SPRING 2005 Volume 7.2 STATE CORPORATION COMMISSION
BUREAU OF FINANCIAL INSTITUTIONS

Quarterly Newsletter

THE CREDIT UNION REFLECTION

Highlights

- Risk Assessment First Step in BSA Compliance
- Bounce Protection: A Good Deal For Credit Union Members?

Inside

- Growth in Member Business Lending Draws Regulatory Attention
- NASCUS Lends Support to CURIA Bill
- SEG Activity and Mergers

RISK ASSESSMENT FIRST STEP IN BSA COMPLIANCE

Media accounts of enforcement actions taken against financial institutions illustrate with certainty that credit union regulators mean business when it comes to Bank Secrecy Act (BSA) compliance. Because of the importance of compliance with BSA, the Bureau recently conducted an examination survey of all state-chartered credit unions in Virginia. The survey revealed that most credit unions have a BSA policy and appear to be compliant. However, as the Bureau progresses through its examination cycle, examiners will document their review of each credit union's BSA program to verify the survey results. Risk assessment is the first area that will be addressed by the examiner.

For a credit union to have a sound Bank Secrecy Act/Anti-Money Laundering (BSA/AML) compliance program, management must first perform a risk assessment of not only their membership but also of all the services and products offered by their credit union. Risk assessment is not accomplished by copying another credit union's program, but a process must be developed whereby management can assess the risks and complexities of their own credit union.

A credit union offering only shares and loans and that has only one sponsor requires a less complicated risk assessment program than a large credit union offering multiple products, online access to member accounts and loan products, and a community charter.

The first step of the risk assessment process is to identify if the community or trade area where the credit union does business is considered a high risk area. The term "high risk" relates to services or accounts that expose the credit union to an increased potential for use as a money laundering or terrorist financing vehicle. Examples of "high risk" areas are:

- Is the credit union in a High Intensity Money Laundering and Related Financial Crime Area (HIFCA)? (A current list of designated HIFACs can be found at: http://www.treas.gov/irs/ci/factsheets/docterroristtaskforces.htm)
- Is the credit union in a High-Intensity Drug Trafficking Area (HIDTA)? (A list of designated HIDTAs can be found at: http://www.whitehousedrugpolicy.gov/hidta/index.html)
- Is there a university in the field of membership that may have international students?

The second step of the risk assessment process is to identify all the products and services that have a risk associated with them. A list of some of the products and services credit unions offer where higher risk is associated with them include number of branches, types of shares (regular shares, CDs, money market accounts), types of loans (auto, real estate), types of services (money wires, web site, home banking), and cash transactions (large currency and structured transactions).

Credit unions that experience large cash transactions through regular share accounts may identify those accounts as high risk. Then the credit union must make certain that all employees that handle cash transactions (tellers, loan officers) have been trained on how to properly complete and file a Currency Transaction Report (CTR) and/or a Suspicious Activity Report (SAR). Those credit unions that never have realized large cash deposits may assign a low risk to their regular share accounts. Even though the regular shares are classified as low risk, management must document that their employees received the proper training on filing and completing of CTRs and SARs.

Risk factor	High =3	Moderate =2	Low =1	Score
# of Branches				
Share accounts				
Share Certificates				
Money Orders				
Travelers Checks				
Consumer Loans				
Credit Card Loans				
Real Estate Loans				
New account Internet delivery				
New account mail/ telephone delivery				
New account opening delivery				
Aggregate cash reporting system				
HIFCA or HIDTA				

Using the grid on the previous page, management would document their risk assessment process for each of their products and services. A specific weight is assigned to each product or service. For example, 4 or more branches may be consider high risk, while 2-3 branches may be considered only moderate risk. Or if 10 or more regular share accounts have balances of over $10,000, that might be considered high risk, while no accounts with a balance greater than $1,000 may be considered low risk. The scores of the risk assessment for each product or service shown in the grid is then added. In the example grid the following ranges of scores could be used to determine the credit union's risk for BSA : High: 39-27; Moderate: 26-12; Low: 13 or less. Once the risks have been identified management must incorporate internal controls to protect the credit union from those risks.

In summary, risk assessment is crucial in order to be compliant with the BSA/AML provisions of the Patriot Act. For example, the Financial Crime Enforcement Network (FinCEN) found that Riggs Bank "did not implement an effective system to identify and assess the BSA/AML risk present throughout the institution." Riggs Bank was fined $25 million dollars by the Office of the Comptroller of the Currency (OCC) for BSA violations—a penalty that clearly indicates how serious regulators are that credit unions and other financial institutions comply with BSA. --*Thanks to Werner Paul for submission of this article*.

BOUNCE PROTECTION:
A GOOD DEAL FOR CREDIT UNION MEMBERS?

