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CREDIT UNION EXECUTIVE NEWS

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EFFECTIVELY PRICING PAYDAY LOANS

Many Credit Unions have developed and offer a form of short term loan to provide members with a better alternative to pay-day lenders and the high cost of pay day loans. However, Credit Unions are now coming to realize that making money or even breaking even on alternative payday loan products is tough. We have worked with a number of our Credit Union and CUSO clients to consider the requirements and limits on "pricing" such loans. Obviously this is most difficult for federal Credit Unions.

So, how can FCUs make any money on payday loans and still comply with the 18% rate cap? In order to find the right blend of interest rate and application or other fees, there are two key elements to consider: (i) how the 18% rate cap is calculated, and (ii) what non-finance charge fees can be charged.

Calculating the APR. Under Reg. Z, annual fees, renewal fees, processing fees, transaction fees, etc. are all considered "finance charges" and must be disclosed as such. Also under Reg. Z, the APR is calculated on all finance charge components including interest and the various fees that are finance charges. Consistent with Reg. Z, NCUA's calculation of the 18% interest rate (per annum) limit on any loan includes the actual interest rate plus any finance charges such as an annual fee, a renewal fee, account access fee, transaction fee etc.

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The FCU creates significant exposure for itself with excessive payday loan application fees.

THE REAL RISK AREAS OF WEBSITE NON-COMPLIANCE

For years, Credit Union websites were simply the electronic rack for the Credit Union's financial product and service marketing brochures. Compliance for the marketing website is not difficult as the same rules that apply to print marketing (newsletters, newspaper advertising, brochures, rate sheets, etc.) apply to the same product promotion, rate sheets, etc. on a marketing website. These include the usual regulations: Reg Z (Truth-in-Lending), Truth-in-Savings, NCUA advertising rules etc., which set forth the advertising trigger terms and disclosures in a simple fashion. However, once a Credit Union has implemented home banking and bill payment services and provides online account and service opening capabilities, more complex compliance requirements apply and real risks arise.

We regularly review Credit Union websites and assist clients in implementing necessary compliance changes. Most Credit Unions have the basic marketing

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PAYDAY LOANS (CONT.)

The Application Fee. One approach is to charge an "application fee" in addition to an interest rate. This is attractive because the amount of the application fee is not treated as a "finance charge" under Reg. Z and this is not factored in to the APR calculation. However, the exclusion from the finance charge treatment requires the application fee to be imposed on all applicants, successful or unsuccessful. For example: ABC FCU can charge a $10 application fee (charged to all applicants) and charge 18% interest on the payday loan without exceeding the federal limit.

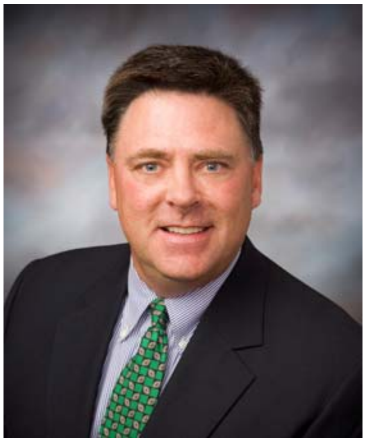
Renewal Fees. What if the FCU wants to charge the same application fee to renew the loan at the end of a short term (e.g. 30 day) repayment period? Can the FCU call this renewal fee an "application fee" to again avoid the finance charge treatment under Reg Z? Is there a limit on the amount or number of the application fees on a $500, payday loan?

Neither Reg Z nor NCUA regulations place any caps on the amount an FCU can charge for loan applications. However, that does not mean an FCU's ability to charge multiple application fees is limitless. The application fee needs to be reasonably related to the application function and not a way to bury the true cost of credit. For example, can the FCU charge a minimal interest rate (10%) along with a $50 application fee for a $500, 30 day loan? It all depends. If the FCU imposes a similar $50 application fee for other unsecured consumer loans¾maybe. Also, the FCU would still need to have support that the fee is reasonably comprised of the cost of processing, credit reports and handling the remaining elements of the application process. In contrast, if the FCU does not impose an application fee for a $10,000–18% unsecured consumer loan, it is difficult for the FCU to say the payday loan $50 application fee is truly an application fee rather than a "cost of credit" disclosed as application fee. The FCU creates significant exposure for itself with excessive payday loan application fees. In fact, the FCU could open itself up to claims for (i) inaccurate APR disclosures under Reg. Z; (ii) violation the 18% rate cap; (iii) deceptive advertising of loan interest rate loans and possible, and (iv) possible predatory loan practices – all for trying to effectively price the payday loan.

