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CREDIT UNION EXECUTIVE NEWS

October 13, 2006

NEW 36% INTEREST RATE CAP ON LOANS TO SERVICEMEMBERS

Earlier this month, new federal legislation was enacted setting a 36% interest rate cap on loans to military servicemembers. The new federal usury rate is an amendment to the Servicemembers Civil Relief Act designed to protect servicemembers and their families against predatory lenders. The new rate cap becomes effective on October 1, 2007. (The Secretary of Defense is, however, authorized to prescribe an earlier effective date.) The new rate cap will not impact federal credit unions (which are already limited to 18% under the Federal Credit Union Act) but might impact CUSOs and state chartered credit unions that offer payday lending type products. For those states where the applicable rate limit is lower than 36% the state limit would apply.

Coverage. The consumer protections under the Act go beyond the protections under the existing Servicemembers Civil Relief Act. The new protections will apply to consumer loans made to servicemembers and their dependents. A covered member includes a member of the armed forces who (a) is on active duty under a call or order which exceeds 30 days; or (b) is on active Guard or Reserve Duty; and (c) that servicemember's "dependent." A dependent is the covered member's spouse, child (natural, adopted, or stepchild), or persons for whom the servicemember provides more than one-half of the support for 180 days immediately preceding the extension of credit.

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FINAL REGULATION E CHANGES FOR ELECTRONIC CHECK TRANSACTIONS

Recently the Federal Reserve Board (FRB) amended Reg. E. to further define the rights and responsibilities of parties involved in electronic check conversion (ECK) transactions. As you may recall, the FRB revised Reg. E several years ago to expressly include ECK transactions. In an ECK transaction, a member provides a check to a payee and information from the check is used to initiate a one-time EFT from the member's account. An ECK transaction is covered by Reg. E if the member "authorizes" the transaction as an EFT. This typically occurs at a merchant point-of-sale with a notice to the member. Over the last several years, a number of issues have arisen relating to ECK transactions.

These recent changes will impact merchants initiating ECK transactions and the required disclosures the Credit Union provides members regarding unauthorized use liability for ECK transactions. The mandatory compliance date for the new rules is January 1, 2007.

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The new rate cap will not impact federal credit unions but might impact CUSOs and state chartered credit unions that offer payday lending type products.

INTEREST RATE CAP (CONT.)

Interest Rate Limitation. The Act prohibits unsecured consumer loans to a covered member if the APR exceeds 36%. Residential mortgages, car loans, or loans secured by personal property are excluded from the rate cap. Under the amendments, the term "interest" is defined to include service charges, renewal charges, premiums for credit insurance and related fees on similar products sold in connection with the extension of credit. This raises some real questions on how to properly calculate the APR. For open-end credit, it is still unclear whether the 36% APR limit applies only to the "corresponding APR," which takes into account only the periodic interest rate and no finance charge fees, or whether it will apply to the historical APR, which is calculated each billing cycle and includes fees and other charges. However, due to the expansive definition of "interest" it is likely that related fees must be considered.

Disclosure Requirements. Specific loan disclosures will also be required when extending consumer credit to covered members. The following disclosures must be provided orally and in writing before issuing consumer credit to a covered member: (1) a statement of the applicable APR; (2) required TILA disclosures; and (3) a clear description of the payment obligations. The disclosures must be presented in accordance with TILA.

Prohibited Loan Practices. The amendments establish a series of prohibited lending practices. A lender is prohibited from making an automatic renewal, repayment, refinancing, or consolidation of a loan with the proceeds of another loan extended by the same lender without new executed loan documents. Additional prohibited lending practices include:

- required waivers of borrower's rights to take legal action;
- unreasonable notice requirements;
- required allotments to repay the debt;
- mandatory arbitration requirements;
- taking a check or car title as security for a loan (e.g., payday/title lending); and
- imposing any prepayment penalty.

Future Regulations. The Secretary of Defense, after consultation with the FTC, federal banking agencies, and the NCUA, must issue regulations necessary to carry out

the provisions of the Act. The regulations must establish the required disclosures, the method for calculating the APR, and the maximum amount of allowable fees or charges which may be imposed.

Some Credit Unions and CUSOs provide payday lending products that are quite competitive with the 300-400% payday lenders will need to carefully review and revise their products to make exceptions for loans to servicemembers under these limitations. We will be following any developments in this area regarding disclosure guidance. Please call if you have any compliance questions.

Connie Speck

FINAL REG. E CHANGES (CONT.)

Impact to Merchants

The FRB revisions have a major impact on merchants. First, merchants are now officially subject to Reg E. compliance. Second, the changes significantly increase the nature of the notice provided and authorization obtained from the member at the time a merchant initiates an ECK transaction.

