April 30, 2007

The Honorable Bernard Sanders
United States Senate

Subject: Information on Selected Issues Concerning Banking Activities

Dear Senator Sanders:

This letter responds to your request for information on (1) selected federal expenditures, policies, and programs that affect the U.S. banking industry and (2) certain banking industry trends. These include the savings and loan industry crisis, trade finance, tax policies, and profits and executive compensation. Your letter also asked us for information on bank fees; as agreed with your staff, we will discuss this topic in a separate report. On December 11, 2006, we briefed your staff on information gathered during our preliminary work. This letter summarizes and updates the information presented at the briefing.

The U.S. banking industry encompasses different types of federally insured depository institutions, including over 8,000 state and national banks, over 860 savings and loan associations (known as “thrifts”), and nearly 8,700 federally insured credit unions. Five federal banking regulatory agencies are collectively responsible for supervision of the industry: the Federal Deposit Insurance Corporation (FDIC), the Office of the Comptroller of the Currency (OCC), the Board of Governors of the Federal Reserve System (the Federal Reserve), the Office of Thrift Supervision (OTS), and the National Credit Union Administration (NCUA). During the 1980s, many thrifts experienced severe financial losses. In response to this crisis, Congress took a number of steps, including augmenting the Federal Savings and Loan Insurance Corporation’s (FSLIC) insurance fund through the issuance of bonds and ultimately creating new insurance funds administered by FDIC. Congress also established new organizations to resolve the failing thrifts, and incentives were offered for financially healthy banks and thrifts to take over the troubled ones. These incentives included certain tax benefits administered by the Department of the Treasury’s Internal Revenue Service (IRS).

Banks engaged in financing international trade may participate in programs offered by the Export-Import Bank of the United States (Ex-Im), which helps finance exports of goods and services. Among other things, Ex-Im guarantees loans—including loans made by U.S. banks—to private companies engaged in exporting and provides credit insurance.

1 First established by executive order in 1934, Ex-Im currently operates as an independent agency of the U.S. government and is the official export credit agency of the United States.
As discussed with your office, this letter provides information on (1) the cost of resolving the savings and loan industry crisis; (2) the extent of U.S. banks’ use of Ex-Im products, and factors affecting banks’ use of these products; (3) federal tax deductions, credits, and other provisions available to banks and thrifts and their use of transactions that IRS has found to be abusive; (4) trends in depository institutions’ profits and income; and (5) trends in executive compensation in the banking industry. This letter summarizes these issues; further details can be found in enclosures II through VI.

To accomplish our first objective, we reviewed relevant past GAO reports, obtained and analyzed information from FDIC and the Federal Housing Finance Board, and interviewed FDIC officials regarding costs associated with resolving the savings and loan industry crisis that have been identified since 1996. For the second objective, we obtained and analyzed available data from Ex-Im on the trade finance activities of U.S. lenders between 2000 and 2005 and interviewed officials from Ex-Im and the federal banking regulators. We also interviewed industry representatives and participants about changes in trade finance over the past decade and reviewed past GAO work on various aspects of Ex-Im. For the third objective, we analyzed IRS data on tax deductions and credits claimed by depository institutions in 2004—the most recent year for which data were publicly available—and used Treasury’s tax expenditure list to identify tax expenditures available to banks and thrifts. We also interviewed IRS officials, attended IRS briefings on tax issues affecting the banking industry, and reviewed relevant past GAO work. For the fourth objective, we analyzed data from FDIC and NCUA on profits, retained earnings, and income for depository institutions from 1996 to 2006. We also interviewed officials from the federal banking regulatory agencies about trends in the data and the potential causes of these trends. For the last objective, we performed a literature search for relevant professional or academic papers, articles, or studies on executive compensation in the banking industry. We reviewed relevant past GAO work that addressed executive compensation issues in the credit union industry and results from a recent survey of community banks on compensation issues. We also reviewed congressional testimony regarding executive compensation and relevant sections of the Internal Revenue Code. We conducted this work from August 2006 to April 2007 in Washington, D.C., in accordance with generally accepted government auditing standards. See enclosure I for a detailed description of our scope and methodology.

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2 The Federal Housing Finance Board oversees the system of 12 Federal Home Loan Banks (FHL Banks), a government-sponsored enterprise that is cooperatively owned by member financial institutions, typically commercial banks and thrifts. The FHL Banks have a role in financing the costs associated with resolving the savings and loan crisis.


4 Tax expenditures result in forgone revenue for the federal government due to preferential provisions in the tax code, such as deductions and credits. These provisions grant special tax relief for certain kinds of behavior by taxpayers or for taxpayers in special circumstances.
Summary

Since 1996, when we reported that the total estimated cost of resolving the savings and loan industry crisis was $160.1 billion (equivalent to $198 billion in 2006 dollars), there have been limited additional costs associated with litigation expenses; however, our 1996 estimates of tax benefit costs and the interest expense on certain bonds issued to provide financing are consistent with recent FDIC and Federal Housing Finance Board data. Litigation costs have arisen from cases against the government regarding both the use of accounting practices by institutions that acquired failing thrifts and the tax benefits associated with certain FSLIC-assisted acquisitions. FDIC data indicate that since 1996, these cases have resulted in judgments, settlements, and related litigation expenses that total $2 billion ($2.1 billion in 2006 dollars). FDIC’s current estimates of realized and future tax benefits for institutions that acquired failed thrifts generally correspond with our 1996 estimate of $7.5 billion ($9.3 billion in 2006 dollars) for the total cost of these tax benefits. Specifically, according to FDIC, through tax year 2005, acquiring institutions have received approximately $6.51 billion in tax benefits and will receive an estimated $609.24 million in such benefits in subsequent tax years. In addition, while the Gramm-Leach-Bliley Act of 1999 changed the method of determining the annual interest amounts the FHL Banks pay on certain bonds issued to provide financing to FSLIC, our estimate of the total interest expense on these bonds remains unchanged.

We could not determine the precise extent to which U.S. banks use Ex-Im products because Ex-Im records do not specifically distinguish between banks and nonbank lenders. However, relatively few U.S. commercial banks appear to use Ex-Im products or participate in trade finance. In fiscal year 2005 (the most recent year for which Ex-Im could provide data), U.S. lenders—including both banks and nonbank lenders—accounted for about $1.8 billion in Ex-Im loan guarantees and over $2 billion in Ex-Im insurance products. However, U.S. lender participation in trade finance, including Ex-Im programs, has generally been declining in recent years, and Ex-Im data show that for fiscal years 2000 through 2005, only about 100 U.S. lenders (both banks and nonbank lenders) participated in Ex-Im programs annually. Trade finance industry participants noted that most U.S. banks involved in trade finance are large, money center banks, along with a limited number of regional and small banks. Ex-Im officials and industry participants noted that transactions involving Ex-Im products generally result in high internal administrative costs and low profit margins for banks. However, officials and participants also identified a number of factors that might prompt bank use of Ex-Im products, including risk mitigation through Ex-Im’s loan guarantees and insurance and increased liquidity through the sale of certain Ex-Im products in the secondary market. Furthermore, Ex-Im officials and industry participants said that using Ex-Im products offers U.S. banks the opportunity to develop broader relationships with their customers and, in turn, offer them other services.

According to IRS data and officials, banks and thrifts use tax deductions, credits, and other provisions that are generally available to all corporations. Treasury considers only one tax provision—the deduction of excess bad debt reserves—a tax expenditure available exclusively to banks and thrifts and estimates revenue losses for this tax expenditure at $10 million in 2007. IRS data indicate that the largest deductions banks and thrifts took in 2004—the most recent year for which data were available—were for business expenses,

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5 Where noted, we have adjusted expenditures for inflation and we report them in 2006 dollars.
such as interest paid, as well as salaries and wages. The largest tax credits banks and thrifts claimed in 2004 were for the general business credit and foreign tax credit. To bypass federal corporate income taxation, some eligible banks and thrifts also have taken advantage of the option to elect Subchapter S tax status (companies that elect this option are referred to as S-corporations). Instead of being taxed directly at the entity level, an S-corporation’s income is passed through to its shareholders, who are then taxed (as individuals) on their portion of the corporation’s income. As of December 2006, 2,356 depository institutions, including 31 percent of banks, had elected Subchapter S status, according to FDIC data. IRS officials also noted that some banks have participated in tax shelters and transactions the IRS considers to be abusive. For example, in a January 2007 summary judgment decision, a U.S. district court ruled in favor of IRS in disallowing over $9 million in tax deductions associated with a bank’s participation in a certain transaction in 1997 that IRS considered abusive.6

The profits of U.S. depository institutions have grown over the last 15 years, accompanied by changes in sources of income. FDIC data indicate that in 2006, banks and thrifts reported a total of $146 billion in net income, representing an inflation adjusted 7 percent average growth rate over the previous 10 years. NCUA data indicate that credit unions, which are not-for-profit organizations, reported $6 billion in net income in 2006, representing a 3 percent average annual inflation adjusted growth rate over the previous 10 years. The industry’s growth in profits has been accompanied by a gradual shift toward greater reliance on noninterest income—investments, fees, and service charges, among other things. Since the early 1990s, banks, thrifts, and credit unions have all experienced an increase in noninterest income relative to net operating revenue. For example, as of 2003, noninterest income at banks accounted for 43 percent of net operating revenue, up from 32 percent in 1990.

