



NATIONAL CREDIT UNION ADMINISTRATION
Washington, D.C. 20456

GC/RD:sg
4630

August 7, 1987

Office of General Counsel

Ms. Marie Nunn
Manager
Northwest Navigation Federal Credit Union
P.O. Box 831
Vancouver, Washington 98666

Dear Ms. Nunn:

This responds to your recent letter requesting our review and opinion concerning a proposal currently under consideration by your Credit Union. As outlined in your letter, your Credit Union proposes to implement a dividend structure that will pay a reduced dividend rate on shares that have been pledged by members to secure loan obligations and charge a lower rate of interest on such share-covered loans. Your board of directors is considering such a combined deposit/credit arrangement due to various tax consequences.

Section 117 of the Federal Credit Union Act (12 U.S.C. §1763) provides that the FCU board of directors may, after provision for required reserves, pay a dividend at different rates on different types of shares. Therefore, your board could create a special share account classification which could be tied with a special low interest loan agreement.

Section 701.35 of NCUA's Rules and Regulations requires an FCU's accounts to accurately reflect the terms and conditions of the members' accounts (12 C.F.R. §701.35). The FCU's account agreements would have to accurately reflect the interplay between the members' share account and outstanding loan in terms of interest rate charged on the loan, dividends to be paid on the share account, and access to the frozen shares.

The power of the FCU board of directors to set interest rates on loans is governed by Section 107(5)(A)(vi)(I) of the FCU Act (12 U.S.C. §1757(5)(A)(vi)(I)). Within these guidelines, an FCU board of directors may set the interest rates on FCU loans and lines of credit.

The NCUA has issued guidelines concerning deposit balances required by an FCU in connection with a loan to a member. Enclosed is IRPS 79-9 concerning compensating balance deposits

ICD/Vol I, Part C

Special loan plan -
required deposits

Ms. Marie Nunn
Page Two

which, if determined to be such, would have to be considered in calculating the rate of interest on an FCU loan to a member for purposes of Section 107(5)(A)(vi)(I) of the FCU Act.

Generally, under IRPS 79-9, if an FCU grants a loan to a member and requires a portion of the loan or an amount of money from an outside source to be deposited in a frozen share account or other type of account at the FCU for the life of the loan, then the account would be considered a compensating balance and the computation provisions of IRPS 79-9 would apply. The term "compensating balance" does not include any deposit in the FCU that the member/borrower has made previously without regard to any loan requirement or lending policy that such a deposit be made, even though the account is given as security for the loan.

In addition to satisfying the requirements of IRPS 79-9, the FCU board must comply with the Truth in Lending Act (15 U.S.C. 1601 et seq.) and Regulation Z (12 C.F.R. §226 et seq.). The definition of a finance charge is found at §226.4(a) of Regulation Z. The finance charge is the cost of consumer credit as a dollar amount. It includes any charge payable directly or indirectly by the creditor as an incident to or a condition of the extension of credit. The Official Staff Interpretation to Section 226.4(a) found in Supplement I to Regulation Z discusses forfeitures of interest. As explained below, in some instances a forfeiture of interest on a member's deposit must be reflected in the finance charge. The Official Interpretation states in part that:

"If the creditor reduces the interest rate it pays or stops paying interest on a consumers deposit or any portion thereof . . . the interest lost is a finance charge. . . . A consumer must be entitled to the interest that is not paid on an account in order for the lost interest to be a finance charge."

We have contacted the Consumer Affairs Division of the Federal Reserve Board for their comment on this interpretation. It is their opinion that one must look to the deposit contract of the member to determine whether or not the member is entitled to the interest (or dividend in the case of a credit union). It is our understanding that if the deposit contract entitles a member to the dividend, the amount of forfeiture would be a part of the finance charge. For example, if a member enters into a combined share account/line of credit agreement with the FCU where the share account may pay a 1% dividend and there is a 5% interest rate on the line of credit, there is no forfeiture of dividends since the member was never entitled to more than a 1% dividend on the share account. On the other hand, if a member has a share certificate account paying a 6% dividend and then enters into a credit

Ms. Marie Nunn
Page Three

agreement which will offer a loan at 1% but will stop paying dividends on the share certificate account for the life of the loan even though other similar accounts (without the loan tie-in) receive dividends, an interest or dividend forfeiture occurs and the forfeiture is part of the finance charge.

