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NATIONAL CREDIT UNION ADMINISTRATION
Washington, D.C. 20456

June 17, 1987

Office of General Counsel

Robert Duggan, Esq.
Palmer & Dodge
One Beacon Street
Boston, Massachusetts 02108

Dear Mr. Duggan:

This is in response to your letter of March 16, 1987, regarding **prohibited fees under proposed Section 701.21(c)(8) of the NCUA Rules and Regulations.**

As you may know, in April 1987, the NCUA Board adopted a final rule concerning prohibited fees on all loans made by Federal credit unions. The new rule, Section 701.21(c)(8), is effective on July 1, 1987, and provides as follows:

> A Federal credit union shall not make any loan or extend any line of credit if, either directly or indirectly, any commission, fee or other compensation is to be received by the credit union's directors, committee members, senior management employees, loan officers, or any immediate family members of such individuals, in connection with underwriting, insuring, servicing, or collecting the loan or line of credit. However, salary for employees is not prohibited by this Section. For purposes of this Section, "senior management employees" means the credit union's chief executive officer (typically this individual holds the title of President or Treasurer/Manager), any assistant chief executive officers (e.g., Assistant President, Vice President or Assistant Treasurer/Manager) and the chief financial officer (Comptroller), and "immediate family member" means a spouse or other family member living in the same household.

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Section 741.3 of the NCUA Rules and Regulations subjects federally-insured state chartered credit unions to the requirements contained in Section 701.21(c)(8) unless their state regulatory authority has adopted regulations substantially equivalent to those of the NCUA.

You stated in your letter that the credit union you represent employs a collection agency to collect its consumer loans. The collection agency's present engagement is for a one-year term at a flat fee. The collection agency is a corporation. The president and owner of the common stock of the corporation is one of thirteen directors on the board of directors of the credit union.

The board of directors of the credit union does not participate in the selection of a collection agency. Instead, this is the responsibility of the credit union president, who is elected by the board.

The board of directors does not make decisions regarding specific loans except in the case of mortgage loans. (The collection agency collects only consumer loans). Decisions regarding consumer loans are made by a senior loan officer who reports to the president. The only involvement of the board of directors in consumer loans is through a subcommittee of the board. The subcommittee reviews the consumer loan portfolio from time to time. The subject director is not on this subcommittee. The board also participates in consumer loans by issuing guidelines and limitations on the types and amounts of consumer loans which are available.

The purpose of Section 701.21(c)(8) is to ensure that the decisions a Federal credit union goes through at the various stages of making a loan, i.e., underwriting, insuring, servicing, or collecting, will not be influenced by the receipt of things of value by those at the credit union involved in such decisions. You stated in your letter that because the collection agency is not selected by the board, and because of the board's limited involvement with consumer loans, the rule should not be applied to the subject director.

Section 701.21(c)(8) prohibits a Federal credit union from making any loan or extending a line of credit if compensation is to be received by a director, either directly or indirectly, in connection with collecting the loan or line of credit. This provision clearly applies to the subject director due to his stock ownership in the collection agency. Your argument is that under the facts you present, the rule should not apply. However, this interpretation of the rule cannot be sustained as the rule does not contain an exception for mitigating circumstances.

You further argued that use of the language "is to be received" in the rule assumes an ability to determine at the time of making a loan whether or not a fee will be received, and that a

determination as to whether the rule will apply is to be construed on the occasion of each loan. You concluded that the intent of the rule is "to prohibit day-to-day servicing and collection activities, but not the referral of loans in default to an outside agency, because in the case of any particular loan, the likelihood of default is low and at the time of closing it cannot be determined whether a fee 'is to be received'." We do not agree. Use of the phrase "is to be received" in the rule merely indicates that the compensation will be received after the loan is entered into. Your interpretation of the rule, that only day-to-day servicing and collection activities are prohibited, is not consistent with the rule as written or with its intent.

We do agree that at the time a loan is granted or a line of credit is extended, a determination should be made as to whether the conflicts of interest sought to be eliminated by Section 701.21(c)(8) are present. However, this initial inquiry does not satisfy the rule. The conflicts of interest sought to be eliminated by the rule may arise after the loan is entered into. The rule will also apply to prohibit these types of conflicts. For instance, assume that a credit union has employed Collection Agency X. The credit union subsequently decides to hire another collection agency. One of the collection agencies under consideration employs one of the directors. A director could use his influence to ensure that the collection agency by which he is employed is selected. This conflict of interest is sufficient to trigger the application of the rule, despite the fact that the collection agency will be collecting loans that were made prior to the time it was employed.

The fact that a director would be required to remove himself from discussions and deliberations in which he had a conflict of interest pursuant to Article XIX, Section 4 of the Federal Credit Union Bylaws is not sufficient to negate his potential influence. Furthermore, since the establishment and review of lending practices and procedures is one of the major functions of a Federal credit union board of directors, to remove oneself from participating in discussions and deliberations in which the director has a potential conflict of interest would significantly impact on the fiduciary role of the director.

You also argued that because the collection agency receives a flat fee rather than a commission, the rule is not applicable to the subject director. You analogized the flat fee received by the collection agency to a salary that a director of a credit union could receive if he was also a salaried employee in the credit union's collection office. The rule provides a specific exception for salaries paid by Federal credit unions to employees in conjunction with their loan underwriting, insuring, servicing or collection activities. There is no exception for salaries paid by parties other than the Federal credit union (or by a federally-insured state chartered credit union under Section 741.3).

Lastly, you argued that the rule should not be applied to prohibit the collection agency from collecting loans granted prior to the time it was employed. As stated above, the rule prohibits conflicts that exist both at the time a loan is granted as well as conflicts that arise subsequently. The effective date of the rule is July 1, 1987. As of that date, either the subject director must resign or the credit union must employ a new collection agency.

We trust this has been of assistance.

Sincerely,

STEVEN R. BISKER
Assistant General Counsel

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