Although publicly available information on executive compensation in the banking industry is limited, several studies that we reviewed identified an increase in bank executives’ compensation over the past decade, and some generally attributed the increase to the elimination of interstate banking barriers and competitive pressures. Federal banking statutes limit executive compensation in certain circumstances—for example, the compensation of senior executive officers at significantly undercapitalized institutions. The federal statutes also place limitations on golden parachute agreements, which generally, provide executives with significant benefits in the event that the executives’ employment is terminated. The federal banking regulators routinely collect information about salaries and wages at depository institutions, but the information is not specific to the institution’s executives.

Agency Comments

We provided a draft of this report to OCC and FDIC for comment. We also provided selected portions of a draft of this report to officials at IRS, the Federal Reserve, OTS, NCUA, the Federal Housing Finance Board, and Ex-Im for their technical comments. All of the agencies except the Federal Reserve provided technical comments, which we incorporated where appropriate.

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As agreed with your office, we plan no further distribution of this report until 30 days from its issue date unless you publicly release its contents sooner. We will then send copies of this report to interested congressional committees, the Commissioner of IRS, the Chairman of FDIC, the Comptroller of the Currency, the Chairman of the Board of Governors of the Federal Reserve System, the Director of OTS, the Chairman of NCUA, the Chairman of the Federal Housing Finance Board, and the Chairman of Ex-Im. We will also make copies available to others on request. In addition, the report will be available at no charge on GAO’s Web site at http://www.gao.gov.

If you or your staff have any questions on matters discussed in this report or need additional information, please contact me at (202) 512-8678 or woodd@gao.gov. Contact points for our Offices of Congressional Relations and Public Affairs may be found on the last page of this report. GAO staff who made major contributions to this report are listed in enclosure VII.

Sincerely yours,

David G. Wood
Director, Financial Markets and Community Investment
Enclosure I

Scope and Methodology

To provide information on the estimated total cost of resolving the savings and loan industry crisis and estimated future tax benefits, we followed the approach for updating the cost estimates presented in our audit of the Resolution Trust Corporation’s 1995 and 1994 financial statements. We reviewed our annual audits of the Federal Deposit Insurance Corporation’s (FDIC) financial statements from 1995 through 2006 to identify information on litigation against the government for breaches of contract regarding (1) the use of supervisory goodwill in calculating regulatory capital and (2) tax benefits associated with Federal Savings and Loan Insurance Corporation (FSLIC) agreements. We also analyzed data from FDIC on expenses associated with this litigation, including expense payments made to the Department of Justice (DOJ), and adjusted these data for inflation using a gross domestic product price index. In addition, we interviewed FDIC officials about litigation expenses and tax benefits and analyzed information from FDIC on tax benefits received and estimated future benefits stemming from FSLIC agreements. We also examined relevant banking statutes and court rulings. Finally, we reviewed our past work to identify information on the interest expense of bonds issued to finance the resolution of failed savings and loan institutions. We reviewed relevant legislative amendments since 1996 to identify changes affecting the interest obligation of those bonds. We also obtained information from the Federal Housing Finance Board on the interest obligation.

To determine the extent to which U.S. banks use the Export-Import Bank of the United States (Ex-Im) products, we obtained and analyzed information from Ex-Im regarding its products used by U.S. lenders. Specifically, we analyzed Ex-Im’s data on loan guarantees and insurance products for fiscal years 2000 through 2005 and reviewed Ex-Im annual reports from the same time period. We obtained available information from Ex-Im on claim payments to guaranteed lenders and insured parties, as well as recoveries, for fiscal years 2002 through 2006, and determined the amount of payments made to U.S. lenders. In addition, we interviewed officials at the federal banking regulatory agencies, Ex-Im officials, and trade finance industry representatives and participants about U.S. banks’ participation in trade finance, use of Ex-Im products, and participation in the secondary market for certain Ex-Im products. We also attended Ex-Im’s trade financing seminar. To determine the reliability of data provided by Ex-Im’s data systems, we reviewed the reliability assessment of the same Ex-Im systems performed for one of our recent reports and confirmed with Ex-Im officials that the information obtained remained valid. We are

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9 GAO, Export-Import Bank: Changes Would Improve the Reliability of Reporting on Small Business Financing, GAO-06-351 (Washington, D.C.: March 3, 2006). This report found weaknesses in Ex-Im’s data systems and data for calculating its small business support but concluded that the overall data were reliable.
confident that for purposes of describing Ex-Im product authorization levels and the proportion attributable to U.S. lenders in this report, these data are similarly reliable.

To identify tax expenditures available exclusively to depository institutions, we reviewed Treasury’s list of tax expenditures and revenue loss estimates from the President’s fiscal year 2008 annual budget. The Congressional Budget and Impoundment Control Act of 1974 defines tax expenditures as revenue losses due to provisions of the tax law that allow special exclusions, exemptions, and deductions from income or provide special credits, preferential tax rates, or deferral of tax liability. Tax expenditures are revenue losses resulting from tax provisions granting special relief for certain kinds of taxpayer behavior or for taxpayers in special circumstances. These provisions could, in effect, be viewed as spending programs channeled through the tax system and are classified in the U.S. budget by budget function. We consulted an official in Treasury’s Office of Tax Analysis to ensure that we included all of the tax expenditures provided exclusively to depository institutions. Also, we drew on our past work on economic development tax expenditures to provide perspective on banks’ use of these provisions. To identify tax deductions and credits claimed by depository institutions, we analyzed publicly available tax data from the IRS Corporation Source Book of Statistics of Income. We used data from tax year 2004, the most current year for which the data were available. We compared deduction and tax credit amounts and ratios for the industry classifications “All Corporations” and “Depository Credit Intermediation.” To identify Subchapter S-corporation banks and thrifts, we analyzed data from the FDIC’s Statistics on Depository Institutions. We calculated the number and assets of S-corporation banks and thrifts for the years 1997 through 2006. We reviewed relevant public laws related to changes in S-corporation eligibility. We interviewed Internal Revenue Service (IRS) officials to identify (1) common tax provisions and strategies used by depository institutions and (2) any instances for which depository institutions used tax provisions that IRS considered abusive. We also reviewed relevant IRS documents and notices as well as a recently decided court case involving an abusive tax shelter.

To evaluate the profits and noninterest income of depository institutions, we analyzed aggregate annual call report (banks and credit unions) and thrift financial report data provided by FDIC and National Credit Union Administration (NCUA) for 1990 through 2006. We identified potential causes for trends in the data by interviewing bank regulators and reviewing their documents and reports.

To identify trends in executive compensation in the banking industry, we reviewed publicly available research papers from academic researchers and various Federal Reserve Banks. We reviewed relevant banking regulations that included limits or controls on certain

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executive compensation in the banking industry as well as sections of the Internal Revenue Code and Securities and Exchange Commission (SEC) regulations regarding limits on the deductibility of and disclosure requirements for executive compensation. We also interviewed officials at the federal banking regulatory agencies and banking industry representatives about executive compensation issues. We did not review annual proxy statements of 10-K annual reports or other filings that may contain information on executive compensation made by companies with securities registered with SEC, because they do not necessarily distinguish the salary information of executives associated with a company’s depository institution from that of executives associated with other parts of the organization.

We conducted this work from August 2006 to April 2007 in Washington, D.C., in accordance with generally accepted government auditing standards.
Developments in Costs Associated with Resolving the Savings and Loan Crisis Represent Limited Changes to Estimated Total Cost

Developments in litigation associated with resolving the savings and loan industry crisis resulted in limited changes to the $160.1 billion ($198 billion in 2006 dollars) total cost we estimated in 1996. In 1996, we determined that these costs, which were associated with litigation against the government (called supervisory goodwill litigation) regarding contracts with institutions that acquired failing thrifts, were uncertain. FDIC data indicate that since 1997, $1.34 billion ($1.39 billion in 2006 dollars) has been paid for judgments and settlements in these cases. FDIC reports that an additional $274 million ($276 million in 2006 dollars), has been paid in judgments and settlements in separate litigation (called Guarini litigation) against the government for breaches of contract regarding benefits associated with acquiring institutions’ tax benefits. In contrast to this change, FDIC’s estimates of tax benefits related to FSLIC agreements generally correspond with estimates we made in 1996. Similarly, while the Gramm-Leach-Bliley Act of 1999 changed the method of determining the annual interest amounts the Federal Home Loan Banks (FHL Banks) pay on certain bonds issued to provide financing to FSLIC, the total annual interest payments made by the FHL Banks and other sources correspond with the $2.6 billion in annual expense that we reported in 1996.

