NCUA LETTER TO FEDERAL CREDIT UNIONS

NATIONAL CREDIT UNION ADMINISTRATION
1775 Duke Street, Alexandria, VA 22314

DATE: **September 2010** **LETTER NO.: 10-FCU-02**

TO: **Federal Credit Unions**

SUBJ: **Multi-Featured Open-End Lending (MFOEL)**

Dear Board of Directors:

As a result of recent action by the Federal Reserve Board, federal credit unions using a multi-featured open-end lending product need to review their policies and procedures to ensure they are in compliance with changes to Regulation Z that became effective July 1, 2010.[1]

BACKGROUND

Multi-featured open-end lending (MFOEL) plans are single accounts with separate sub-accounts for different loan products.[2]

In February 2010, the Federal Reserve Board (FRB) issued changes to Regulation Z that significantly alter the way financial institutions must support open-end credit.[3] [75 Fed. Reg. 7659 (Feb. 22, 2010)].

The 2010 final rule, which primarily focused on implementing the Credit Card Accountability Responsibility and Disclosure Act (CARD) of 2009, incorporated substantive portions of the FRB's January 2009 Regulation Z rule. [75 Fed. Reg. at 7659; 74 Fed. Reg. 5244 (Jan. 29, 2009)]

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[1] The Truth in Lending Act makes the Federal Reserve Board responsible for implementing its provisions in Regulation Z but NCUA has enforcement authority for federal credit union compliance with Regulation Z while the Federal Trade Commission is responsible for enforcement for state-chartered credit unions. [12 U.S.C. §§1607(a)(3), 1607(c)]

[2] Many credit unions offer MFOEL plans through CUNA Mutual's LOANLINER program. Examples of common MFOEL products include share overdrafts, unsecured lines of credit, share-secured lines of credit, vehicles, and home equity lines of credit.

[3] Regulation Z defines "open-end credit" as consumer credit extended by a creditor under a plan in which (1) the creditor reasonably contemplates repeated transactions, (2) the creditor may impose a finance charge from time to time on an outstanding unpaid balance, and (3) the amount of credit that may be extended to the consumer during the term of the plan, up to any limit set by the creditor, generally is made available to the extent that any outstanding balance is repaid. [12 C.F.R. §226.2(a)(20)]

The changes in the January 2009 Regulation Z rule still permit MFOEL -- but the **FRB's new rule will require changes to policies, procedures, and data processing systems in order to meet the revised definition of MFOEL.**

The FRB retained the effective date of July 1, 2010 for the January 2009 Regulation Z changes. [75 Fed. Reg. at 7659] Describing the reasons for these changes, the FRB noted it was relying on the underlying rationale previously provided in 2009. Thus, for additional guidance, federal credit unions can refer to the discussion of open-end credit in the preamble to the FRB's January 2009 Regulation Z rule. [74 Fed. Reg. at 5258-61]

The FRB is particularly concerned about credit plans where each individual credit transaction is evaluated separately. Changes to the official staff commentary to §226.2(a)(20) (See Commentary 2-(a)(20)-5) essentially mean credit unions offering MFOEL plans may "occasionally or routinely" verify credit information, but verification of credit information cannot be done "as a condition" of granting a new advance under the plan. In other words: **The underwriting of individual advances is no longer allowed.**

To assist federal credit unions in making the necessary modifications to MFOEL policies, procedures and data processing systems, this letter identifies best practices for complying with these changes in Regulation Z.

This letter also emphasizes the need to use the appropriate lending disclosures for the appropriate loan products. When your credit union's safety and soundness requires that underwriting be performed for a particular loan product at the time funds are advanced, then it is appropriate to use closed-end products and provide the member with closed-end disclosures. NCUA examiners will be reviewing compliance with the amended Regulation Z in conjunction with regular safety and soundness examinations.

POLICIES AND PROCEDURES

A foundation of open-end lending is that consumers apply for credit only one time, at account opening. The changes to Regulation Z clarify that ***underwriting* must take place <u>only</u> at the opening of a MFOEL plan**. Creditors using MFOEL plans are permitted to *verify* a person's creditworthiness to ensure it has not deteriorated (and revise credit limits and terms accordingly), but they must <u>not</u> perform *underwriting* because a person has requested an advance.