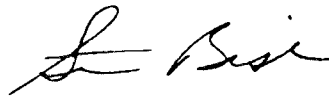
In addition, pursuant to Section 226.18(r) and footnote 45 of Regulation Z, 12 C.F.R. §226.18(r) (for closed-end credit only) if a creditor requires a deposit as a condition of a specific transaction and the deposit earns less than five percent per year, the creditor must disclose that the annual percentage rate does not reflect the effect of the required deposit.

You may wish to have your attorney review any combined share account/credit agreement for compliance with Regulation Z.

Lastly, we would caution you that there may be personal income tax consequences to your members, and reporting obligations on the part of the Credit Union, that you should determine by consulting with your attorney or the Internal Revenue Service.

I hope we have been of assistance.

Sincerely,



STEVEN R. BISKER
Assistant General Counsel

RD:sg

Enclosure

NATIONAL CREDIT UNION ADMINISTRATION

12 C.F.R. Chapter VII

Interpretive Ruling - Rate of Interest

AGENCY: National Credit Union Administration

ACTION: Interpretation of General Applicability

SUMMARY: This statement sets forth the National Credit Union Administration's interpretation of the effect a compensating balance has upon the rate of interest on Federal credit union (FCU) loans for purposes of Section 107(5)(A)(vi) of the Federal Credit Union Act. Under this interpretation, a compensating balance required on an FCU loan must be considered in determining the rate of interest on the loan. Pursuant to Section 107, the resulting rate of interest may not exceed 1% per month (12% per year).

EFFECTIVE DATE: Immediately upon publication.

ADDRESS: National Credit Union Administration, 1776 G Street, N.W.,
Washington, D.C. 20456

FOR FURTHER INFORMATION CONTACT: Robert M. Fenner, Assistant General Counsel, or Edward J. Dobranski, Senior Attorney, both of the Office of General Counsel, National Credit Union Administration, at the above address. Phone: (202) 357-1030.

ENCLOSURE

Interpretation
[IRPS No. 79-9]

This interpretation states that the effect of a compensating balance must be considered in order to determine the rate of interest on a Federal credit union (FCU) loan to a member for purposes of Section 107(5)(A)(vi) of the Federal Credit Union Act (12 U.S.C. 1757(5)(A)(vi)). That section states that the rate of interest on a loan to a member shall not exceed 1% per month (12% per year) on the unpaid balance inclusive of all service charges.

I. DEFINITION OF COMPENSATING BALANCE

1. The term 'compensating balance' means a deposit in a Federal credit union (FCU):

(a) that the FCU requires that the member/borrower make;^{1/}

(b) that is created from either (i) part or all of the proceeds of the loan or (ii) from any outside source (including the borrower's own funds); and

^{1/} Systematic loan/savings plans do not fall within the scope of this interpretive ruling. The issue of whether such plans must be considered for purposes of 12 U.S.C. 1757(5)(A)(vi) will be addressed in a subsequent interpretive ruling.

(c) that is not accessible to the member/borrower for a given period of time.

2. The term does not include any deposit in the FCU that the member/borrower has made previously without regard to any loan requirement or lending policy that such a deposit be made, and the amount of which is given as security for the loan.

An explanation of the terms used in the definition is set forth below.

The term 'deposit' refers to a share account of any type, or a share certificate account,^{2/} or a certificate of indebtedness. It does not include the \$5 share membership requirement, for that requirement exists independently of any loan (even if given concurrently with a loan) and is mandated by Section 109 of the Federal Credit Union Act (12 U.S.C. 1759).

The term 'requires that the member/borrower make' means that funds must be placed in the FCU in order to obtain a particular loan. It is important to note that this requirement can arise in a number of ways; for example, on the face of the loan agreement (such as a security requirement or a requirement of deposit [with or without security]); as an FCU lending policy (e.g., that to qualify for a loan the member/borrower must have 20% of the loan amount in shares); or a requirement that is conveyed orally to a particular borrower (e.g., by the loan officer).