Participation Fees. To the extent your Credit Union has developed its payday loan program as an open-end credit plan (and it should in order to offer the member a long term plan for financial health) there is another fee that is far more appropriate than multiple application or renewal fees and is not considered a finance charge – a participation fee. A participation fee can be imposed as a condition to access the plan itself and can be charged monthly, annually or other periodic basis, but not as a on-time, nonrecurring fee nor based upon any account activity. So in an open-end payday lending plan, the Credit Union could charge a monthly participation fee of $10-20 for continued access to the plan. This should more consistently match the costs of processing small periodic advances each month. Again, the participation fee will not be a finance charge and thus will not impact the APR calculation.

Are SCCUs and CUSOs similarly limited? Most state chartered Credit Unions will have a much easier time reaching an appropriate payday loan pricing strategy as many states do not have a state usury limit or at least a rate comparable to the 18% cap for FCUs. Thus a blend of application fees and interest rate, lower than payday industry standards, should be achievable.

For CUSOs, the opportunities are narrow. CUSOs with any federal FCU owners do not even need to give any consideration, as under the NCUA CUSO rules (Part 712), to consumer lending, including whether payday lending is impermissible. A CUSO owned by state chartered Credit Unions would need to review applicable state CUSO rules to determine whether consumer lending is permissible. If so, the CUSO may also need to get a consumer finance license or applicable payday lending license. After jumping through these regulatory hurdles, the CUSO may not find this higher risk lending economical without serving multiple Credit Union participants.



If you are considering a payday loan program, please give us a call for any assistance on documentation, pricing and related compliance issues.

Brian Witt

Website Compliance (cont.)

disclosures for open- and close-end loans and deposit products (APR, APY and required terminology) handled pretty well. To the extent there are oversights on the terminology requirements, the compliance risk is minimal and also easy to fix. In contrast, common errors on the more complex rules involve more risk and more challenging corrective steps. Here are the most common errors we see:

Loans

- Using the word “term” to describe open-end loan repayments
- Incomplete HELOC disclosures as these are more extensive than other open-end loans
- Incomplete listing of loan rates for risk based loan types
- Lack of payment example for closed-end loans
- Legible Fair Housing logo
- Credit card applications without credit card tabular format disclosures
- HELOC applications without updated early HELOC disclosures

Deposits

- Improper disclosure of the initial tier for money market account rate tiers
- Omission of the new TIS overdraft protection disclosures
- Legible NCUA official sign (new sign effective May 2007)
- Membership applications that do not designate rights of joint owners
- Incomplete TIS account opening disclosures

E-services

- Offering and providing e-statement access without a Consent Notice required under E-SIGN to deliver e-statements online
- Offering and providing home banking/bill payment services without a Consent Notice required under E-SIGN to deliver the agreement and disclosures online

…once a Credit Union has implemented home banking and bill payment services and provides online account and service opening capabilities, more complex compliance requirements apply and real risks arise.

- Initiating deposit account opening without a Consent Notice to deliver TIS account opening disclosures
- Home banking and bill payment services provided without the required Reg E disclosures and contract provisions

Other

- Equal Opportunity Employment disclosures for website employment applications and information
- Ineffective disclaimer language for links to third party sites

Invariably any Credit Union with a website will have some errors or omissions. The important point is not to sweat the little stuff but to focus on the real areas of compliance risk for the Credit Union. There are a number of accountants and consultants offering website compliance reviews and will offer to tell you what is wrong with your website. That is not enough. Farleigh Witt will help you implement the corrections and solutions for proper website compliance. Please give us a call if we can assist you.

Brian Witt

Punitive Damages Standard for FCRA Non-Compliance Gets U.S. Supreme Court Review

On January 16, 2007, the U.S. Supreme Court considered what a consumer must prove in order to recover punitive damages for a violation of the Fair Credit Reporting Act (FCRA). While the case involved rate-setting by insurance companies based on consumer credit reports, it has far-reaching implications for all consumer lenders, including Credit Unions.