Costs Associated with Supervisory Goodwill and Guarini Litigation Represent Slight Increases to Total Estimated Costs

FDIC data on judgments and settlements associated with litigation that arose from cases against the government regarding the use of accounting practices by institutions that acquired failing thrifts and tax benefits associated with certain FSLIC-assisted acquisitions, represent a limited increase to the $160.1 billion ($198 billion in 2006) total cost that we estimated in 1996. FDIC data indicate that from 1997 through January 2007, institutions that acquired failed thrifts were paid $1.34 billion ($1.39 billion in 2006 dollars) in judgments and settlements have been paid in litigation against the government involving the use of favorable accounting treatment for intangibles, such as goodwill, in calculating regulatory

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14 GAO/AIMD-96-123. We determined that in 1996, approximately $132.1 billion was provided from taxpayer funding sources and the remaining $28.0 billion was provided from industry assessments and other private sources.
Supervisory goodwill is an accounting measure that refers to the excess of a purchase price over the fair value of all identifiable assets acquired. Upon FSLIC’s insolvency, the Federal Home Loan Bank Board (FHLBB), the former thrift industry regulator, embarked on a forbearance program to induce new investors to purchase or merge with failed thrifts. The program not only permitted the acquiring institutions to count supervisory goodwill toward their reserve requirement, it also allowed acquiring institutions to amortize goodwill over many years, up to a 40-year maximum. The net effect of including supervisory goodwill was avoiding the need for the regulator or the failed institution to transfer tangible assets or cash to cover the deposit accounts transferred in the transaction.

Several institutions that had entered into agreements with the government that allowed the use of goodwill, which came to be called supervisory goodwill, brought suit against the government after legislative changes eliminated the use of supervisory goodwill in calculating the amounts of capital that regulators require the institutions to maintain (referred to as regulatory capital standards or requirements). Specifically, in 1989, Congress enacted FIRREA, which, among other changes, mandated new regulatory capital accounting for depository institutions and provided for the elimination or rapid phase-out of the use of supervisory goodwill in calculating the regulatory capital of depository institutions. FIRREA also provided the director of the new thrift industry supervisor, the Office of Thrift Supervision (OTS), with the authority to take certain actions against institutions not in compliance with the new capital standards. In 1990, OTS issued guidance indicating that it

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15 The FSLIC Resolution Fund (FRF) is the primary source of payments for judgments and settlements in Goodwill litigation. The Financial Institutions Reform, Recovery, and Enforcement Act (FIRREA) abolished FSLIC after it became insolvent, created the FRF, and transferred the assets and liabilities of FSLIC to the FRF on August 8, 1989. Today, the FRF consists of two distinct pools of assets and liabilities: one composed of the assets and liabilities of FSLIC transferred to the FRF upon the dissolution of the FSLIC and the other composed of the Resolution Trust Corporation (RTC) assets and liabilities transferred upon the dissolution of the RTC. See 12 U.S.C. § 1441a(m)(2). The assets of one pool are not available to satisfy the obligations of the other. On July 22 1998, the DOJ concluded that the FRF is legally available to satisfy all judgments and settlements of the supervisory goodwill litigation involving supervisory action or assistance agreements. The FRF is also authorized to draw from an appropriation provided by the Department of Justice Appropriations Act, 2000, Pub. L. No. 106-113 § 110, 113 Stat. 1501, 1501A-20 (Nov. 29, 1999), the funds necessary for the payment of judgments and settlements in the Goodwill litigation. This appropriation is to remain available until expended. DOJ determined that nonperformance of these agreements was a contingent liability that was transferred to the FRF on August 9, 1989, upon FSLIC’s dissolution and advised that the FRF was the appropriate source of funds for payment of judgments in the Winstar-related cases. See 22 Op. Off. Legal Counsel 141, 1998 WL 1180050 (1998). On July 23, 1998, the U.S. Department of the Treasury determined, based on DOJ’s opinion, that the FRF is the appropriate source of funds for payments of any such judgments and settlements.

16 The financial benefits provided to acquiring institutions associated with supervisory goodwill are described in United States v. Winstar Corp., 518 U.S. 839, 848-854 (1996).


18 Although FIRREA significantly altered many aspects of the thrift industry, the provision most relevant to this litigation was the requirement that OTS “prescribe and maintain uniformly applicable capital standards for savings associations” and the phase-out and elimination of supervisory goodwill in calculating core capital. 12 U.S.C. § 1464(t). Section 301 of FIRREA provided that failure to maintain capital at or above the minimum level could be treated as an unsafe or unsound practice and that substantially insufficient capital was grounds for appointment of a conservator or receiver. 12 U.S.C. §§ 1464(d)(2) and (s)(3) (1990).
was applying the new capital standards to all savings associations, including those that had been operating under previously granted capital and accounting forbearances, including supervisory goodwill. As a result, acquiring institutions that had agreements with the government became subject to OTS-imposed sanctions under FIRREA for failing to meet the minimum capital requirements. Plaintiffs subsequently brought suit against the government alleging breach of contract. In United States v. Winstar Corp., the Supreme Court held that the government was liable for damages to the acquiring institutions for breach of contract. In the damages phase of the case, over 120 other claimants who had entered into similar accounting method agreements with the government, had joined the original three plaintiffs as of January 7, 1997, in seeking recovery for contract damages. According to FDIC, as of December 31, 2006, there were approximately 26 cases pending against the government based on alleged breaches of such agreements.

In addition, FDIC data indicate that from 2002 through April 11, 2007, approximately $274 million ($276 million in 2006 dollars) had been paid in judgments and settlements in separate litigation regarding tax benefits that parallels the supervisory goodwill cases. Like the goodwill cases, the tax benefits involve agreements between investors and thrift regulators in the context of acquiring failing thrifts. In the tax benefit litigation—called Guarini cases, after the legislation that established the relevant tax provisions—the plaintiffs entered into agreements with FSLIC, providing that the regulators would reimburse them for the losses that they sustained when disposing of certain assets that they acquired in the transaction. Under provisions of the tax law then in existence that were specifically applicable to FSLIC, the acquirers could take advantage of the losses and were not required to include the FSLIC reimbursement in calculating their income. A provision of the Omnibus Budget Reconciliation Act of 1993—popularly referred to as the “Guarini legislation”—eliminated the tax deductions for these covered losses. According to FDIC, as of April 2007, all of the Guarini cases have been adjudicated and associated payments made; however, additional claims for attorney costs are still pending.

Costs associated with supervisory goodwill and Guarini litigation also involve expenses incurred by DOJ. Because the supervisory goodwill and Guarini lawsuits are against the United States, DOJ defends the government. According to FDIC data, since 1998,

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22 These agreements allegedly contained the promise of tax deductions for losses incurred on the sale of certain thrift assets purchased by plaintiffs from FSLIC, although FSLIC provided the plaintiffs with tax-exempt reimbursement.

approximately $374 million ($427 million in 2006 dollars) has been paid to DOJ in litigation expenses.\textsuperscript{24}

**Estimated Cost of Tax Benefits and Interest Expense on REFCORP Bonds Remain Unchanged**

FDIC’s estimates of the tax benefits received by institutions that acquired failing thrifts under certain FSLIC assistance agreements generally correspond with the $7.5 billion ($9.3 billion in 2006 dollars) we estimated in 1996 (including $3.1 billion that had already been realized through December 31, 1995). According to FDIC, through tax year 2005, institutions that acquired failed thrifts received approximately $6.51 billion in tax benefits associated with FSLIC assistance agreements, and approximately $609.24 million remain in tax year 2006 and future benefits. Tax benefits included treating assistance paid to an acquiring institution as nontaxable and, in some cases, reducing the tax liability of the acquiring institution by carrying over certain tax losses and tax attributes of the troubled institutions.\textsuperscript{25} The effect of these special tax benefits was to reduce the amount of FSLIC assistance payments.

Similarly, our estimates of the interest expense associated with certain bonds used to help finance resolution of the savings and loan crisis have not changed.\textsuperscript{26} These bonds were issued by the Resolution Financing Corporation (REFCORP) and the Financing Corporation (FICO). Congress established REFCORP by the enactment of FIRREA in 1989 primarily to provide funds for RTC, which was created during the savings and loan crisis as a means of liquidating insolvent institutions. Beginning in 1989, REFCORP issued six series of 30- and 40-year bonds with fixed coupon rates. From the proceeds of these bonds, REFCORP purchased a special domestic series of long-term, zero-coupon bonds issued by Treasury that are pledged to pay the principal amount of the REFCORP bonds. The zero-coupon bonds are the primary source for repaying the principal of the obligations at maturity. FIRREA also provided that if REFCORP income from other sources was insufficient to pay the interest due on the bonds, the FHL Banks would be required to annually contribute up to $300 million. FIRREA further provided that the U.S. Treasury would cover any interest shortfall between the total interest on REFCORP bonds and the FHL Banks contribution. In

\textsuperscript{24} The FRF pays the goodwill litigation expenses incurred by DOJ based on a memorandum of understanding, dated October 2, 1998, between FDIC and DOJ. DOJ returns any unused fiscal year funding to the FRF unless special circumstances warrant that these funds be carried over and applied against current fiscal year charges.

\textsuperscript{25} The tax benefit agreements are described in *Local America Bank of Tulsa, v. United States*, 52 Fed. Cl. 184, 185 (2002); *First Nationwide Bank v. United States*, 49 Fed. Cl. 750, 751 (2001); and *Centex Corp. v. United States*, 49 Fed Cl. 691, 693 (2001).