^{2/} Thus, if a share certificate is required to be purchased as a condition of a loan, and it is required to be given as security on the loan, then a compensating balance arises.

The term 'created from the loan proceeds' is essentially self explanatory, i.e., part of the loan is kept in an account in the FCU.^{3/}

The term 'created from any outside source (including the borrower's own funds)' covers the situation where the borrower receives the entire amount contracted for in the loan agreement, but is required to place a certain amount of funds (from any source) in the FCU, and such funds may not be withdrawn for a given time period.

The term 'not accessible to the member/borrower' means funds to which a borrower does not have an automatic, unfettered right of withdrawal.^{4/} Thus, e.g., funds that are placed with the FCU as a requirement of the loan, and that are subject to withdrawal only with credit committee approval pursuant to a separate requirement in the loan agreement or pursuant to a security interest in those shares, would be considered not accessible for purposes of this interpretation.

The term 'compensating balance' as used herein does not include any funds that were previously and independently placed into a share account (without regard to any lending policy or loan requirement) and that are subsequently offered as security for the loan. Such funds do not affect

^{3/} Note that estate loans (where the borrower requests that all proceeds of the loan be placed into shares, and which are inaccessible), will be addressed in a subsequent interpretive ruling.

^{4/} Pursuant to the same rationale applicable to the \$5 share membership requirement, the imposition by the FCU of the 60 day notice of withdrawal requirement on all accounts, as provided for in Article III, Section 5(a) of the Federal Credit Union Bylaws, does not render shares inaccessible for purposes of this ruling.

the 1% per month interest rate limitation. For example, suppose an FCU requires 20% of the loan balance to be maintained in shares in order to qualify for a loan. If a member wishes to borrow \$5,000, in order to be eligible to borrow such an amount, \$1,000 must be in shares (with such \$1,000 being inaccessible for a certain period of time). If the member already had \$1,000 in shares (and no portion of the \$1,000 was placed in shares for the purpose of meeting the FCU 20% requirement for a contemplated loan), and if the shares are given as security on the loan, no compensating balance arises, even though the funds are inaccessible until the loan balance is less than the share amount. However, if the member had only \$600 in shares, and put \$400 from his or her own pocket into the share account in order to qualify for the loan (or agreed to place \$400 from the loan proceeds into shares), then a \$400 compensating balance exists and that compensating balance must be considered in determining the rate of interest for purposes of Section 107(5)(A)(vi) of the Federal Credit Union Act.

II. LEGAL RATIONALE

As stated above, the pertinent provision of the Federal Credit Union Act is Section 107(5)(A)(vi) (12 U.S.C. 1757(5)(A)(vi)), which provides that the rate of interest on an FCU loan shall not exceed 1% per month (12% per year) on the unpaid balance inclusive of all service charges. The issue which has arisen concerning the relationship between Section 107 and compensating balances is best illustrated through an example. If a loan of

\$1,000 is contracted for, with monthly payments, and if the FCU requires that \$200 of such loan be placed in the borrower's share account (to be inaccessible for a given period of time), upon what amount may the FCU charge 12% per year (i.e., what is the unpaid balance)?5/

It is NCUA's position that 12% per year may not be assessed upon the entire amount of the loan (\$1,000 in the example). This position is predicated upon recognition of the time value of money and upon the resolution of this issue reached by a vast majority of those courts that have addressed it.

The term 'interest', by definition, mandates consideration of the funds a borrower has use of and of the time the borrower has use of such funds.6/ Interest is thus the value of funds available for one's use. That value varies depending upon how long the funds may be used, i.e., the time value of money. When funds 'borrowed' may not be used for a period of time, the value of those funds decreases. The resulting value is termed 'present value'. Thus, for example, given a loan of \$1,000 with a \$200 compensating balance, 1% per month may be assessed only upon the sum of

5/ Stated another way, what is the maximum monthly interest rate factor that may be applied to the full \$1,000? It is understood that FCU's will of necessity perceive the computation as a determination of the periodic interest rate factor and treat the loan as one for \$1,000. The discussion in the text is used simply to more clearly explain the issue.

