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CREDIT UNION EXECUTIVE NEWS

November 17, 2006

MODEL FCU BYLAWS—TO ADOPT OR NOT TO ADOPT?

In April 2006, NCUA issued its latest version of the Model FCU Bylaws. NCUA is strongly encouraging FCUs to adopt these revised bylaws due to the added clarity and flexibility they bring. Nice spin! The Model FCU Bylaws remain "one-size fits all" bylaws that leave FCUs with little flexibility and are full of issues and potential pitfalls. Before you consider adoption of the Model FCU Bylaws, carefully review them. The following is a summary of concerns and recommendations we have. You may have more:

Uniform Entrance Fee. Do you charge a "membership fee?" Do you ever waive it, for example with indirect loan applicants or a minor's account? If so, you are violating the Federal Credit Union Act and the Model FCU Bylaws. Consider a different fee that you have more discretion to waive, such as an "account opening fee." Ironically, NCUA allows you to waive the "membership share" requirement. Go figure. (Art. II, Sec. 2).

Suspending Services. In one of the few areas that NCUA will permit the Credit Union to tailor its bylaws to its own operations, Credit Unions can and should implement service limitations on suspended, but not yet expelled members. (Art. II, Sec. 4).

Cont. p 2

Inside this issue:

The model FCU Bylaws remain "one-size fits all" bylaws that leave FCUs with little flexibility and are full of issues and potential pitfalls.

REGULATORY HOT BUTTON—THIRD PARTY SERVICE PROVIDER DUE DILIGENCE—THE NEXT EPIDEMIC?

Over the last two years, the Centrix virus became epidemic. The virus spread to credit unions holding portfolios of loans generated and serviced by Centrix. NCUA quickly dispensed what it believed were the necessary remedies to credit unions (Documents of Resolution and NCUA Letter No. 04-CU-13 SubPrime Lending and Outsource Lending Relationships), which appears to have killed the virus.

Third party service provider due diligence looks to be the next epidemic for credit unions. NCUA and state regulators are using "safety and soundness" examination authority to require credit union adherence to best practices in due diligence and risk management regarding third party service providers. In some cases, regulators have extended such requirements beyond third party service providers as originally intended.

Cont. p 3

MODEL FCU BYLAWS (CONT.)

Membership Share Installments. What member still needs six months to increase a balance to meet the $5 (or even $25) membership value? Do you terminate zero balance accounts without regard to the installment period? Avoid noncompliance by minimizing irrelevant installment periods. (Art. III, Sec. 3).

Transferring Shares. Do you offer cross-account transfers (transfers from one member to another member)? NCUA would only permit such transfers by use of an "instrument." Avoid Bylaw violations in favor of operational efficiencies, by not adopting this revision. (Art. III, Sec. 4).

Withdrawals from Irrevocable Trust Accounts. NCUA has now shifted responsibilities for trust administration of irrevocable trusts to your tellers. Generally withdrawals from irrevocable trust accounts are not restricted. But now a Bylaw reference to trust agreement restrictions would shift monitoring responsibilities to your tellers. Avoid this setup for operational errors and Bylaw violations by not adopting the last sentence of Art. III, Sec. 5(c).

Shares for Pension Plans. Do you offer and issue shares to pension plans? If not, you can simplify your Bylaws to avoid such inapplicable operational provisions. (Art. II, Sec. 6).

Joint Membership. The NCUA contains no provision or support for the concept of "joint membership." While accounts with multiple members are possible, few credit unions have the data processing capabilities to accurately handle such multiple member accounts for notices and ballots. (Art. III, Sec. 7).

Meeting Rules of Procedure. Have you ever had a parliamentary issue arise at a member meeting and then had to scramble to find and apply *Robert's Rules of Order* to make a reasonable ruling? It's an impossible situation. *Robert's Rules of Order* were designed for legislative bodies not regulated financial institutions. Spare the grief and frustration and adopt something readable and understandable: *Democratic Rules of Order*. (Art. IV, Sec. 4).

Duties of Financial Officers. Is your Credit Union's financial officer the President or a volunteer Board member? The Model FCU Bylaws provide that one Board member is the financial officer and the model Bylaws grant that officer substantial financial authority and responsibility including hiring and firing employees. Your Bylaws will need to be carefully drafted to assure accurate and proper authority for these functions is delegated to management and not the Board. This may require a nonstandard provision to be accurate. (Art. VII, Sec. 1 and 6).

Board Authority Over Employees. Who employs your Credit Union staff, the President or the Board? NCUA added a new section that places that power with the Board and for limited functions with the Supervisory Committee (for audit assistance) and Credit Committee (for loan officers). Rather than invite micromanagement, the Credit Union should carefully document the delegation of authority of such functions to management. (Art. VII, Sec.8).