\textsuperscript{26} In 1996, we determined that the known interest expense on bonds issued to finance FSLIC’s costs for savings and loans resolutions totaled $111.8 billion ($138.2 billion in 2006 dollars). Specifically, we determined that $76.2 billion of the $111.8 billion in total known interest expense was paid by the taxpayers. We also estimated that Treasury would incur $209 billion in interest expense associated with appropriations resulting from legislation enacted to specifically address the savings and loan industry crisis. This legislation was enacted during a period in which the federal government was financing—via deficit spending—a sizable portion of its regular, ongoing program activities and operations. We based our estimate of Treasury interest expense on various simplifying assumptions, including (1) the entire amount of appropriations used to pay direct costs was borrowed and (2) appropriations for the FRF and RTC would be financed for 30 years at 7 percent interest, with no future refinancing. For further information, refer to GAO/AIMD-96-123.
1987, Congress also created the FICO as a financing mechanism for FSLIC. FICO provided funding for FSLIC-related costs by issuing bonds to the public.\textsuperscript{27}

Section 607 of the Gramm-Leach-Bliley Act of 1999 (GLBA) revised the obligations of the FHL Banks to pay annual interest payments on REFCORP bonds, from approximately $300 million annually to 20 percent of the FHL Banks’ annual net earnings, after deducting certain expenses.\textsuperscript{28} To ensure that the FHL Banks pay their entire obligation, GLBA requires the Federal Housing Finance Board, which oversees the FHL Banks, to determine annually the extent to which the value of their aggregate payments under the 20 percent regime exceeds or falls short of an annuity of $300 million per year, commencing on the issuance date of the REFCORP bonds and ending on the final scheduled maturity date of those bonds.\textsuperscript{29} According to the Federal Housing Finance Board, as of March 2007, the FHL Banks had paid approximately $6.2 billion in interest payments on REFCORP bonds.

REFCORP’s 2006 financial statements and reports indicated that $2.6 billion was paid in interest on REFCORP’s long term obligations in 2005 and 2006. Annual interest expenses will continue through maturity of the REFCORP bonds in the years 2019, 2020, 2021, and 2030.

\textsuperscript{27}FICO was established by the Federal Savings and Loan Insurance Corporation Recapitalization Act of 1987, Pub. L. No. 100-86, tit. III, § 302, 101 Stat. 552 (Aug. 10, 1987). FICO is a mixed-ownership government corporation whose main purpose is to function as a financing vehicle for FSLIC. FICO provided funding for FSLIC-related costs by issuing $8.2 billion of noncallable, 30-year bonds to the public. The annual interest obligation on the FICO bonds will continue through the maturity of the bonds in the years 2017 through 2019. We determined that the total nominal interest expense over the life of the FICO bonds will be $23.8 billion. FDIC acts as collection agent for FICO. The Deposit Insurance Funds Act 1996 (DIFA), Pub. L. No. 104-208, div. A, tit.II, subtit.G, 110 Stat. 3009-479 (Sept. 30, 1996), authorized FICO to assess both Bank Insurance Fund (BIF)- and Savings Association Insurance Fund (SAIF)-insured deposits, and require the BIF rate to equal one-fifth the SAIF rate through year-end 1999, or until the insurance funds are merged, whichever occurs first. Since the first quarter of 2000, all FDIC-insured deposits have been assessed at the same rate by FICO. Effective March 31, 2006, BIF and SAIF were merged into the newly created Deposit Insurance Fund (DIF).


\textsuperscript{29}According to REFCORP’s December 31, 2006, Report of Independent Auditors, interest on REFCORP’s long-term obligations is funded in the following order, to the maximum extent each is available: (1) interest on earnings on REFCORP investments; (2) annually, 20 percent of the FHL Banks’ net earnings after the deduction for the Affordable Housing Program; (3) FRF proceeds from the sale of assets transferred by RTC; and (4) Treasury.
Relatively Few U.S. Commercial Banks Appear to Use Ex-Im Products or Participate in Trade Finance for Various Reasons

Because Ex-Im records do not specifically differentiate banks from nonbank lenders, we could not determine precisely the extent of bank participation in Ex-Im’s programs. In fiscal year 2005 (the most recent year for which Ex-Im could provide data), U.S. lenders—including both banks and nonbank lenders—accounted for about $1.8 billion in loan guarantees, $2.4 billion in insurance products, and $1.1 billion in working capital guarantees. However, U.S. lender participation in trade finance has generally declined in recent years, and some evidence suggests that Ex-Im programs are used by relatively few banks. Trade finance industry participants noted that most U.S. banks involved in trade finance are large, money-center banks, along with a limited number of regional and small banks. Ex-Im officials and industry participants noted that transactions involving Ex-Im products generally result in high internal administrative costs and low profit margins for banks compared with other bank product lines. Nevertheless, officials and participants identified a number of other factors that might prompt banks to use Ex-Im products, including risk mitigation through Ex-Im’s loan guarantees and insurance, and increased liquidity through the sale of certain Ex-Im products in the secondary market. Furthermore, Ex-Im officials and industry participants said that using Ex-Im products offers U.S. banks the opportunity to develop broader relationships with their customers and, in turn, offer them other services.

Ex-Im’s mission is to help U.S. companies create and maintain American jobs by financing exports of goods and services and filling gaps in the availability of commercial financing for creditworthy export transactions. Ex-Im also helps American exporters meet government-supported financing competition from other countries so that American exports can compete for overseas business on the basis of price, performance, and service. To accomplish its mission, Ex-Im offers a variety of financing instruments, including the following:

- **Loan guarantees and direct loans for buyer financing.** Under its loan guarantee program, Ex-Im agrees to guarantee loans made by other lenders to help buyers in other countries obtain financing to purchase U.S. exports. Guarantees are offered to qualified lenders, primarily commercial banks.

- **Export credit insurance.** This product protects U.S. exporters against nonpayment by their customers. Ex-Im provides this insurance either directly to exporters, or to banks that in turn, finance U.S. exporters.

- **Working capital guarantees for pre-export financing.** Ex-Im guarantees to working capital lenders making loans to U.S. companies who would like to export but need funds to produce or market their goods or services for export.

These guarantees and insurance programs reduce some of the risks involved in exporting by insuring against commercial or political uncertainty. Given Ex-Im’s mission of encouraging U.S. exports, Ex-Im officials and trade finance industry representatives and

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30 First established in 1934, Ex-Im is the official export credit agency of the United States under the authority of the Export-Import Bank Act of 1945, as amended, and operates as an independent agency of the U.S. government. Ch. 341, 59 Stat. 526 (July 31, 1945) (codified at 12 U.S.C. §§ 635, 635a, 635b, 635d to 635h, 635i-3, 635i-5 to 535i-9).
participants commented that the role of lenders—including U.S. banks—in transactions involving Ex-Im products is that of an intermediary.

Data Indicate That a Small Number of U.S. Lenders Participate in Ex-Im Programs

Ex-Im data that we obtained on lenders participating in Ex-Im transactions did not specifically differentiate banks from nonbank lenders. Further, the data did not consistently provide lender domicile information (indicating whether or not the lender was a U.S.-headquartered lender) until fiscal year 2000; accordingly, we confined our analysis to data for fiscal years 2000 through 2005. As shown in figure 1, Ex-Im data indicate that a fairly small number of U.S. lenders—generally around 100 annually representing both banks and nonbank lenders—participated in its programs. Nevertheless, this small number of U.S. lenders constituted a majority of Ex-Im’s top lenders since fiscal year 2000.

Figure 1: U.S. Percentage of Total Ex-Im Lenders, Fiscal Years 2000-2005

<table>
<thead>
<tr>
<th>Year</th>
<th>Number of lenders</th>
<th>U.S. Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>2000</td>
<td>103</td>
<td>137</td>
</tr>
<tr>
<td>2001</td>
<td>100</td>
<td>131</td>
</tr>
<tr>
<td>2002</td>
<td>91</td>
<td>126</td>
</tr>
<tr>
<td>2003</td>
<td>90</td>
<td>129</td>
</tr>
<tr>
<td>2004</td>
<td>100</td>
<td>138</td>
</tr>
<tr>
<td>2005</td>
<td>103</td>
<td>135</td>
</tr>
</tbody>
</table>

Ex-Im officials attributed the problems in identifying lenders within Ex-Im data primarily to consolidation within the banking industry. They noted that in Ex-Im’s software systems a lender and its subsidiaries could each be coded as individual lenders, making comparisons over time difficult. However, according to the officials, Ex-Im is undertaking a multiyear program to reengineer and automate its primary business processes—including short- and medium-term export insurance and loan guarantees—through an online computer system.  

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31 Ex-Im defines a U.S.-domiciled bank or nonbank as one in which the global parent is headquartered in the United States. According to Ex-Im, in general, a nonbank lender is a financial institution that provides banking services without meeting the legal definition of a bank (i.e., one that does not hold a banking license). Ex-Im also indicated that nonbank institutions frequently act as suppliers of loans and credit facilities; however, they are typically not allowed to take deposits from the general public and have to find other means of funding their operations, such as issuing debt instruments (e.g., Sears and American Express).