When Congress enacted FCRA, it included two different damages provisions, depending on the severity of the conduct. If a creditor is negligent in violating FCRA, the consumer may recover actual damages and attorneys fees. However, if the consumer can prove that the creditor was more than merely negligent, that is the creditor "willfully" violated a provision of FCRA, the statutory damages kick in.

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FCRA NONCOMPLIANCE (CONT.)

In this case the consumer can recover statutory damages between $100 and $1,000, as well as punitive damages and attorneys fees.

In *Edo v. Geico* and *Safeco v. Burr*, the Ninth Circuit Court of Appeals (which includes all of the Western states including Oregon, Washington, Idaho, California and Alaska), considered the type of conduct that justifies an award of punitive damages. The court held that a company is liable for a willful violation of FCRA if it "knowingly and intentionally committed an act in conscious disregard for the rights of others." However, the Ninth Circuit also held that the company could be liable for punitive damages for a lower standard of conduct – acting in "reckless disregard" of its obligations under FCRA. The Ninth Circuit's decision was inconsistent with most other appellate court in the country, which have held that willful requires a higher standard: a "knowing and intentional commission of an act" the creditor knows violates FCRA. This latter standard is obviously much more difficult for the consumer to meet.

Geico and *Safeco* appealed the decision to the U.S. Supreme Court, which heard oral arguments in the case on January 16th. While it is impossible to predict how the Court might rule based on oral argument, the justices questioned the consumer's lawyer repeatedly with respect to his contention that the term "willful" includes "reckless disregard." The lawyer for the insurance companies argued that, in order for punitive damages to be available, a creditor must have known that its conduct violated the law, not simply have mistakenly or inadvertently violated FCRA.

The applicable standard under FCRA is important to all entities subject to FCRA, including Credit Unions. Credit Unions are required to comply with FCRA in connection with any reporting of debt obligations to the credit reporting agencies. Improperly verifying a debt once a consumer has disputed it can lead to FCRA liability. Because it is often difficult for a consumer to prove that they suffered actual damages (such as an increased interest rate or lost borrowing opportunity) arising from an improper verification, the ability for a consumer to recover punitive damages will make these cases much more attractive to plaintiffs' lawyers. Therefore, the Supreme Court's is crucial to all creditors, including Credit Unions.


Kim McGair

The court is expected to issue its opinion in the next few months. We will report on the opinion once it is issued. In the meantime, we can assist you with all aspects of FCRA compliance so you never risk having recklessly disregarded or willfully violated the FCRA.

THE WORLD OF PAYMENT SYSTEMS: ELECTRONIC/REMOTE CHECKS—POTENTIAL MEMBER CLAIMS

In the not-too-distant past, when a consumer bought goods or services from a merchant, there were two basic non-cash payment options: write a check (which the merchant physically presented to the drawee institution through established channels) or charge the purchase to a credit card account. The past few years have witnessed a rapid expansion of the available methods for moving a payment from the consumer's account to the merchant's. These methods include: debit card transactions, remotely created drafts, traditional ACH entries, and electronic check conversion ACH entries (an entry that starts out as a check, but is converted to an ACH entry). Paper checks written by the member may be presented electronically under Check 21. In addition, if a check or ACH entry is dishonored, the merchant may initiate another entry and may also attempt to collect an NSF fee.

This article discusses the member's rights and the Credit Union's duties when the member claims that all or a portion of such a transaction was not authorized.

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PAYMENT SYSTEMS (CONT.)

In order to minimize losses, Credit Unions must be aware of which rules and regulations govern each type of transaction, and apply those rules correctly.

Electronic Checks

Electronic checks are ACH debit entries created using MICR information from a check. Because they are electronic transfers, they are subject to Federal Reserve Regulation E. Because they are ACH entries, they are also subject to the NACHA rules. Finally, because they are a means of clearing a check that the member wrote, they are also subject to Uniform Commercial Code ("UCC") Articles 3 and 4.