6/ 'Interest' is universally defined as compensation received by a lender for the use of money. See, e.g., 47 C.J.S. Interest §1 and 45 Am. Jur. 2d Interest §1, for a listing of a number of cases that have recognized this definition. Interest can also be viewed as compensation for the creditor's loss of the use of funds. Thus, when a compensating balance is required for a given time period, the creditor is not deprived of the use of funds for such time.

\$800 plus the present value of the \$200 compensating balance. (That is, the FCU will be permitted to charge 1% per month [12% per year] on an amount somewhere between \$800 and \$1,000, depending upon the present value of the \$200). The present value will vary depending upon how long the \$200 is inaccessible. The longer the period of inaccessibility, the less its present value. In the alternative, the unpaid balance can be carried on the FCU's books as \$1,000 in the example. In that situation, the monthly interest rate factor assessed upon that \$1,000 cannot be 1%, because of the time value of money, and thus must necessarily be less than 1% (how much so again depends upon how long the \$200 is inaccessible).^{7/}

The concept of the time value of money, and why it must be considered when determining the relationship between a compensating balance and section 107, is clearly evident when a compensating balance type loan is compared to a multiple advance loan. Given a loan for \$1,000 for one year, if the FCU states that it will advance \$250 to the borrower at once, \$250 after one month, and \$500 after six months, it is clear that if the FCU charges 1% per month on \$1,000 from the date of the first advance, the rate of interest is greater than 1% per month on the unpaid balance. Such a scheme would generate a greater rate of interest to the FCU than if the transaction was viewed as three separate loans, with 1% being charged on \$250 for one year, 1% on \$250 for 11 months, and 1% on \$500 for six

^{7/} As noted in footnote 5, since the FCU will choose to consider the unpaid balance to be the full amount of the loan, the monthly interest rate factor must be arrived at by considering the elements of use and time (i.e. the time value of money).

months. The crucial aspect in this type of determination is the time value of money (i.e., the funds the borrower has use of). A compensating balance is similar. If the FCU withholds part of the loan until a later date, (\$200 in the example), the maximum interest rate may not be assessed upon that \$200 if the borrower does not have immediate use of it.^{8/} Of course, time value methods of computation exist so that present value and the resulting rate of interest may be determined at the inception of a compensating balance loan. This rate may not exceed 12% per year.

As noted previously, a number of courts have addressed the issue of whether a compensating balance must be considered in determining the rate of interest on a loan, and the vast majority have concluded that such a consideration is necessary.^{9/} It is important to note that the cases referred to dealt with state law usury provisions. In short, many of the courts determined not only whether an excessive rate was actually reserved or received, but also determined whether the lender intended to reserve or receive such an excessive rate. This dual determination was necessary in those cases for each involved a provision imposing a penalty for charging an excessive rate of interest. The cases thus dealt with allegations of usury, i.e., excessive interest rates and allegations that such rates were charged by a lender with usurious intent, the latter being necessary to

^{8/} Given the concept of the use of money, it makes no difference whether the compensating balance is created from the loan proceeds or from the borrower's own funds.

^{9/} For a general overview of case law addressing the question of whether usury results when a creditor requires a deposit of a debtor's funds, see 92 ALR 3d 769.

Invoke the penalty provisions.

Unlike the court decisions, this interpretation does not address an entire usury provision. The usury provision of the Federal Credit Union Act is composed of two sections, §107(5)(A)(vi) and §107(5)(A)(vii). The former sets forth the maximum interest rate (1% per month); the latter, the penalty a borrower may invoke in court for a knowing violation of that limit. This interpretation necessarily encompasses only §107(5)(A)(vi) for it is solely that section of the usury provision for which NCUA is charged with regulatory responsibility. That responsibility extends only to interpreting what is necessary to determine the 'rate of interest on the unpaid balance'. It does not extend to making a determination of whether any particular action is usurious, i.e., taken with knowledge that an excessive rate was reserved or received (or cloaked with an intent that evidences such knowledge) so that the penalty provision of §107(5)(A)(vii) would be invoked. That type of determination is for a court, in an action brought by a borrower under §107(5)(A)(vii) (12 U.S.C. 1757(5)(A)(vii)).^{10/}