32 Ex-Im officials said that the program includes an interface with a commercial provider of business credit information that would help resolve problems in identifying lenders that have merged or been acquired and noted that in June 2006, Ex-Im had implemented the first phase of the new online system for insurance products.
Ex-Im data show that while U.S. bank and nonbank lenders represented the largest percentage of Ex-Im's top lenders, their participation level in terms of lenders and authorizations varied among the products. Specifically, participation in the loan guarantee and insurance programs significantly declined while the working capital guarantee program saw increased participation. Figure 2 provides authorization levels for Ex-Im products from fiscal years 2000 through 2005.

**Figure 2: U.S. Participation in Ex-Im's Products, Fiscal Years 2000-2005**

<table>
<thead>
<tr>
<th>Loan guarantee product</th>
<th>Insurance product</th>
<th>Working capital product</th>
</tr>
</thead>
<tbody>
<tr>
<td>Dollars in billions</td>
<td>U.S. Percentage</td>
<td>Dollars in billions</td>
</tr>
<tr>
<td>2000 $3.8</td>
<td>17.7</td>
<td>48.9</td>
</tr>
<tr>
<td>2001 2.4</td>
<td>5.1</td>
<td>46.6</td>
</tr>
<tr>
<td>2002 2.3</td>
<td>6.5</td>
<td>35.4</td>
</tr>
<tr>
<td>2003 2.8</td>
<td>7.0</td>
<td>37.5</td>
</tr>
<tr>
<td>2004 1.4</td>
<td>7.3</td>
<td>19.3</td>
</tr>
<tr>
<td>2005 1.8</td>
<td>8.3</td>
<td>21.4</td>
</tr>
</tbody>
</table>

It is important to note that these loan guarantee and insurance programs are credit programs, and the amounts shown in the figure do not necessarily represent costs to Ex-Im or the U.S. government. Ex-Im’s loan guarantee and insurance programs essentially reimburse guaranteed lenders and insureds in the event of an eligible default. According to Ex-Im officials, low rates of default on its loan guarantees and insurance claims, and a high rate of recovery on assets involved in these products, have resulted in generally low costs in Ex-Im programs. Figures 3 and 4 illustrate claims paid to guaranteed lenders and insureds and recoveries from fiscal year 2002 through 2006, respectively.

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33 According to Ex-Im, the agency reimburses after default, subject to the insured’s or guaranteed lender’s compliance with terms and conditions of the policy or guarantee (e.g., timely filing, proof of export) that make the claim eligible for reimbursement.

34 These recoveries do not necessarily relate to the claims paid in the same year.
Figure 3: Ex-Im Claims Paid to Guaranteed Lenders and Insureds, Fiscal Years 2002-2006

<table>
<thead>
<tr>
<th></th>
<th>Dollars in millions</th>
<th>U.S. Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>2002</td>
<td>$293.5</td>
<td>442.6</td>
</tr>
<tr>
<td>2003</td>
<td>181.0</td>
<td>214.8</td>
</tr>
<tr>
<td>2004</td>
<td>157.7</td>
<td>200.5</td>
</tr>
<tr>
<td>2005</td>
<td>131.9</td>
<td>170.5</td>
</tr>
<tr>
<td>2006</td>
<td>123.9</td>
<td>256.4</td>
</tr>
</tbody>
</table>

Source: GAO analysis of Ex-Im data.

Figure 4: Ex-Im Recoveries, Fiscal Years 2002-2006

<table>
<thead>
<tr>
<th></th>
<th>Dollars in millions</th>
</tr>
</thead>
<tbody>
<tr>
<td>2002</td>
<td>$615.6</td>
</tr>
<tr>
<td>2003</td>
<td>349.4</td>
</tr>
<tr>
<td>2004</td>
<td>445.9</td>
</tr>
<tr>
<td>2005</td>
<td>297.8</td>
</tr>
<tr>
<td>2006</td>
<td>1,012.1</td>
</tr>
</tbody>
</table>

Source: Ex-Im data.

Note: According to Ex-Im officials, the recovery figures include repayments of claims that were rescheduled under the Paris Club, an informal group of creditors that meets, as needed, to negotiate debt rescheduling and relief efforts for public or publicly guaranteed loans. The large amount in fiscal year 2006 was the result of one country prepaying its Paris Club debt, which was $592 million of the total.

In 2006, Ex-Im’s chairman testified before the U.S. Senate Committee on Banking, Housing, and Urban Affairs that the overall loss rate throughout Ex-Im’s history has been less than 2 percent. Further, information that we reviewed on Ex-Im’s program subsidy rate from fiscal year 2001 to fiscal year 2007 indicated a general downward trend.

Although U.S. Banks’ Involvement in Trade Finance Appears Limited, Banks May Use Ex-Im Products for a Variety of Reasons

According to Ex-Im and Office of the Comptroller of the Currency (OCC) officials and trade finance industry representatives, U.S. bank involvement in trade finance is limited and has generally declined in recent years. Nevertheless, they noted several factors that prompt continuing bank involvement in trade finance transactions and in Ex-Im programs. Ex-Im officials and trade finance industry representatives noted that most U.S. banks involved in trade finance are large, money center banks, along with a limited number of regional and small banks. OCC officials said that only a small group of OCC-supervised banks participate in international lending, comprising large banks and some institutions located along the U.S. border. According to FDIC officials, FDIC supervises fewer than 10 institutions that hold more than 25 percent of their capital in trade finance activities.
Ex-Im officials and trade finance industry representatives and participants described several factors that had contributed to a decline in U.S. bank participation in trade finance, including the industry’s continuing consolidation activity and increased competition from nonbank lenders and foreign banks. According to Ex-Im officials, U.S. bank participation in trade finance has declined over the past 25 years. Additionally, an OCC official noted that lending survey data indicate that the trade finance activities of U.S. banks remained relatively stable over the past decade, decreased during the late 1990s, and increased near the end of 2005.35 A representative of a U.S. trade finance industry association said that the association membership had decreased by one-half. Ex-Im officials and industry experts noted that competition from nonbank entities and foreign banks was also a contributing factor to the decline in U.S. bank participation in trade finance. Other factors cited included capital requirements and competition from foreign banks. One Ex-Im official posited that under the Basel Capital Accord, the capital requirements for assets involved in emerging markets could have caused U.S. banks to move out of medium- and long-term trade financing activities into lines of business requiring lower capital.36 Furthermore, according to the official, European banks are subject to the same requirements but achieve greater operational efficiency in trade finance transactions because of the borders of European countries are closer and the countries have a much larger volume of trade financing. The Ex-Im official also noted that foreign bank participation in trade finance also increased as they began providing services to corporate customers in the United States through their U.S. correspondents.

Ex-Im officials and industry participants noted that although trade finance transactions are associated with relatively high administrative costs and low returns, they can also foster relationship banking, help mitigate risk, increase liquidity, and thus prompt U.S. bank involvement. Ex-Im officials and a trade finance participant characterized bank returns on transactions involving Ex-Im products as low relative to other business lines and noted that these transactions typically involved high labor and administrative costs. Ex-Im officials explained that trade finance generally is not the key profit-making business line for banks relative to other business lines and, as a result, banks approach it as a vehicle for relationship banking—that is, as a way to offer additional services to customers.

Banks also use Ex-Im products to reduce risk associated with uncertainty about overseas buyers and increase liquidity through a secondary market, according to Ex-Im and trade finance industry participants. Ex-Im officials indicated that Ex-Im’s guarantees of commercial loans to international buyers of U.S. capital goods and services protect lenders against nonpayment due to commercial and political events. Through these medium- and

35 The Country Exposure Report collects information on the distribution, by country, of claims on foreigners held by U.S. banks and bank holding companies. The Federal Reserve, FDIC, and OCC use the data to determine the degree of risk in bank portfolios and the effect of adverse developments in particular countries may have on banks or the U.S. banking system.

36 The Basel Capital Accord (Basel Accord) is an international framework for risk-based capital. These risk-based capital requirements, which were fully implemented by U.S. regulators by 1992, focused on limiting credit risk by requiring certain firms to hold capital equal to at least 8 percent of the total value of their risk-weighted on-balance sheet assets and off-balance sheet items, after adjusting the value of the assets according to certain rules intended to reflect their relative risk.
long-term guarantees, Ex-Im covers 100 percent of the loan principal and interest. Ex-Im officials also indicated that their export credit insurance policies limit lenders’ exposure to country and credit risks. A trade industry participant explained that if a country’s creditworthiness is a concern or the country has not provided for defaults and other contractual disagreements in law, the use of an Ex-Im product can be the deciding factor in a bank’s willingness to help a new or existing customer.