Under Regulation E, a member is not liable for an unauthorized EFT. Because the check is not an "access device" under Regulation E, the increased liability of the member for failure to notify the Credit Union within two business days after becoming aware of the loss or theft of the access device does not apply. In other words, the Credit Union will almost always have to recredit the member's account if an electronic check was truly not authorized. Keep in mind however, that for Regulation E purposes, a transaction is not "unauthorized" if the member benefited at all from the transaction. Thus, if a member ordered goods from a merchant but claims that the merchant was not authorized to submit the electronic check, the Regulation E unauthorized transaction rules will not apply, because the member benefited from the transaction.

The NACHA Operating Rules permit the Credit Union to recover from the originating depository financial institution ("ODFI") for the amount of any unauthorized electronic check debited against the member's account. In order to recover, the Credit Union must obtain from the member a written statement under penalty of perjury ("WSUPP"), and must initiate an adjustment entry to recover from the ODFI in time for the adjustment entry to reach the ODFI by the beginning of the sixtieth calendar day after the settlement date for the original entry.

NSF Fees

Last year, the Federal Reserve Board ("FRB") amended Regulation E to provide rules for merchants initiating electronic check entries.

These rules allow merchants to notify the member that a point of purchase electronic check will be initiated by posting a notice in a conspicuous location in the place where the transaction occurs. Regulation E also permits the merchant use such a notice as authority to initiate an electronic entry to collect an NSF fee from the member. A number of merchants have started doing this. However, these ACH entries are not only subject to Regulation E, but also to the NACHA Operating Rules. The NACHA rules require that in order to collect an NSF fee via ACH, the merchant must initiate a separate entry from the transaction entry; the separate entry must be for the NSF fee alone. Also the NSF entry must satisfy the standard ACH authorization requirements, which means that the member must actually sign an authorization for the NSF fee entry – a posted notice is not enough!

So if a member complains that an NSF fee entry was not authorized, the Credit Union should obtain the WSUPP and should initiate an adjusting entry the same as it would for any other unauthorized ACH. Again, the adjustment entry must be made in time for it to reach the drawee institution within 60 days after the original settlement date for the fee entry.

Remotely Created Checks

Remotely created checks ("RCCs") are a darling of the telemarketing industry. An RCC is a physical item with MICR encoding of the member's financial institution and account number information at the bottom, listing the merchant as the payee. In other words, an RCC is like a regular check, except that it is not signed by the member. Most RCCs bear a legend on the front where the signature would be – something like "Payment authorized by drawer." RCCs are usually created in a telemarketing transaction where the merchant asks the member for the member's account information, and obtains the member's permission to submit a draft on the account for payment of the purchase price.

Because RCCs are physical items, they are governed by UCC Articles 3 and 4, but are not subject to Federal Regulation E or the NACHA Operating Rules. The standard version of UCC Articles 3 and 4, if a member did not authorize creation of an RCC and timely reported it to the Credit Union, the Credit Union is

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PAYMENT SYSTEMS (CONT.)

required to re-credit the member's account. The standard version of Articles 3 and 4 did not offer the Credit Union any recourse against the merchant's financial institution, and collection from the merchant (usually in another state) generally proves difficult. (Oregon is one of a handful of states that modified its UCC to allow the drawee institution (i.e. the Credit Union) to recover from the merchant's bank for an unauthorized remotely created check.) Last year, the Federal Reserve Board revised Regulation CC Section 229.34 to include special provisions governing RCCs. These provisions specify that the merchant's bank (and any intermediary collecting banks) warrant to the drawee institution that the RCC was authorized by the drawer. They permit the drawee institution to recover from the merchant's financial institution for any unauthorized RCC.

When a member claims that an RCC was not authorized, the Credit Union should have the member complete an affidavit to that effect. The Credit Union can then submit a breach of warranty claim through its clearing institution.

Non-ACH Electronic Presentment of Checks (Check 21)

A paper check that is presented electronically through non-ACH channels is governed by UCC Articles 3 and 4. It is technically not governed by the FRB's Check 21 rules unless it is reconverted to a paper substitute check, even though Check 21 was designed to promote and facilitate electronic presentment. A paper check that is presented electronically is subject to the same rules as a paper check presented conventionally. If the member did not sign or authorize the check, the Credit Union is usually obligated to recredit the member's account and will not have any warranty or other recourse against the depositary or collecting banks. The membership and account agreement can limit the Credit Union's obligation to reimburse the member if the member is late in reporting the item to the Credit Union, and other UCC rules limiting the Credit Union's liability may come into play. But these disputes will generally play out between the member and the Credit Union and will not involve the other financial institutions in the collection stream.