Lending Procedures. In order to support the statutory decree to lend to persons of modest means, the Model FCU Bylaws contains a mandatory lending preference: "…in all cases to the applications for lesser amounts" all other factors being equal. Be careful here, this could be a discrimination claim ready to happen. You can follow the Bylaw policy, but you must also follow the law. (Art. VIII, Sec. 4).

Indemnification. The Model FCU Bylaws allow the FCU to implement indemnification protection for volunteers, but the two options provided are problematic. One option simply refers to the "law of the state of _____," which is broad and inarticulate. The other option is the "Model Business Corporation Act" that are nonstatutory guidelines for which there is little case law directly interpreting its provisions. Consider a nonstandard Bylaw provision that is specific, like your state's Business Corporation Act. (Art. XVI).

Bylaws for a Fee. Did you know you can charge your member a reasonable fee for a requested copy of the Bylaws? Under the Model FCU Bylaws, NCUA provides that a copy of the Bylaws "will be provided for a reasonable fee." Before you add this to your Rate and Fee Schedule, consider how member friendly the fee is,

Cont. p 3

MODEL FCU BYLAWS (CONT.)

not to mention that there is no support in the FCUA for such a fee. (Art. XVI).

FCUs do not need to adopt the new model Bylaws. Rather, you may adopt portions of the revised Bylaws and retain the remainder of your previously adopted Bylaws. However, to the extent you adopt provisions, even corrective provisions not drafted by NCUA, such amendments will require NCUA approval. Please call us if you want more in-depth analysis of the new Model FCU Bylaws or need assistance in updating your Bylaws.

Brian Witt

THIRD PARTY (CONT.)

Since 2001, NCUA has issued a series of Letters to Credit Unions that provide "guidelines" rather than rules and regulations, related to credit union risk management of relationships with service providers. The NCUA's guidance is directed to relationships with third parties, including service providers and vendors with whom credit unions' contract for services, which are not regulated by the NCUA. NCUA guidance includes:

NCUA Letter No. 01-CU-20 (Nov. 21) Due Diligence for Third Party Service Provider – addresses risk management issues credit unions need to consider when partnering with outside parties to enhance the services provided to members.http://www.ncua.gov/letters/2001/01-CU-20.pdf

NCUA Letter 02-CU-13 (July 2002) Vendor Information Systems and Technology Reviews – addresses issues and concerns related to NCUA examination of vendor information systems and technologies (IST) and e-Commerce applications. http://www.ncua.gov/letters/2002/02-CU-13.html

NCUA Letter No. 04-CU-13 (Sept. 2004) Specialized Lending Activities (SubPrime Lending Controls and Direct Lending Controls, Outsourced Lending Relationships) – NCUA's guidance to examiners on specific high risk activities in offering loans to credit unions (also the Centrix virus antidote). http://www.ncua.gov/letters/2004/04-CU-13.pdf

Interagency Guidance on Nontraditional Mortgage Products Risk (Sept. 2006) – clarifies how credit unions can offer nontraditional mortgage products in a safe and sound manner. http://www.ncua.gov/letters/2006/CU/06-CU-16.pdf

In addition to this series of guidance, in July 2006 NCUA issued its final rule, Third Party Servicing and Indirect Vehicle Loans (NCUA 701.21(h) to regulate purchases by federally insured credit unions of indirect vehicle loans and services of (noncredit union) third parties. http://www.ncua.gov/RegulationsOpinionsLaws/RecentFinalRegs/F-701-741.pdf

Credit Unions using third party loan service providers (e.g., mortgage brokers, MBL underwriting, indirect dealers, loan participation brokers, etc.) need to carefully review NCUA's guidance above and implement the necessary vendor management practices recommended or required by NCUA. For the typical nonlending service provider, credit unions should conduct and document the following:

- Due diligence review
- Legal review of contract
- Ongoing vendor supervision

We believe these are the practical ("apple a day, keeps the doctor away") remedies that should be in place. If they are not, regulators can exercise their safety and soundness examination authority to assure that they are. Also, as mentioned above, NCUA and state regulators are requiring credit unions to do so.

Cont. p 4

THIRD PARTY (CONT.)

Unfortunately, in one recent case, NCUA is over prescribing its medicine and extending its vendor management guidance to loan participations and loan purchases under NCUA 701.22 and 701.23. Nowhere in these regulations or in NCUA's guidance do the vendor management guidelines apply to credit union to such credit union relationships or transactions. However, in the absence of any legal authority, NCUA is offering its "safety and soundness" authority as the credentials for such prescriptive advice. Credit Unions active in loan purchases and loan participations should beware of NCUA's propensities—this may be the next epidemic.