Repayment terms for Ex-Im’s medium-term loan guarantees extend up to 5 years and repayment terms for long-term loan guarantees extend over 10 years.
Banks and Thrifts Lower Their Federal Taxes Primarily by Using Tax Deductions, Credits, and Other Provisions that Are Generally Available to All Corporations

According to IRS data and officials, banks and thrifts use tax deductions, credits, and other provisions that are generally available to all corporations. Treasury considers only one tax provision—the deduction of excess bad debt reserves—to be a tax expenditure available exclusively to banks and thrifts and estimates revenue losses from this tax expenditure at $10 million in 2007. IRS data from 2004—the most recent year with available data—indicate that the largest deductions that banks and thrifts took were for business expenses, such as interest paid and salaries and wages, while the largest tax credits they claimed were the general business credit and foreign tax credit. To bypass federal corporate income taxation, some eligible banks and thrifts have also taken advantage of the option to become S-corporations, which pass their income through to shareholders, who are then taxed as individuals on that income. As of December 2006, 2,356 depository institutions, including 31 percent of banks, had elected Subchapter S status, according to FDIC data. IRS officials also noted that some banks have participated in tax shelters and transactions the IRS considers to be abusive.

Banks and Thrifts Receive Few Industry Specific Tax Expenditures

Like other corporations, banks and thrifts use general corporate tax deductions, credits, and other tax provisions to lower their federal income taxes. Some of these tax provisions are considered tax expenditures. Tax expenditures result in forgone revenue for the federal government due to preferential provisions in the tax code, such as deductions, credits, and deferral of tax liability. These provisions grant special tax relief for certain kinds of taxpayer behavior or for taxpayers in special circumstances. Both the congressional Joint Committee on Taxation and Treasury annually compile lists of tax expenditures and estimate their cost. Treasury’s estimates are included as an informational supplement to the annual federal budget. Tax expenditures are considered exceptions to the normal structure of the individual and corporate tax base. Determining whether an individual provision should be characterized as a tax expenditure is a matter of judgment about what should be included in the income tax base. The income tax base includes most corporate deductions for general business expenses which reflect costs of earning income.

In the President’s fiscal year 2008 annual budget, Treasury lists only one tax expenditure that is available exclusively to banks and thrifts—the deduction of excess bad debt reserves. Commercial banks, mutual savings banks, and savings and loan associations with less than $500 million in assets may generally deduct additions to bad debt reserves in

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38 Treasury estimates the one tax expenditure available to credit unions—tax exempt status—to cost $1.4 billion in revenue losses in 2007.
39 31 U.S.C. § 1105(a) (16) requires that a list of tax expenditures be included in the budget.
40 26 U.S.C. §§ 585 and 593. Bad debt reserves are an account maintained by financial institutions and used to offset losses from foreclosed or uncollectible loans.
excess of actually experienced losses. This tax expenditure will cost $10 million in revenue losses in 2007, according to Treasury’s estimates.\textsuperscript{41}

In addition to the one tax expenditure available exclusively to banks and thrifts, other tax expenditures result when banks invest in certain specific activities, including certain school improvements and the economic development of low-income communities and economically depressed areas. The tax credit for qualified zone academy bonds—whose proceeds are used to renovate or improve schools in low-income school districts—is available only for banks, insurers, and other corporations in the business of lending money.\textsuperscript{42} Banks also use economic development tax expenditures such as the new markets tax credit (NMTC) and the empowerment zones and renewal communities (EZ/RC) tax benefits.\textsuperscript{43} As investors in these community development projects, banks can claim the tax credits and lower their tax liability.\textsuperscript{44} The communities benefit from the increased investment. Banks and other regulated financial institutions made up 38 percent of total NMTC claimants through 2006 and also accounted for the majority of the investment funds.

**Banks and Thrifts Use Tax Deductions and Credits That Are Available to All Corporations**

Like other corporations, banks and thrifts lower their tax liability by claiming tax deductions and credits. IRS categorizes banks, thrifts, and similar institutions as depository credit intermediation corporations. As shown in table 1, IRS data indicate that depository credit intermediation corporations represent 0.55 percent of total receipts for all corporations and 2.67 percent of total income taxes paid by all corporations. These calculations are based on IRS data for the 2004 tax year, the most recent year for which data are publicly available.


\textsuperscript{42} See 26 U.S. C. § 1397E(d)(6). Treasury estimates that the 2007 revenue losses from the qualified zone academy bond tax credit are $140 million in aggregate; the share by industry is not available.


\textsuperscript{44} Treasury estimates that 2007 tax revenue losses from the NMTC are $210 million from corporate income taxes, with a total revenue loss of $810 million (corporate and individual income taxes). The estimated 2007 revenue losses from the EZ/RC tax benefit are $340 million from corporate income taxes, with a total revenue loss of $1.34 billion (corporate and individual income taxes). The share by industry is not available.
### Table 1: Tax Deductions, Credits, and Payments for Depository Credit Intermediation Corporations Compared with All Corporations, 2004

<table>
<thead>
<tr>
<th>All tax returns (with and without net income)</th>
<th>Depository credit intermediation (Dollars in millions)</th>
<th>Depository credit intermediation as a percentage of all corporations</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total receipts a</td>
<td>$22,711,864</td>
<td>$125,388</td>
</tr>
<tr>
<td>Deductions</td>
<td>-21,636,156</td>
<td>-108,474</td>
</tr>
<tr>
<td>Adjustments b</td>
<td>-218,316</td>
<td>+684</td>
</tr>
<tr>
<td>Taxable income</td>
<td>857,392</td>
<td>17,598</td>
</tr>
<tr>
<td>Tax rate</td>
<td>≈35%</td>
<td>≈35%</td>
</tr>
<tr>
<td>Income tax before credits</td>
<td>299,555</td>
<td>6,197</td>
</tr>
<tr>
<td>Tax credits</td>
<td>-75,120</td>
<td>-200</td>
</tr>
<tr>
<td>Total income tax</td>
<td>$224,435</td>
<td>$5,997</td>
</tr>
</tbody>
</table>


a Total receipts equal the amount of gross receipts and other forms of positive income before deductions.

b Includes constructive taxable income from related foreign corporations, statutory special deductions; excludes Interest on government obligations: state and local, applicable S-corporations, regulated investment companies, and real estate investment trusts.

Deductions claimed by depository credit intermediation corporations consist largely of deductions for business expenses.\(^\text{45}\) As shown in table 2, IRS data indicate that in 2004, these corporations claimed deductions totaling about $108 billion. The largest deductions claimed were for interest paid and salaries and wages.

\(^{45}\) Deductions for expenses incurred in earning income are considered part of the normal tax structure and not tax expenditures.
Table 2: Depository Credit Intermediation Corporations Deductions, 2004

<table>
<thead>
<tr>
<th>Deductions</th>
<th>Dollars in thousands</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total receipts</td>
<td>$125,387,897</td>
</tr>
<tr>
<td>Cost of goods</td>
<td>$198,898</td>
</tr>
<tr>
<td>Compensation of officers</td>
<td>2,522,529</td>
</tr>
<tr>
<td>Salaries and wages</td>
<td>19,400,167</td>
</tr>
<tr>
<td>Repairs</td>
<td>1,289,065</td>
</tr>
<tr>
<td>Bad debts</td>
<td>3,163,894</td>
</tr>
<tr>
<td>Rent paid on business property</td>
<td>2,116,502</td>
</tr>
<tr>
<td>Taxes paid</td>
<td>3,117,885</td>
</tr>
<tr>
<td>Interest paid</td>
<td>45,422,737</td>
</tr>
<tr>
<td>Charitable contributions</td>
<td>222,564</td>
</tr>
<tr>
<td>Amortization</td>
<td>1,133,415</td>
</tr>
<tr>
<td>Depreciation</td>
<td>4,314,159</td>
</tr>
<tr>
<td>Depletion</td>
<td>2,427</td>
</tr>
<tr>
<td>Advertising</td>
<td>1,316,714</td>
</tr>
<tr>
<td>Pension, profit sharing, stock,</td>
<td>1,080,607</td>
</tr>
<tr>
<td>annuity</td>
<td></td>
</tr>
<tr>
<td>Employee benefit programs</td>
<td>2,406,261</td>
</tr>
<tr>
<td>Net loss, noncapital assets</td>
<td>1,437,786</td>
</tr>
<tr>
<td>Other deductions</td>
<td>19,328,600</td>
</tr>
<tr>
<td>Total deductions</td>
<td>$108,474,210</td>
</tr>
</tbody>
</table>


As shown in table 3, in 2004, depository credit intermediation corporations claimed about $199 million in tax credits, the largest being the general business credit (1.5 percent of total income taxes) and foreign tax credit (1.1 percent of total income taxes).46

46 The general business credit consists of a combination of 27 individual credits for such things as research, low-income housing, employer-provided child care, and community development. Of these, 26 are considered tax expenditures. The foreign tax credit provides credit against U.S. income tax for income taxes paid to foreign countries or U.S. possessions, and this credit is not a tax expenditure.
### Table 3: Depository Credit Intermediation Corporations Tax Credits, 2004

