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BUREAU OF FINANCIAL INSTITUTIONS

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THE CREDIT UNION REFLECTION

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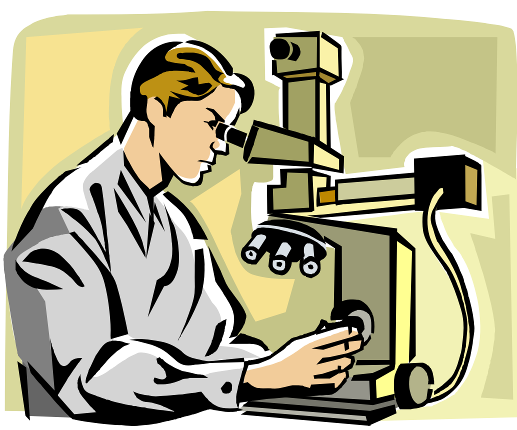


BUREAU MONITORING INVESTMENTS IN CUSOs & OTHER BUSINESSES

A recent study of Call Reports by the Bureau indicated that investments in credit union service organizations (CUSOs) and other businesses have grown to a substantial amount. Nineteen of fifty-eight state chartered credit unions in operation at the end of 2006, or nearly 33%, had invested in 20 CUSOs and other businesses. The CUSOs generally provide shared branching, electronic data, electronic financial, or credit card services to credit unions. A few businesses provide services to credit union members such as investment services, mortgage processing, or title insurance and closing services.

Section 6.1-225.57 (8) of the Code of Virginia provides that Virginia state-chartered credit unions may invest in "*such stock, securities, obligations, or other investments as may be approved from time to time by the Commission.*" Furthermore, subsection 10 provides that state-chartered credit unions may invest in "*shares, stock, deposits in, loans, or other obligations of any organization, corporation, or association, if (i) the membership or ownership, as the case may be, of such organization, corporation, or association is primarily confined or restricted to credit unions or* *organizations of credit unions and (ii) the purpose for which such organization, corporation, or association is organized is to strengthen or advance the development of credit unions or credit union organizations*." The language in subsection 10 has been interpreted as permitting credit unions to invest in companies that provide products or services to one or more credit unions, but not directly to credit union members. Investments in companies that provide services directly to credit union members are subject to subsection 8 rather than subsection 10 of § 6.1-225.57.

When subsection 10 was enacted in 1990, it was envisioned that credit unions would invest together in companies that provide mutually beneficial services to themselves. Credit unions providing services to members through such companies was not conceived of at that time.

Over the years federally-chartered credit unions have been allowed to offer services to their members through CUSOs. Part 712 of NCUA's Rules and Regulations currently requires federally-chartered credit unions to document the business decision to invest in a CUSO. This regulation also prescribes the type of organizational structure that is allowed and what services CUSOs may provide to credit unions or to their members. Unlike the Virginia statute, the statute governing federally-chartered credit unions does not contain a purpose requirement.

Given the increased investment activity in CUSOs and other businesses by state-chartered credit unions, the Bureau has studied the various issues involved. The Bureau plans to seek in the second quarter of 2007 a parity regulation that addresses the permissibility of such investments. In the meantime Virginia state chartered credit unions are strongly encouraged to notify the Bureau of their intent to invest in CUSOs or other businesses by submitting business plans and the financial analysis of the proposed venture.

PROPOSED REGULATION ON FINANCIAL SERVICES TO NONMEMBERS

Recently the Bureau sent copies of a proposed regulation to all state chartered credit unions in Virginia. The proposed regulation would authorize state chartered credit unions to provide limited services to nonmembers of a credit union who are within the credit union's field of membership. Comments on the proposed rule are due by April 6, 2007, and are to be submitted to the Clerk's Office of the State Corporation Commission. The proposed regulation (Case No. BFI-2007-00015) may be viewed at http://www.scc.virginia.gov/caseinfo/notice.aspx.

The initiative for the proposed regulation was a similar rulemaking by the NCUA Board that was approved on February 15, 2007. The proposed regulation is intended to permit state chartered credit unions to exercise powers comparable to federal credit unions.

INCREASING ATTENTION ON UNRELATED BUSINESS INCOME TAX

For over 40 years the Bureau has filed with the Internal Revenue Service a Consolidated Form 990. This federal tax form reports the total assets, and income and expenses, for all Virginia state chartered credit unions. The form is to be used by organizations that are exempt from income tax. If the Bureau did not file the form, each state chartered credit union would have to file an individual Form 990.