ECK Authorization. Generally, ECK authorization is obtained when a merchant provides notice to the member that a check received will be converted to an EFT and the member goes forward with the transaction. At POS, the notice must be posted in a prominent and conspicuous location and a copy of the notice must be provided to the member at the time of the transactions, such as on a receipt. The final rule also legitimized the industry practice of collecting NSF fees.

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FINAL REG. E CHANGES (CONT.)

The final rule provides that merchants who choose to collect a service fee via an EFT due to insufficient or uncollected funds in the member's account must obtain the member's authorization to collect the fee. However, the authorization is obtained when the merchant provides notice to the member stating the amount of the fee and that the fee will be collected via an EFT and the member goes forward with the transaction. The final rule requires merchants to provide a copy of the notice initially but does not require the member's "signed authorization" for ECK transactions.

New ECK Disclosures. To help members better understand the nature and consequences of ECK transactions, the final rule makes several changes to the ECK notice and adds uniform model disclosure language. The new disclosure language alerts members: (1) when funds may be withdrawn from the member's account as soon as the same day payment is made; and (2) that the member's check will not be returned to the member's Credit Union. These disclosures may appear on a sign or be printed on the merchant's receipt but written receipt is not required. The disclosure requirements sunset three years from the mandatory compliance date.

Impact on Credit Unions

The FRB made a number of clarifications regarding the Credit Union's EFT disclosures related to ECK transactions. When we alerted our Credit Union clients about ECK transactions several years ago, we anticipated most of these disclosure requirements so if we assisted with your EFT disclosures, only minimal changes will be necessary.

These recent changes will impact merchants initiating ECK transactions and the required disclosures the Credit Union provides members regarding unauthorized use liability from ECK transactions.

BRIEF OUTLINE OF NEW EFT DISCLOSURES RELATED TO ECK TRANSACTIONS:

1. **Types of EFT Transactions**. Credit Unions must list ECK transactions among the types of transactions members can make. (*We addressed this previously in our compliance release*.)

2. **Unauthorized EFTs**. The FRB has additional required new disclosure language to disclosures for unauthorized EFTs to address unauthorized ECK transactions. At the same time, the FRB confirmed that ECK transactions are not subject to the two tier liability limits applicable to other EFTs. (*This language is new and we did not anticipate this change. Therefore Credit Unions will need to make minor changes to your EFT Agreement at your next printing. Please contact us for the necessary changes.)*

3. **Change in Terms**. Where Credit Unions have already amended their EFT disclosures to notify members that ECK transactions may be made from their accounts, they will not be required to make new disclosure terms or provide a notice of change in terms for the new unauthorized use EFT language. However, new disclosures or a Notice of Change in Terms will be required for existing EFT users, if your Credit Union has not previously made ECK disclosures.

Please contact us if you need assistance with updating your EFT disclosures and providing a Notice of Change in Terms.

Brian Witt

FRB AMENDS REGULATION E TO COVER PAYROLL CARDS

In addition to the Reg E. changes for ECK transactions, the FRB amended Reg. E to include the newest EFT—payroll cards.

The final rule provides that Reg E. cover payroll card accounts that are established directly or indirectly through an employer and to which transfers of the member's wages or other compensation are made on a recurring basis. The final rule will become effective January 1, 2007.

Payroll cards have become increasingly popular for employers and financial institutions to serve the unbanked consumer. A payroll card account is typically established by an employer arranging with a financial institution to make available to its employees a magnetic stripe card that accesses an account or subaccount assigned to the employee. Each payday, the employer transfers funds to or credits the account for the employee's compensation in lieu of a paycheck or direct deposit. The employee can use the card to make withdrawals at ATMs and POS purchases.

Under the Reg. E. changes, the FRB provided specific guidelines regarding the rights and responsibilities of the applicable parties: employer, employee and Credit Union.

1. Payroll card account holders will be able to assert their Reg. E rights against the Credit Union holding their account (or subaccount).

2. Employers are expressly not considered financial institutions despite their role in the payroll card marketing, initiation and processing.

3. The Credit Union is required to provide EFT disclosures to card holders. However, the Credit Union is not required to provide periodic statements to the card holders if the Credit Union makes available balance information to the consumer through a readily accessible telephone line or electronic access. In addition, upon request, the Credit Union would need to provide a written history of the consumer's transactions covering a 60 day period.

The final Reg. E rule covers only payroll accounts established through an employer and does not extend to all stored value cards or prepaid gift cards issued by merchants.