Again, the courts, although making the dual determination noted, have overwhelmingly concluded that the imposition of the maximum interest rate on the amount contracted for, without consideration of the loss of use of money for a period of time which results from the imposition of a

^{10/} We recognize, of course, that an agency pronouncement such as this could very well be perceived by a court, in an action by a borrower under §107(5)(A)(vii) against an FCU, as imparting knowledge to an FCU for purposes of that section. That resolution, however, is for the judiciary, not NCUA, and will necessarily turn upon the facts in each particular case.

compensating balance, constitutes the charging of an excessive rate of interest.

Given such judicial precedent, and given present day concepts of the time value of money, NCUA interprets Section 107(5)(A)(vi) of the Federal Credit Union Act as requiring that compensating balances and their resulting loss of use of money must be considered when determining the rate of interest on the unpaid balance. This does not mean, of course, that compensating balances are illegal. It does mean, however, that a violation of Section 107(5)(A)(vi) occurs if, given consideration of any compensating balance, the rate of interest exceeds 1% per month (12% per year) on the unpaid balance inclusive of all service charges.

III. COMPUTATION

As noted previously, accepted methods of computation for determining the effects of a compensating balance may be employed.^{11/} Such methods determine how the compensating balance affects the rate of interest through consideration of the length of time the funds are inaccessible to the borrower and the amount of such funds. The computation for this determination must be done pursuant to such accepted methods of determining present value (i.e., determining the present value of funds that are

^{11/} For example, Supplement I to the Federal Reserve Board's Regulation Z sets out such a method. Note, however, that that method encompasses the actuarial computation of interest, not the U.S. Rule computation. Supplement I can be adapted to fit the U.S. Rule method however.

inaccessible for a given period of time). Once the present value of the compensating balance is determined, the unpaid balance can be computed. Or, in the alternative, the FCU can compute the maximum periodic rate factor which may be applied so that the rate of interest does not exceed 1% per month (12% per year). Although NCUA will advise any FCU that intends to impose a compensating balance of the methods of calculation, it should be noted that any FCU that does impose a compensating balance will bear the burden of demonstrating that the rate of interest does not exceed 1% per month (12% per year) on the unpaid balance. In this regard, FCU's should note that since the computations are somewhat difficult, they should ensure that they can accurately perform them. This is especially important given §107(5)(A)(vii), the penalty provision.

Two other aspects of the computation deserve note. First, any dividends paid on a compensating balance may be considered in determining the rate of interest. Thus, the greater the dividends paid on the compensating balance, the lower the rate of interest.^{12/} Consideration of dividends is not mandatory (since dividends serve to lower the rate of interest), however, they may be considered by any FCU that can compute their effect.

^{12/} Although FCU's do not know in advance what the dividend rate will be (nor can they guarantee a rate), legally no objection exists to the use of a good faith estimate based upon past dividend rates or reasonable projections.

Second, since an FCU by law^{13/} may not freeze shares in excess of any loan balance, portions of the compensating balance must be made available whenever the compensating balance exceeds the outstanding loan balance. If this happens, the staggered accessibility of funds can be considered in calculating the interest rate, if the FCU so chooses (and if it has the capability of performing the requisite mathematical computations). However, in making its calculations to determine the effect of the compensating balance, the FCU may also choose to simply treat the compensating balance as though it is not accessible for the life of the loan.

IV. SCOPE

NCUA recognizes that this interpretation raises a host of other questions concerning a myriad of situations that do not fall within the definition of the term 'compensating balance' as set forth herein. It is the agency's intent to address in a subsequent interpretive ruling a number of those situations, such as FCU thrift plans, open end loans, estate loans, prepaid interest, and funds that are withheld from the borrower but are not placed in a deposit account or CI (e.g. in escrow with a third party).

12 DEC 1979

ROSEMARY BRADY
Secretary
National Credit Union Administration Board

^{13/} Article III, Section 5(c) of the Federal Credit Union Bylaws.