State chartered credit unions are exempt from federal income tax pursuant to Section 501(c)(14) of the Internal Revenue Code. However, over the years as credit unions have expanded their products and services, the IRS has selectively audited state chartered credit unions around the country. Rightly or wrongly, the IRS has deemed some of these products and services to be substantially unrelated to the purposes served by having a tax exemption for credit unions, and has assessed taxes on the income from these products and services. This has become known as the Unrelated Business Income Tax (UBIT).

Credit unions and various states have challenged these IRS rulings for years, but with little effect. In recent years a coalition of industry associations and organizations has formed a UBIT Steering Committee to combine resources and to provide coinciding direction. The UBIT Steering Committee has met with the IRS on several occasions, and has expressed the industry's disagreement with the IRS' rulings. The IRS apparently takes an anachronistic view of credit unions, and does not consider current innovations as relevant to traditional credit union operations. The UBIT Steering Committee intends to challenge the IRS' decisions through litigation following the procedural process individual credit unions have to appeal the tax assessment imposed by the IRS.

The IRS recently issued five technical advice memoranda (TAMs) on UBIT. TAMs are specific to IRS audited credit unions, but they set a precedent for the IRS in connection with audits of other credit unions around the country. In the five TAMs, the financial products determined to be "unrelated," and thereby subject to taxation, include:

- sale of accidental death and dismemberment (AD&D) insurance;
- sale of group life, dental, health and cancer insurance;
- car buying service and sale of car warranties;
- sale of guaranteed auto protection (GAP) insurance;
- sale of credit disability insurance; and
- sale of MEMBERS financial management services.

In the TAMs, the IRS stated that the sale of checks and collateral protection insurance are substantially related to the purposes served by exempting credit unions from taxation. Therefore, these products and services are not subject to UBIT.

Virginia state chartered credit unions are encouraged to consult with their tax and legal experts on UBIT filing considerations. Even though state chartered credit unions are tax exempt, they may be exposed to tax liability if there is income from products or services such as those listed above. If so, a Form 990-T should be timely filed with the IRS. State chartered credit unions are also urged to utilize sound accounting principles to assess potential tax liability. The UBIT Steering Committee has developed an accounting tool to aid in this process. The tool and other resources can be obtained by contacting the Bureau.

SEG, FIELD OF MEMBERSHIP, AND MERGER ACTIVITY

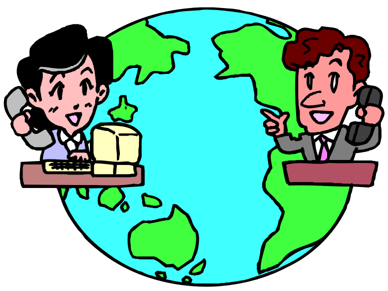
During the fourth quarter of 2006 the Bureau approved 14 small employee groups (SEGs). The two credit unions requesting these groups added 890 new potential credit union members. The average size of the approved SEGs was 64 members, which is well below a threshold of 600 the Bureau has determined is necessary for a new credit union charter to be feasible. Since formal legislation to permit SEG expansion went into effect on July 1, 1999, there have been 406 SEGs approved for total new potential membership of 112,690.

The Nansemond CU merged into ABNB FCU in December 2006. This marked the end of the oldest community field of membership credit union in Virginia. The Nansemond CU was chartered in 1949. Struggling the last few years, assets decreased from $3.2 million at the end of 2000 to just $2.0 million as of September 2006. Also, L.O.M.H. FCU, located in Suffolk, merged into Prime Care CU in Norfolk in December 2006. Thus, at year end 2006 there were 58 state chartered credit unions with total assets of $4.4 billion, which represents 5.7% growth from $4.2 billion for credit unions at year end 2005. This asset growth is up from asset growth in 2004 and 2005 of 4.4% and 3.7%, respectively.

In the fourth quarter of 2006 Virginia CU was approved to serve underserved communities in Richmond, Fredericksburg, Petersburg, and the Greater Farmville area (Buckingham, Prince Edward, and Nottoway Counties, including the Town of Farmville). The total new potential membership for these four underserved areas is 297,565. There was no other community or underserved area activity in 2006.

At year end 2006 there were nine Virginia state chartered credit unions operating with community fields of membership. The total assets of these nine credit unions was $2.3 billion, or 52.5% of total assets of all Virginia state chartered credit unions. That percentage is down from 53.8% at the end of 2005, and represents that asset growth in credit unions with community fields of membership at 3.4% was less in 2006 than total asset growth of all 58 credit unions of 5.7%. In addition, total membership in these nine credit unions grew less than 8,000, or only 3.1% membership growth. However, membership actually declined during the year in five of the nine credit unions. Total penetration into potential members was only 5.0%, up slightly from 4.9% at year end 2005.

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.



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IMPORTANT INFORMATION INSIDE