Brian Witt

FINANCIAL SERVICES REGULATORY RELIEF— MINIMAL PROGRESS FOR CREDIT UNIONS

Late last month, Congress passed the Financial Services Regulatory Relief Act that contained a wide variety of regulatory relief provisions for financial institutions. For credit unions, the relief was minimal. There are only a handful of provisions that directly impact credit unions, mainly federal credit unions. The following is a brief description of the relief provisions for federal credit unions and federally insured credit unions.

Federal Credit Unions

Maximum Loan Term. The maximum loan term on consumer loans was increased from 12 years to 15 years. This increase should have little impact given the existing ability to make HELOCs and 40 year term residential loans.

Non Member Services. Federal credit unions will be permitted to offer money transfer instruments, including international and domestic funds transfers, to persons in the field of membership, not just actual members. Federal credit unions will be able to assist nonmembers with cross-border funds transfers and instruments.

Federally Insured Credit Unions

Military Bases. Military and civilian authorities responsible for buildings located on federal property may extend real estate leases at a minimal charge to a credit union that finances the construction of credit union facilities on such land.

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Who stands behind your Credit Union compliance?

REGULATORY RELIEF (CONT.)

PCA Net Worth for Mergers. The FCUA is amended to revise the definition of net worth for prompt corrective action (PCA) purposes to include amounts that were previously retained earnings of a credit union with which a credit union has merged.

Hal Scoggins

ARE YOU UP-TO-DATE ON THE WHITE COLLAR EXEMPTIONS?

When the DOL issued new regulations defining the white-collar exemptions established in the Fair Labor Standards Act ("FLSA") for executive, administrative, professional, outside sales, and computer employees, many of our clients wondered how they would be affected. The DOL's economic analysis issued with the regulations predicted they would result in 1.3 million formerly exempt white-collar workers gaining overtime protection (i.e., losing their exempt status).

Although the regulations are now two years old, we continue to field a lot of questions about them from credit unions and seminars on the subject are ubiquitous. Some clients have proactively reclassified jobs as non-exempt because they recognized they were on the dark side of a gray area. Others gained confidence that they could correctly treat certain positions as exempt in the new era, even though they had been unsure before. Since the DOL's edicts may not be followed quite as closely as those of the NCUA, we offer this short summary as a guide to see if your credit union is up to date:

Executive Salary Test. The minimum weekly pay level now required to satisfy the salary test for the executive, administrative, and professional exemptions is $455 (an annualized salary of $23,660). It is almost triple the $155 federal threshold that previously was in effect.

Limited Liability Protection. The regulations limit liability for improper salary deductions if certain policies and practices are adopted. Credit Unions now have an opportunity to protect themselves by adopting clearly communicated policies that prohibit improper pay deductions, provide a complaint mechanism, require reimbursement for any improper deductions, and express a good faith commitment to comply with wage and hour laws in the future.

Disciplinary Measures. Full-day suspensions without pay are now allowed for disciplinary reasons, as long as they relate to written workplace conduct rules, such as policies prohibiting harassment.

Highly Compensated Employee Exemption. The regulations create an entirely new exemption for "highly compensated" employees who earn $100,000 per year (with a minimum weekly salary of $455) and customarily and regularly perform exempt duties.

Duties Test. The "duties tests" for various exemptions have changed. Those affecting the administrative exemption may be of greatest interest to credit unions. Administrative employees must have a primary duty of office or nonmanual work directly related to the management or general business operations of the employer or its customers, and they must exercise discretion and independent judgment with respect to matters of significance. The DOL explains that "employees in the financial services industry generally meet the duties requirements for the administrative exemption if their duties include work such as collecting and analyzing information regarding the customer's income, assets, investments or debts; determining which financial products best meet the customer's needs and financial circumstances; advising the customer regarding the advantages and disadvantages of different financial products; and marketing, servicing or promoting the employer's

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CUTTING THROUGH SKIP PAY CONFUSION

Last Spring, the NCUA General Counsel's Office issued a somewhat confusing letter regarding truth-in-lending disclosures for skip payment programs, and treatment of skip payment fees. The opinion letter (GCO No. 05-0903) was quickly followed by a clarification (05-0903A). Those letters and subsequent comments and questions from NCUA field examiners have created a great deal of uncertainty about skip payment programs. Unfortunately, the NCUA General Counsel opinion letters have contributed to some misconceptions about skip pay programs and their treatment under Federal Reserve Regulation Z. In this article, we will try to clear up some of the confusion.

No Change in Terms

As a starting point, we need to remember that there are two types of skip payment programs and two types of credit. It would be possible to have a "contractual" skip payment program in which the loan documents themselves provide the member with a right to skip one or more payments during the course of a loan, if specified conditions are satisfied. However, most credit unions do not offer a contractual skip payment program. Instead, most credit unions offer skip payments on an occasional basis as a promotional device or benefit to the members.