Having proper vendor management tools in place is good business, whether required or not. Farleigh Witt has designed comprehensive vendor management guidance checklists that satisfy the various NCUA guidance Letters. We also review and assist credit union clients nationwide with vendor contract negotiations. If you have issues or need vendor contract management support at your credit union, give us a call.

Brian Witt

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can be "negated"
by the excessive use of overrides.

RISKED BASED LENDING—HOW OFTEN CAN YOU OVERLOOK THE CREDIT SCORE?

Most Credit Unions have implemented some aspect of credit scoring in their credit decision process. Whether it's one credit score or a combination of multiple credit scores, credit score tools have made loan decisions quick and have reduced Regulation B compliance risks. However, the most significant fair lending concern in using credit scores may be increasing—the inconsistent use of scoring models through excessive overrides.

We wanted to address some of the compliance issues related to credit score practices and some recommended actions Credit Unions can take to minimize fair lending scrutiny.

Disparate Treatment and the Use of Overrides

The most common category of illegal discrimination identified under the fair lending laws: is "disparate treatment" discrimination. One of the easiest ways for disparate treatment to occur is where scoring system overrides are employed in a discriminatory manner. Also, examiners will especially scrutinize overrides when testing for disparate treatment discrimination.

Reg B Compliance

The Credit Union can certainly use credit scoring either as the sole or primary factor in the credit decision process or as one of several factors in which decisions are based. However, a credit scoring system can be "negated" by the excessive use of overrides.

Regulation B and the FRB Commentary are clear that combined credit scoring and judgmental systems are appropriate under the fair lending laws and such practices will not negate the classification of credit scoring under the combined system as demonstrably and statistically sound. However, Credit Unions must be careful with the interaction of credit scoring and underwriter judgment in rendering a credit score based lending decision. The greater the override discretion permitted, the greater the fair lending risk. Unfortunately there is little guidance distinguishing appropriate levels of overrides from excessive levels.

Compliance Strategies

We believe the Credit Union can and should take certain measures to ensure that its credit scoring tools and practices comply with the Fair lending laws as follows:

Reg. B Compliance. As a starting point the Credit Union needs to ensure that its scoring model meets the validity of requirements of Reg. B. Where credit decisions are based upon both a credit scoring model and human judgment, the Credit Union should regularly confirm the validity of its scoring model, as well as the judgmental factors it employs.

Cont. p 5

RISKED BASED LENDING (CONT.)

Adopt Clear Policies and Guidelines Regarding Overrides. The greatest fair lending exposure with respect to overrides arises where a large number of employees are authorized to effect overrides to the credit score and/or where clear and specific policies are not established as to when overrides are permissible. The Credit Union's policy decision to limit the number of loan officers who can approve overrides is important and this guideline should be explicit in your risk based lending policy. To the extent the Credit Union uses credit scoring as the "primary" basis for loan decisions, the Credit Union should adopt clear policy guidelines that identify the circumstances under which such overrides may be approved.

*Establish Targets Regarding the Rate of Override*s. While there is no federal Reg. B or FFIEC guideline as to what constitutes an appropriate level of overrides, we believe that override rates in excess of 10% may trigger increased scrutiny. We recommend specifying a maximum allowable override percentage in your policy.

Secondary Review of Override Decisions. Even when a loan officer or limited group of officers is authorized to approve overrides, the Credit Union should consider a secondary review of each application in which the credit score is overridden, and should audit overrides credit union-wide to insure uniform treatment.

Over the last several years, the use of credit scoring models to make lending decisions has emerged as a significant fair lending concern of the federal financial institution regulatory agencies and a major enforcement priority of the Department of Justice. Fair lending examinations by the federal agencies have focused both on the variables used in credit scoring systems and on the combined use of credit scores and traditional judgmental factors in the loan decision making process. In light of the increased regulatory focus on credit scoring, your Credit Union should carefully review override policy and practices to avoid fair lending scrutiny.

Brian Witt

FCUs EXEMPT FROM WASHINGTON REAL ESTATE EXCISE TAX

Everyone knows that federal Credit Unions are exempt from Washington's sales and use taxes. But did you know that federal Credit Unions are also exempt from Washington's real estate excise tax? The real estate excise tax (REET) is imposed on each sale or transfer of real property located in Washington. In most counties, it is either 1.53% or 1.78% of the sales price. This applies not only to Credit Unions located in Washington, but to any Credit Union that owns property located in Washington. Credit Unions encounter this tax when selling a branch or other Credit Union facility, and also when reselling collateral property that the Credit Union has obtained in a foreclosure.