The world of payment systems has gotten a lot bigger – and it pays to know your geography.

Hal Scoggins

MAJOR CONSUMER PROTECTION VIOLATIONS IN ALASKA

Last month, the Alaska Attorney General announced that the state and Lithia auto dealerships in Alaska entered into a consent judgment requiring Lithia to pay a $500,000 civil penalty and restitution to consumers for violating Alaska's consumer protection laws.

The state's investigation focused on two issues. The first was Lithia's practice of charging an "administrative" or "document preparation" fee on all of its vehicle sales. These fees, called "doc prep fees" in the industry are nothing more than dealer profit and consumers often confuse this fee with state title, licensing and registration fees paid to the DMV. Alaska law prohibits Alaska auto dealers from charging doc prep fees unless they are included in the advertised price of the vehicle. Lithia agreed to refund this fee—typically $200—to all consumers who purchased vehicles from Lithia if the fee was paid in addition an advertised price.

The second issue focused on Lithia's failure to provide certain disclosures to consumers who purchased used vehicles. Alaska law requires all auto dealers to obtain accident and repair information from consumers who trade in vehicles and then disclose this information to perspective purchasers. These disclosures were not provided.

This type of action raises issues for Credit Unions engaged in indirect lending. First, the Federal Trade Commission's "Holder in Due Course" rule allows a borrower who has a claim against a dealer to use that claim as a defense to repaying the borrower's purchase contract, even if the credit union that purchased the contract had no knowledge of the problem. In other words, a consumer claim against the dealer creates a potential loan loss for the credit union. There is also the potential damage to the credit union's reputation if members view the credit union as being in league with the dealer – perception can be more important than reality in these issues.

There are two primary ways for a Credit Union to minimize the potential damage from dealer misconduct. First, know the dealer, and manage the relationship

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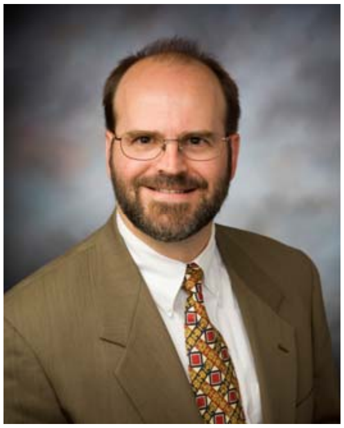
ALASKA (CONT.)

carefully. Credit Unions should carefully investigate a dealer's financial strength, business practices, compliance, and reputation before entering into a relationship with the dealer. The credit union should regularly monitor the dealer's operations for trouble signs. Second, the Credit Union should have a strong dealer agreement that requires the dealer to indemnify the Credit Union and pay for its defense against claims by members due to alleged dealer misconduct. The dealer agreement is usually the only thing that can provide the legal leverage you need to keep the dealer on the hook in such cases.



Hal Scoggins

OTHER FED REGULATIONS

The Department of Defense has requested comments, due February 5, 2007, in connection with its obligation to prescribe new consumer protection rules pursuant to the John Warner National Defense Authorization Act for Fiscal Year 2007. The new law imposes a federal usury limit (36%) for extensions of credit made to servicemembers and their dependants.

The Federal Trade Commission (FTC) has set the ceiling for allowable disclosure charges under the Fair Credit Reporting Act, which will remain at $10 in 2007. The charge does not apply to free annual disclosures to consumers under FACTA.

The FTC has issued its second interim report to Congress under FACTA. Section 319 of FACTA requires the FTC to study the accuracy and completeness of information in consumers' credit reports and to consider methods for improvement. This is the second of five interim reports and a final report scheduled for 2014 (when we predict the final FACTA rules should be issued).

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Be sure to access this month's Current Issues in Credit Unions, a Credit Union industry podcast in which Brian Witt regularly participates. A great discussion with Bruce Jolly regarding the Nationwide FCU merger and its impact for the industry. The podcast is accessible on the Internet through the iTunes Music Store or direct download www.ciicu.libsyn.com.

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Who stands behind your Credit Union compliance?