For occasional skip payment programs, the skip payment terms are not contractual, and are not included in the initial disclosures or loan agreement. When the credit union offers an occasional skip payment to members as a promotion, no change-in-terms notice is required because the credit union is not actually changing the terms of the loan. Instead, the credit union is merely agreeing that it will not strictly enforce the payment requirements.

Impact on APR

The question of how the credit union treats skip payment fees for periodic statement purposes is where things get a little tricky. The fee should be disclosed on the statement and labeled as a "finance charge." The NCUA General Counsel's "clarification" also states that federal credit unions must ensure that interest (including any finance charge) does not exceed the usury limit for federal credit unions (currently 18%). This leaves two questions: First, does a skip payment fee affect the annual percentage rate disclosed by a credit union on the periodic statement? Second, does the skip payment fee "count toward" the 18% for federal credit unions? The second question is answered by reference to the first. NCUA has always taken the position that determination of the interest rate for purposes of the federal credit union rate limitation is based on the treatment of fees and charges under Federal Reserve Regulation Z. If a fee is not calculated into the annual percentage rate for purposes of Regulation Z, it also does not count toward the 18% rate limitation for federal credit unions.

Though the answer is far from clear, we believe there is a strong argument based on Regulation Z § 226.14(c)(2), fn. 32 and 33, and the Official Staff Commentary to those sections, that a skip payment fee is not calculated into the annual percentage rate. Footnote 32 provides that "if there is no balance to which the finance charge is applicable, an annual percentage rate cannot be determined under this section." A skip payment fee does not apply to a particular balance; instead, it is a fee related to forbearance from enforcing the terms of the agreement. Official Comment 7 to Regulation Z § 226.14(c) provides that charges that do not relate to specific transactions or activity on the account, but relate solely to opening, renewing, or continuing the account are not included in the annual percentage rate calculation even though they are finance charges. As an example, the Comment refers to a fee charged only to members who have not used their card for a specified dollar amount of transactions in the prior year. A skip payment fee could be viewed as similar to a charge that relates only to continuing the account.

Compliance Choices

Given the lack of clarity in the regulation, credit unions are faced with several choices. First, you may calculate the annual percentage rate including the skip payment fee and disclose it accordingly on the statement. Few data processors are equipped to handle this treatment. Alternatively, you could stop charging a fee for skip payments. Finally, you may charge the fee, list it as a "finance charge," but not calculate it into the annual percentage rate. We believe there is adequate support in the regulation to justify this treatment.

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WHITE COLLAR EXEMPTIONS (CONT.)

financial products. However, an employee whose primary duty is selling financial products does not qualify for the administrative exemption."

Credit Unions can take a number of steps to ensure compliance with DOL's regulations. Ensure that HR staff is trained and up-to-date on the changes. Review job descriptions to reassess if positions are correctly classified. Adopt the policies and procedures necessary to take advantage of the safe harbor rules for improper salary deductions. The FLSA provides minimum standards that may be exceeded, but cannot be waived or reduced. Employers must continue to comply with state laws providing additional worker protections, such as a higher minimum wage or tighter restrictions on the duties performed by exempt employees. Our Employment Group offers training, advice, policy development, and many other services designed to help our clients comply with wage and hour laws.

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BSA TRAINING—SOME OF THE BEST RESOURCES ARE FREE

Have all the recent BSA education and training opportunities left you nervous and feeling uninformed? Last month, the FFIEC conducted two free conference calls on the July 2006 updates to its BSA/AML Examination Manual. In addition, Credit Union Times and CUES are offering up BSA education (not for free) in the next two months to address BSA enforcement actions, best practices, etc. Why the big push for BSA education? Except for a few forms changes, there have been no new BSA requirements lately. In fact, it has been two years since BSA compliance was put on top of the examination priority list by NCUA and other regulators. Since then, Credit Unions have experienced in depth BSA exams including zero tolerance for errors in CTR and SAR reporting.

From our experience, Credit Unions have generally done a sound job with BSA compliance and really need to focus on BSA exam requirements. We think one of the best resources for Credit Unions for compliance and/or training is the FFIEC's BSA/AML Examination Manual. This is free and can be downloaded at http://www.ffiec.gov/bsa_aml_infobase/pages_manual/manual_online.htm. (If you are printing, load lots of paper as it is 350+ pages long). This is an excellent comprehensive resource for understanding federal BSA requirements, filling in gaps in your written compliance program and organizing and putting risk assessments in place

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