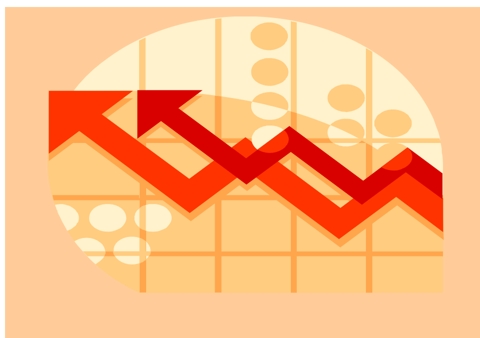
Some credit unions have been offering an overdraft checking product with different brand names, but which fall under the generic term of "bounce protection." Typically, bounce protection programs differ from overdraft protection, which usually draws on a line of credit, in that there are no written agreements, no disclosures, and no credit approval, but there are fees charged for overdrafted checks.

Concerns have been raised that credit unions offering bounce protection programs charge members high fees, do not provide adequate disclosures, and encourage members to overdraw their credit union accounts. Others argue that members want bounce protection programs to avoid the embarrassment of a returned check, and to avoid the associated returned-check fees from the credit union and from the merchant. But when the effective cost of bounce protection is compared to the cost of a payday loan, how do these bounce protection programs stack up?

The payday lending industry has grown from no retailers in the early 1990s to about 22,000 nationwide today. Typically, a payday loan is for 14 days, and all the borrower must provide is proof of income and a checking account. The effective interest rate on a payday loan will vary depending on the size of the loan and the fee, but this effective rate can run up to 500% or higher.

Under a bounce protection program, in addition to the initial fee to pay over-drafted checks up to a predetermined limit, members may be charged daily overdraft or balance fees. Members are usually required to bring their checking account to a positive balance within a relatively short period of time. The accumulated fees associated with the size of the over-drafted check can drive the effective cost of bounce protection to the same effective rate or more as a payday loan—several hundred percent.

No credit union official wants to think they are charging their members such exorbitant rates. But Congress and financial institution regulators are looking at bounce protection with an eye towards requiring disclosure of true costs, marketing, and implementation of the program. When developing or considering a bounce protection program, credit union management should consider all factors before implementing this product.



GROWTH IN MEMBER BUSINESS LENDING DRAWS REGULATORY ATTENTION

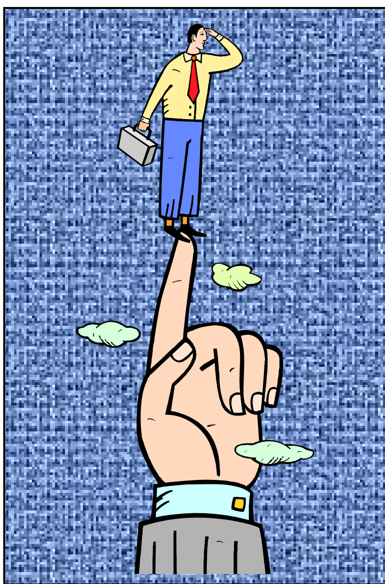
Member business lending (MBL) is a rapidly growing market for credit unions across the country. Statistics published by Callahan and Associates indicate that a total of 1,642 or 17.8% of all U.S. credit unions were actively engaged in MBL as of December 31, 2004. NCUA year-end statistics for 2004 reveal that federally insured credit unions nationwide had invested a net of $12.3 billion in MBL (including participations). This figure is nearly 3.0% of all loans made by federally insured credit unions, and represents 38.7% growth during 2004.

Virginia's state-chartered credit unions reported a total of $25.3 million in MBLs as of end of the first quarter of 2005. While this figure is only 1.0% of total loans made by Virginia state-chartered credit unions, it does represent a 24.1% increase in volume during the 12 month period ending March 31, 2005.

With the increased focus of credit unions making MBLs, the Bureau and other credit union regulators are giving more attention to making sure credit unions use sound underwriting standards. For Virginia state-chartered credit unions this means first complying with Part 723 of NCUA's Rules and Regulations. A detailed business loan policy must be developed and approved by the board. There are a number of requirements to be

included in the MBL policy. One of the most important is that the person who is involved in making and administering MBLs has certain minimum qualifications and experience. While there is current growth in MBLs, this type of loan has not traditionally been made in credit unions, so it is a "new" product. Making an MBL is much more complicated than making a consumer loan or an auto loan. Expertise is a must to assure success as well as safe and sound MBL underwriting. Continued training is a necessity to keep up with the marketplace.

Any credit union considering increased loan volume through MBLs must give due diligence to researching what MBL involves. Considering the cost of hiring a qualified and experienced MBL underwriter, the concentration and reputation risks, and the burden of complying with the NCUA regulation on MBL, this type of lending is risky, but can be rewarding if done properly. The Bureau will give close supervisory attention to management of an MBL program in credit unions where they are found.