Therefore: **Credit unions engaged in MFOEL must have policies and procedures that differentiate the *underwriting* requirements for opening a MFOEL plan verses the *verification* requirements that may take place "occasionally or routinely."**

MFOEL Policies for Opening Plans: Credit unions engaged in MFOEL must gather enough information about members at the opening of a plan in order to establish creditworthiness. Each credit union must determine the type and extent of information that will be collected. This information will be used as a baseline to verify the future creditworthiness of members. If creditworthiness cannot be established with the information provided at account opening, or the plan is denied, an adverse action notice must be sent to the member.

MFOEL Policies for Advance Requests: Once a MFOEL plan is established, credit unions may *verify* a member's creditworthiness occasionally or routinely by reviewing a subset of the information collected at the plan's opening, but this verification must <u>not</u> be treated as an opportunity to perform *underwriting* again. This means credit unions cannot make members "apply" for an advance. In its preamble to the final regulation, the FRB clarified that a creditor cannot underwrite individual advances in an open-end plan:

> *The [FRB] Board believes that underwriting of individual advances exceeds the scope of the verification contemplated by the statute and is inconsistent with the definition of open-end credit. The Board believes that the rule does not undermine safety and soundness lending practices, but simply clarifies that certain types of advances for which underwriting is done must be treated as closed-end credit with closed end disclosures provided to the consumer.* [74 Fed. Reg. at 5260]

A properly designed verification process will confirm the member's ongoing creditworthiness in a manner that is consistent with the credit union's safety and soundness. Products that typically carry smaller advance limits may require infrequent verification, while those with large advance limits should require more frequent verification. If a credit union has collected sufficient information at the plan's opening, there is only the need to confirm creditworthiness periodically.

Transactions for self-replenishing credit lines[4] such as overdrafts, share-secured lines of credit (LOCs), and unsecured LOCs should entail little beyond verification of borrower identity and performance under the plan, unless there are unusual circumstances such as an over the limit request.

BEST PRACTICES

- Draft and approve policies and procedures that differentiate open-end lending from closed-end lending.

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[4] A line is considered self-replenishing if a consumer can obtain further advances or funds without being required to separately apply for those additional advances and without undergoing a separate review by the creditor of that consumer's credit information, in order to obtain such additional advance. [See Commentary 2-(a)(20)-5.]

- Address the different processes for opening MFOEL plans, performing "occasional or routine" verification, and issuing advances within open-end policies.
- Consider establishing specific credit limits or lines for each feature within a MFOEL plan. While this is not a requirement of Regulation Z, such a practice would provide support for performing underwriting when over the limit requests are received.
- Consider engaging legal counsel to review the credit union's policies, procedures, and documents for compliance with Regulation Z.
- Work with your data processing provider to ensure they can support your credit union's policies and procedures for MFOEL. Data processing systems must be able to identify members with MFOEL plans and send periodic statements appropriately.
- Ensure staff receives the necessary training required to perform MFOEL. This fundamental concept likely requires understanding from staff beyond the lending department. For example, member service representatives and call center staff should be knowledgeable in MFOEL terms and processes.
- When MFOEL plans are secured by collateral such as a member's residence it is still appropriate for credit unions to verify the collateral value with each advance.
- Portfolio credit scoring or "soft pulls" are appropriate if done on a routine or periodic basis for the entire MFOEL portfolio.
- After opening MFOEL plans, credit reports should be used to verify continued creditworthiness, not to re-underwrite a loan. For example, using credit report information to complete debt-to-income ratio computations would go beyond the parameters of permissible "verification" and into the area of impermissible "underwriting."
- Credit unions should use closed-end lending practices and disclosures when it is appropriate to perform underwriting at the time of application. Examples of traditional MFOEL products where closed-end lending is generally more appropriate include vehicle-secured loans and large balance unsecured loans.

If you have questions concerning this Letter to Federal Credit Unions, please contact your NCUA examiner.

Sincerely,

/S/

Debbie Matz
Chairman