers[a]
	Debit Cards	Statutory Powers[a]
	Money Orders	Statutory Powers[a]
	Travelers Checks	Statutory Powers[a]
	Wire Transfer of Money	Statutory Powers[a]
Other Services	Drive Up Windows	Incidental Powers[b]
	Notary Service	Incidental Powers[b]
	Safety Deposit Boxes	Statutory Powers[a]
	Special Programs for Youths	Incidental Powers[b]
	Special Programs for Young Adults	Incidental Powers[b]
	Service Package for Retirees	Incidental Powers[b]
[a] Statutory powers means that the power to provide these services is clearly in state law.		
[b] Incidental powers means that these services and methods can be provided because they are an incidental part of providing other services.		
[c] CUSO powers means that these services can be provided through a credit union's service organization. These powers are listed in Kansas Administrative Regulations.		

APPENDIX C

Agency Response

On April 19, 2006, we provided copies of the draft audit report to the Department of Credit Unions. Its response is included as this Appendix. In its response, the Department indicated that it generally agreed with the findings and conclusions of this report.

RECEIVED
MAY 1 2006
LEGISLATIVE DIVISION OF POST AUDIT

KANSAS

JOHN P.SMITH, ADMINISTRATOR

KATHLEEN SEBELIUS, GOVERNOR

DEPARTMENT OF CREDIT UNIONS

May 1, 2006

Ms. Barbara J. Hinton
Legislative Division of Post Audit
800 S.W. Jackson, Suite 1200
Topeka, Kansas 66612

Dear Ms. Hinton:

Thank you for the opportunity to review and comment on the audit involving the Kansas Department of Credit Unions (the Department). We appreciate your staff's professionalism while conducting the audit.

Following are the Department's response and comments to the audit recommendations.

Recommendations 1a and b, Page 16:

Since the establishment of the Department in 1968, various Department Administrators have interpreted K.S.A. 17-2205 differently as required to ensure credit union safety and soundness. Although we cannot speak for former Administrators, we suggest their decisions were made in the best interest of credit union safety and soundness. Continuity of services to members, continued stability of credit unions during adverse economic times or when the financial services industry was undergoing dramatic changes probably influenced their decisions. The Department's Administrators consideration of common bond or field of membership probably included their reaction to a variety of situations including but not limited to a credit union's common bond or field of membership linked to a business or organization experiencing a decline in employment, ceasing business, relocating from Kansas, or merger. These situations have been interpreted by state and federal regulators as allowing credit unions to expand their field of membership to include multiple common bonds.

While the Department is not opposed to seeking to amend state law, an option to the Department that will simultaneously allow parity of Kansas chartered credit unions with other federally insured credit unions would be for the Department to follow a more narrow construction of K.S.A. 17-2205 but comply with the provisions of K.S.A. 17-2244 through issuance of an order when achievement of parity is required.

Recommendation 2, Page 16:

The Department has adopted K.A.R. 121-3-1; this regulation lists permissible services and activities for credit union service organizations. The Department will consider adopting an Administrative Regulations defining "incidental powers and services" after consulting the attorney general's office to verify authority to do so under current statutory authority.

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May 1, 2006
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Page 2

Recommendation 1a through e, Page 25:

All examiners have completed conflict-of-interest forms and will do so annually.

Department procedures will be revised to prohibit management staff from reviewing and approving examination reports of credit unions where family members are employed.

Written guidance for examiners concerning when to make a formal recommendation to credit union management is being developed.

The Department will evaluate whether the process of tracking only the progress of certain recommendations could be improved by tracking all recommendations.

Procedures will be developed that outline actions the Department will take when credit unions do not submit required documentation of corrective action the due date.

Recommendation 2, Page 26:

The Department believes it is unnecessary to develop written procedures for examiners to follow when reviewing a credit union's quarterly report for the following reasons:

- Quarterly reports are electronic with a built-in algorithm to detect errors.
- Review of quarterly reports is part of examiner training; written procedures cannot replace or be a substitute for training and experience.
- a new 'risk report module' has been implemented as part of the electronic quarterly reporting allowing the Department's retrieval and comparison of quarterly reports one day following uploading.

Recommendation 3, Page 26:

The Department agrees that written guidelines should be developed outlining when enforcement actions will be taken and will do so.

Recommendation found on Page 34:

The Department will review the process utilized for consideration of credit union merger agreements and make changes to ensure improved documentation.

Yours truly,

John P. Smith

John P. Smith, Administrator