<table>
<thead>
<tr>
<th>2004 income tax and credits</th>
<th>Dollars in thousands</th>
</tr>
</thead>
<tbody>
<tr>
<td>depository credit intermediation</td>
<td>$6,196,984</td>
</tr>
<tr>
<td>Total income tax before credits</td>
<td></td>
</tr>
<tr>
<td>Tax credits</td>
<td></td>
</tr>
<tr>
<td>Foreign tax credit</td>
<td>$65,267</td>
</tr>
<tr>
<td>Nonconventional source fuel credit</td>
<td>20,718</td>
</tr>
<tr>
<td>General business credit</td>
<td>95,180</td>
</tr>
<tr>
<td>Prior year minimum tax credit</td>
<td>17,248</td>
</tr>
<tr>
<td>Other tax credits*</td>
<td>1,300</td>
</tr>
<tr>
<td>Total Tax Credits</td>
<td>$199,713</td>
</tr>
<tr>
<td>Total income tax after credits</td>
<td>$5,997,271</td>
</tr>
</tbody>
</table>


* Includes qualified zone academy bond credit

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**Some Banks and Thrifts Bypass Corporate Income Tax by Electing S–corporation Status**

FDIC data indicate that in recent years, an increasing number of banks and thrifts have taken advantage of the option to elect Subchapter S tax status and therefore bypass federal corporate income tax. Subchapter S tax status, which is available to corporations with less than 100 shareholders, is a common corporate tax structure appearing in every industrial sector. In contrast to Subchapter C corporations, which pay taxes as a corporate entity, an S-corporation elects to pass through its income to shareholders. Corporations that elect Subchapter S status generally are not subject to federal corporate-level income tax, as Subchapter C corporations are. S-corporation shareholders are taxed at their individual income tax rates on their portion of the corporation’s taxable income, regardless of whether they receive a cash distribution. The net effect of electing subchapter S status is to lower the total amount of tax assessed on corporate income by avoiding the double taxation of corporate dividends, as shown in figure 5.

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47 Special tax rules for S-corporations are not considered tax expenditures by the Joint Committee on Taxation or Treasury because they are generally available to any entity that chooses to organize and operate in the required manner.

Figure 5: Federal Tax Rates of C- and S-Corporations

<table>
<thead>
<tr>
<th>Taxes applied to net profits</th>
<th>Corporate level</th>
<th>Shareholder level</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>C-corporation</strong></td>
<td>(corporate income tax)</td>
<td>35%</td>
<td><strong>S-corporation</strong></td>
</tr>
<tr>
<td><strong>S-corporation</strong></td>
<td>Profits/losses</td>
<td></td>
<td>15%</td>
</tr>
<tr>
<td></td>
<td>(individual income tax)</td>
<td>35%</td>
<td></td>
</tr>
</tbody>
</table>

Source: GAO analyst.

a Corporate income tax rate on earnings over $18,333,333.
b Maximum tax rate on qualified dividends. Dividends are taxed in the year they are distributed. Capital gains are taxed when an individual realizes gains from the sale of an asset, such as a corporate stock.
c Maximum individual income tax rate.

As of December 31, 2006, FDIC and IRS data indicate that there were 2,356 S-corporation banks and thrifts, accounting for less than 1 percent of the total U.S. S-corporation population (based on 2003 data). As shown in figure 6, the number of S-corporation banks and thrifts has grown steadily since 1997, the first year financial institutions were allowed to elect Subchapter S status.

Figure 6: Number and Assets of Subchapter S Corporations (1996–2006) Compared to All FDIC-insured Institutions (Banks and Thrifts)

Source: GAO analysis of FDIC data.

49 The most recently available IRS data on the total number of U.S. S-corporations is for 2003.

50 Until 1997, financial institutions were not allowed to elect Subchapter S status because of the special methods of accounting for bad debts that were available to them for tax purposes.
Banks comprise the majority of Subchapter S depository corporations. As of 2006, approximately 31 percent of banks have elected S-corporation status, compared to 7 percent of thrifts. S-corporation banks and thrifts are generally smaller institutions with average assets of $175 million, but a couple of the largest S-corporation thrifts have over $10 billion in assets.

Some Banks Have Participated in Tax Shelters IRS Views as Abusive

According to IRS officials, they have found a number of instances in which some banks have participated in tax shelters and transactions that they view as abusive. Abusive tax shelters are generally characterized as transactions that exploit tax code provisions and reap unintended tax benefits rather than engage in any meaningful economic activity. By their nature, abusive tax shelters are varied, complex, and difficult to detect and measure.

IRS officials said that some banks have participated in abusive lease-in/lease-out (LILO) transactions along with other tax shelters. Unlike the traditional lease transactions that banks and other companies commonly engage in, a LILO is merely a transfer of tax benefits. Figure 7 illustrates a simplified structure of a LILO tax shelter. In a LILO transaction, a U.S. taxpayer (i.e., a corporation) purportedly leases an asset (such as subway trains, power plants, or sewer systems) from a tax-exempt entity, such as a municipality or tax exempt organization (shown as A in figure 7). Because the taxpayer then leases the asset back to the same entity, the use and possession of the asset is, in substance, unaltered by the transaction (shown as B in figure 7). The transaction is structured to eliminate any risk to the U.S taxpayer or the tax-exempt entity. The U.S. taxpayer benefits from the transaction by claiming tax deductions for rental payments, transaction costs, and interest income.

IRS issues formal guidance on certain potential tax avoidance transactions that are referred to as listed transactions. See 26 U.S.C. § 6011, 26 C.F.R. § 1.6011-4(b)(2). Taxpayers are required to disclose their participation in listed transactions. As of March 2007, 31 listed transactions have been identified and addressed in formal guidance.


IRS describes LILO transactions in Revenue Ruling 2002-69, 2002-2 C.B. 760, and a related transaction, known as sale–in/lease-out (SILO), in IRS Notice 2005-13, 2005-1 C.B. 630. SILO transactions are structurally similar to LILO transactions, except that in SILO transactions, the U.S. taxpayer purportedly buys the asset from the tax-exempt entity. Also, in SILO transactions, the taxpayer claims depreciation deductions rather than rent expense deductions. According to IRS officials, many of the banks that participated in LILO tax shelters also participated in SILO transactions.
One bank’s participation in a LILO tax shelter was the subject of a recently decided court case. The court granted the government’s motion for a summary judgment, upholding IRS’s disallowance of over $9 million in tax deductions in one taxable year resulting from one bank’s LILO transaction. The bank had entered into an $86 million LILO transaction with a Swedish pulp mill in 1997 involving the lease and sublease of the pulp manufacturing equipment. As a result of the disallowance, the bank paid a tax deficiency (including interest) for 1997 in the amount of $4.6 million. The bank filed a notice of appeal on March 1, 2007.

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Recent Growth in Depository Institution Profits Has Been Accompanied by Changes in Source of Income

Depository institutions have enjoyed strong profits in recent years. In 2006, banks and thrifts reported a total of $146 billion in net income. Credit unions, which are not-for-profit organizations, reported $5.7 billion in net income in 2006. As shown in figure 8, the profits of depository institutions have increased since 1990. Over the past 10 years, net income has increased by an average annual inflation-adjusted growth rate of 7 percent for banks, 8 percent for thrifts, and 3 percent for credit unions.

Figure 8: Profits of Depository Institutions: Net Income for Calendar Years, 1990–2006

One measure of profitability is returns on assets—net income divided by assets. Using this measure, banks are generally more profitable than thrifts or credit unions. Figure 9 shows how the profitability of these institutions has changed since 1990. In 2006, returns on assets were 1.27 percent for banks, 0.96 percent for thrifts, and 0.81 percent for credit unions.
According to a Federal Reserve official, the early 1990s (1990-1992) were a period of relatively low profitability for the banking industry, in part because the industry was adjusting to new regulatory capital standards resulting from the Basel Accord. Banks reduced their lending activities to meet Basel’s new capital requirements. In addition, according to OTS, thrifts were starting to recover from the savings and loan crisis of the 1980s during the same time period. After 4 straight years of losses, the thrift industry posted positive net income in 1991, and credit unions were largely able to avoid the financial turbulence of the early 1990s due to strong growth over the previous decade.\textsuperscript{55}

Since 1992, depository institutions have enjoyed steady growth in net income. Over the past 10 years, average inflation-adjusted annual growth rates in net income have been 7 percent for banks, 8 percent for thrifts, and 3 percent for credit unions. According to Federal Reserve reports, recent profitability is largely attributable to the favorable financial and economic conditions of the U.S. economy.

**Noninterest Income Is a Growing Source of Revenue for Depository Institutions**

Depository institutions have gradually shifted toward greater reliance on noninterest income, such as service charges and fees. As illustrated in figure 10, FDIC and NCUA data indicate that since 1990, banks, thrifts, and credit unions have all experienced an increase in noninterest income relative to net operating revenue. For banks, noninterest income in 2006

accounted for 43 percent of net operating revenues, up from 32 percent in 1990. At thrifts and credit unions, noninterest income in 2006 accounted for 34 and 31 percent, respectively, of net operating revenues, up from about 22 and 15 percent, respectively, in 1990.

**Figure 10: Noninterest Income as a Percentage of Net Operating Revenue**

![Graph showing noninterest income as a percentage of net operating revenue from 1990 to 2006 for banks, thrifts, and credit unions.]