NASCUS LENDS SUPPORT TO CURIA BILL

Amid industry concern that the National Association of State Credit Union Supervisors (NASCUS) had concerns with NCUA's proposed Prompt Corrective Action amendments to the Federal Credit Union Act, NASCUS's testimony before a Congressional subcommittee alleviated those concerns. The Credit Union Regulatory Improvements Act of 2005 (CURIA), H.R. 2317, was introduced in the House on May 12, 2005, and contains a number of provisions that are of interest to and supported by the credit union community.

Before the House Subcommittee on Financial Institutions and Consumer Credit on June 9, 2005, Deputy Commissioner George Latham testified on NASCUS's behalf. In his opening remarks Latham stated, "Capital reform continues to be a critical concern for the nation's credit unions. NASCUS strongly urges the Subcommittee to amend the Prompt Corrective Action provision of the Federal Credit Union Act." The proposed amendment would require federally insured credit unions to include all forms of capital when calculating the required net worth ratio.

Latham, who is a former Chairman of the Board of Directors of NASCUS, also testified that NASCUS has had a long-standing policy in favor of risk based capital. Therefore, NASCUS also supports the risk based capital amendment presented in CURIA. "NASCUS supports capital reform beyond risk weighted capital, and believes credit unions should have access to alternative capital that is complimentary to the proposed risk based system," Latham stated. He added, "As a regulator, I believe it makes sound economic sense for credit unions to access other forms of capital to improve their safety and soundness."

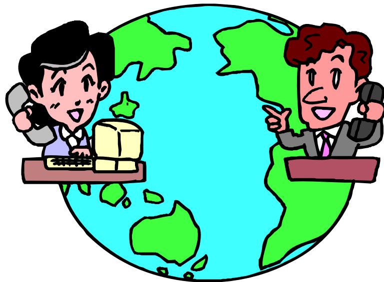
NASCUS's testimony also supported provisions in CURIA that increases the statutory limit on member business loans to 20% of assets, and changes the definition of a member business loan by increasing the minimum from $50,000 currently to $100,000. NASCUS also supports CURIA provisions that grant exemptions to credit unions from Securities and Exchange Commission registration requirements, and that grant privately insured credit unions eligibility to join the Federal Home Loan Bank system.

SEG ACTIVITY AND MERGERS

During the first quarter of 2005 the Bureau approved 20 small employee groups (SEGs). The four credit unions requesting these groups added 7,677 new potential credit union members. The average size of the approved SEGs was 384 members, but this average is skewed upward by approval of one large SEG of 4,325 potential members. Since legislation to permit SEG expansion went into effect on July 1, 1999 there have been 346 SEGs approved for total new potential membership of 110,582.

In March 2005 Lynchburg General CU, a $1.8 million asset sized credit union, completed its merger into V.B.H. ECU, a $2.2 million credit union also in Lynchburg. This merger was approved by the State Corporation Commission nearly a year earlier. Both of these hospitals are owned by Centra Health, so the continuing credit union still has a single sponsor. This merger reduced the number of state chartered credit unions operating in Virginia to 61 as of March 31, 2005. However, assets continue to increase at a 6.0% annual growth rate for the first quarter of 2005, and were nearly $4.1 billion at the end of the quarter.

The mission and purpose of the Credit Union Section is to effectively and efficiently supervise, regulate, and assist credit unions chartered by the Commonwealth of Virginia in order to:
1. Protect the financial interests of credit union members.
2. Ensure compliance with applicable laws.
3. Ensure adherence to safe and sound operating procedures and principles.
These three objectives are to be pursued so as to safeguard a financial environment within Virginia worthy of the public's confidence in credit unions and the financial system as a whole.



CONTACT US AT OUR WEBSITE

www.scc.virginia.gov/division/banking

FAX 804-371-9416

IMPORTANT COMMISSION TELEPHONE NUMBERS

George H. Latham, Deputy Commissioner.............................. 804-371-9698
Internet e-mail: george.latham@scc.virginia.gov
Jeanette J. Sanders, Principal Office Technician 804-371-9267
Internet e-mail: jeanette.sanders@scc.virginia.gov
Nicholas C. Kyrus, Deputy Commissioner 804-371-9690
Corporate Structure and Research
Internet e-mail: nick.kyrus@scc.virginia.gov
(applications or notices for mergers, relocations, name changes, and branch openings and closings)

COMMONWEALTH OF VIRGINIA
STATE CORPORATION COMMISSION
BUREAU OF FINANCIAL INSTITUTIONS
POST OFFICE BOX 640
RICHMOND VA 23218-0640

IMPORTANT INFORMATION INSIDE