Some federal Credit Unions have simply paid the tax, unaware that they are exempt. Some county auditors have also been unaware of the exception. However, we recently obtained confirmation from the Washington Department of Revenue that federal Credit Unions are in fact exempt from the REET. The basis for this exemption is that the Credit Union is treated as a "governmental" entity.

In order to claim the exemption, the Credit Union must refer to Washington Administrative Code ("WAC") Section 458-61A-205 on the excise tax affidavit that is filed when the deed is recorded. The Credit Union should describe the reason for exemption as "transfer by a governmental entity." You may be eligible for a refund! Federal Credit Unions that have paid the REET on real estate sales may obtain a refund of the tax by submitting a petition for refund up to four years after the date of sale.

We are happy to assist federal Credit Unions in seeking a refund of any REET paid within the past four years. We can also assist you if a particular county auditor is unwilling to recognize the exemption. Contact us if you need further information or if you need any assistance.

Hal Scoggins

UPDATE YOUR EMPLOYEE HANDBOOK— OR ELSE!

Has your Credit Union updated its Employee Handbook in the last two to three years? If not, the time has come. Employee Handbooks not only provide guidance and information to employees and supervisors; in some instances they can provide the Credit Union with an affirmative defense against discrimination and wage and hour claims. Conversely, out of date and poorly drafted policies can increase your risk of employment litigation.

There have been a number of changes in state and federal law over the last couple of years that necessitate updating your Employee Handbook. Here are just some of the new developments that should be outlined in your policies:

Washington: "Sexual orientation" has been added as a protected class under the Washington Law Against Discrimination. The term is defined extremely broad and includes "gender expression." Employees must be permitted to exhaust all paid leave benefits if their family member has a serious health condition or emergency medical condition, even if the employer is not subject to or the employee is not eligible under the Family Medical Leave Act.

Oregon: Employers with 25 or more employees need to provide leave to victims of crimes and their family members to attend court proceedings, trial preparation and other meetings. Recent regulations provide some guidelines to employers about what must be included in an enforceable drug and alcohol policy. In mid-2006, the Oregon Supreme Court and the Bureau of Labor and Industries gave guidance to employers on enforcing such policies for employees using medical marijuana.

***Federal*:** Federal Uniformed Services Reemployment Rights Act, which applies to all employers regardless of size, requires a new posting and additional benefits for employees on military leave. A recent Ninth Circuit Court of Appeals decision outlined standards for dress code policies that do not run afoul of federal anti-discrimination laws.

> …out of date and poorly drafted policies can increase your risk of employment litigation.

Because of the changing nature of state and federal law and the expense and risk of employment litigation, keeping your Credit Union's employment policies updated is an important endeavor. Your Employee Handbook should be reviewed every two to three years to ensure that it accurately reflects current state and federal laws and your Credit Union's practices. If you have any questions about updating your policies or Employee Handbook, please call us.

Michelle Kerin

DEFERRED COMPENSATION PLAN— TRANSITION RULES EXTENDED AGAIN

In 2004, the Treasury issued significant new rules ("409A Rules") affecting nonqualified deferred compensation plans. The 409A rules directly impact 457 (f) deferred compensation plans adopted by credit unions. The Treasury adopted proposed regulations in September 2005.

Last month Treasury announced in Notice 2006-79 that the transition relief provided by the proposed regulations will be extended, again, until December 31, 2007. At the same time, Treasury has stated that it will be issuing its final guidance, clarifying numerous areas of 409A by the end of the year.

The 409A Rules are not simple and impose significant restrictions on 457(f) deferred compensation plans of Credit Unions including:

Cont. p 7

DEFERRED COMP. (CONT.)

- Specific events for distribution of compensation
- New definitions of distribution events (e.g., disability and change and control)
- Prohibitions on acceleration of benefits
- Specific deferral election requirement

Nonqualified deferred compensation plans that do not comply with the requirements of § 409A are subject to a 20% penalty tax based on the amount of deferred compensation and executives may be subject to taxation prior to receipt of benefits.

Even though the final guidance is not out and the compliance date extended, new and existing Credit Union deferred compensation plans need to operate in reasonable, good faith compliance with the 409A Rules. To the extent the final guidance provides new clarifications that affect your plan, you can adopt plan amendments to take advantage of such clarifications.

If you need more information on SERPs, nonqualified deferred compensation plans, the 409A rules or need assistance in reviewing or drafting deferred compensation plans for your Credit Union executives, please let us know.

Brian Witt

Our Credit Union Executive News newsletter is prepared for Credit Union executives and Boards. Please feel free to share this with your Board. We hope these topics are timely, insightful and helpful. Please give me any comments so we can continue to provide valuable information to you in the future. We are providing this newsletter free as our appreciation for the work you have given us and the opportunity to serve you in the future. Thank you.

Brian Witt

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