Note: Net operating revenue equals net interest income plus total noninterest income.

According to federal banking regulators, the increase in noninterest income is the result of growth in fee-producing banking services and a relative decline in net interest income. Net interest margins (the difference between what banks incur to obtain funds and what they earn through lending) have narrowed over the past decade because of falling interest rates on bank loans and rising interest rates on bank deposits. Banks collect noninterest income from the sale of investments, fees, service charges, and other sources. FDIC reports that the largest sources of noninterest income for banks are service charges on deposit accounts and other noninterest income (see figure 11). We were not able to obtain comparable data for thrifts and credit unions because they categorize noninterest income sources differently.
Figure 11: Commercial Banks Noninterest Income

Source: GAO analysis of FDIC data.
Limited Information Suggests that Executive Compensation in the Banking Industry Has Increased

Publicly available information on executive compensation in the banking industry is limited. Depository institutions are not required to report compensation for chief executive officers (CEO) separately from overall compensation for the institution. Banks, thrifts, and credit unions are required to provide aggregate information on salaries and employee benefits in quarterly filings of call reports (and thrift financial reports in the case of thrift institutions). However, this information is not specific to executives and includes all of an institution’s officers and employees—for example, temporary help, dining room and cafeteria employees, and guards, among others, including employees of consolidated subsidiaries. One banking industry association, America’s Community Bankers (ACB), conducts annual surveys of its membership on compensation issues and survey results are available for purchase.

Although publicly available data are limited, over the past decade, a number of studies that focused on or included information on executive compensation in the banking industry noted that compensation at this level had increased and that its composition had changed over the past decade, especially for CEOs. For example, one study showed, in part, that from 1992 to 2000 total direct compensation for bank CEOs steadily increased and average direct compensation for bank CEOs more than doubled. A separate study found that prior to the enactment of the Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994 (Riegle-Neal), many bank CEOs had limited investment opportunities and, thus, equity-based compensation was not typically used to motivate bank CEOs to take on risks that could

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56 FDIC-insured commercial banks, FDIC-supervised savings banks, and OCC-supervised noninsured trust companies file consolidated Reports of Condition and Income (call reports) as of the close of business on the last day of each calendar quarter. Similarly, every federally insured savings and loan institution regulated by OTS files a thrift financial report on a quarterly basis. The specific reporting requirements depend on the size of the institution and whether or not it has any foreign offices. The information is extensively used by the banking regulatory agencies in their daily offsite bank monitoring activities. Reports of Condition and Income data are also used by the public, Congress, state banking authorities, researchers, bank rating agencies, and the academic community.

57 ACB Compensation and Benefits Survey, America’s Community Bankers (2006). For information on executive compensation issues in the credit union industry, including results from an industry survey on staff salaries and a pilot program from NCUA that, among other things, collected data on credit union executive compensation, see our recent report, Credit Unions: Greater Transparency Needed on Who Credit Unions Serve and on Senior Executive Compensation Arrangements, GAO-07-29 (Washington, D.C.: Nov. 30, 2006).

58 Our review cites a number of professional studies that date back to the 1990s.

increase shareholders’ value. However, after the act was passed, the equity-based component of CEO compensation increased significantly on average for the industry.

Another paper focused on banks that reported compensation data for CEOs and at least one additional executive in 1996. This study analyzed the components of compensation (base pay, annual bonus, deferred compensation, and the value of options granted) at approximately 300 publicly traded banks. The study found that the structure of compensation varied significantly across firms, with firm size being the most important explanatory characteristic, and that larger firms relied more heavily on annual bonuses, deferred compensation, and option-adjusted compensation and less heavily on base pay.

Another study synthesized various research on CEO compensation. For example, the study discussed how various papers measured incentives and how incentives were determined. Another study described research that noted that bank CEOs, on average, received less cash compensation, were less likely to participate in stock option plans, and received a smaller percentage of their compensation in the form of options than CEOs in other industries. Finally, one paper attributed the disparity in compensation to differences between the banking industry and other industries, rather than to such factors as banks being subject to more stringent regulation and have significantly higher leverage.

Two researchers attributed the increase in CEO compensation to the elimination of interstate banking barriers and increasingly competitive pressures that ultimately affected executive compensation. Before the enactment of Riegle-Neal, most banks generally could only branch out across state lines if the host state permitted this practice. Additionally, most banks that wanted to branch across state lines had to establish a bank holding company and, with certain restrictions, acquire or charter a bank in each state in which they wanted to operate. One researcher suggested that efforts to hire managerial talent after some interstate barriers were removed prior to the enactment of Riegle-Neal led to increases

65 John and Qian, “Incentive Features.”
66 Riegle-Neal authorized interstate mergers between affiliated banks beginning June 1, 1997, generally without regard to state law unless both states had opted out before that date.
in compensation during the 1980s.\textsuperscript{67} According to ACB, its 2006 survey of compensation and benefits indicated that salary increases at community banks continued to be linked to individual performance, with bonuses tied to bank performance.

**Federal Banking Statutes Establish Limits on Compensation as Part of Safety and Soundness**

Federal banking statutes limit the compensation of financial institution executives in certain circumstances.\textsuperscript{68} For example, Section 2523 of the Comprehensive Thrift and Bank Fraud Prosecution and Taxpayer Recovery Act of 1990 provides FDIC with the authority to prohibit or limit, by regulation or order, golden parachute payments.\textsuperscript{69} In general, an executive’s employment contract may include a clause allowing significant compensation if employment is terminated, and the benefits can include severance pay, a bonus, or stock options. In addition, the Federal Deposit Insurance Corporation Improvement Act of 1991 requires the federal banking regulatory agencies, among other things, to issue standards prohibiting excessive compensation, fees, and benefits as an unsafe and unsound practice.\textsuperscript{70} Furthermore, Prompt Corrective Action (PCA) authority provides limitations on executive compensation at certain undercapitalized institutions.\textsuperscript{71}

Officials of the federal banking regulatory agencies said that the agencies had addressed compensation issues indirectly through broader informal and formal enforcement actions that included other safety or soundness issues. The officials noted that routine bank examinations generally do not include a review of executive compensation levels. However, they described other ways of addressing compensation issues:

- OCC officials said that, within the enforcement context, OCC has issued formal orders addressing excessive compensation concerns. OCC officials said that they had ordered institutions to develop and implement appropriate policies to reduce excessive compensation to directors and officers and notified institutions, in some instances, that paying compensation or fees to some individuals was an unsafe and unsound practice and a breach of the individuals’ fiduciary duties to the bank.

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\textsuperscript{68} The Internal Revenue Code also establishes limitations on the deductibility of executives’ compensation at publicly held companies, including banking organizations. 26 U.S.C. § 162(m). In addition, section 403 of the Sarbanes-Oxley Act of 2002 (Pub. L. No. 107-204, 116 Stat. 745 (July 30, 2002)) requires insiders (defined as officers, directors, and 10 percent shareholders) to file with SEC reports of their trades before the end of the second business day on which the trade occurred. This provision applies to grants of stock options, a key form of executive compensation. Before the enactment of Sarbanes-Oxley, disclosure of option grants was not required until 45 days after the end of the fiscal year. SEC rulemaking and a Financial Accounting Standards Board directive contain certain disclosure and accounting requirements for executive compensation.


\textsuperscript{70} Pub. L. No. 102-242 § 132(a), 105 Stat. 2236, 2267-2270 (Dec. 19, 1991), 12 U.S.C. § 1831p-1(c). Among other things, Prompt Corrective Action (PCA) requires regulators to prescribe safety and soundness standards related to noncapital criteria. According to OCC officials, PCA directives are not formal enforcement actions, and most include a provision regarding restrictions on future salaries, fees, and dividends to prevent a future drain on capital.

\textsuperscript{71} 12 U.S.C. § 1831o.
• Similarly, FDIC officials said that they had addressed compensation through informal and formal actions that primarily focused on capitalization issues at undercapitalized institutions and placed restrictions on future salaries.

• An OTS official reported that between January 1996 and October 2006, the regulator issued at least 65 directives (e.g., cease and desist, supervisory agreements, and PCA directives) regarding the executive compensation regulations and laws. The official reported that the compilation of these directives noted no violations of the directives.

• A Federal Reserve official said that the Federal Reserve had not taken any formal action pursuant to these statutes. Similarly, an NCUA official reported that the administration had not taken any formal action (e.g., cease and desist order or civil money penalty) against an institution based on a violation of laws and regulations regarding employees benefits, including executive compensation.
Enclosure VII

GAO Contact and Staff Acknowledgments

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Acknowledgments
In addition to the contact named above, Phillip R. Herr, Acting Director; Barbara I. Keller, Assistant Director; Emily R. Chalmers; Gary Chupka; William W. Colvin; Tonita W. Gillich; Alexandra Martin-Arseneau; Linda Rego; MaryLynn Sergent; and Anne O. Stevens made key contributions to this report.
Related GAO Products


*Overseas Investment: The Overseas Private Investment Corporation's Investment Funds Program*, NSIAD-00-159BR (Washington, D.C.: May 9, 2000).

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