



NATIONAL CREDIT UNION ADMINISTRATION

WASHINGTON, D.C. 20456

February 26, 1991

Kerry D. Briggs, President  
Independent Financial Services, Inc.  
433 E. Deepdale Road  
Phoenix, Arizona 85022

RE: Warranty Service Contracts, Annuities and Insurance (Your Letter of December 14, 1990)

Dear Mr. Briggs:

You requested answers to several questions concerning the permissibility of certain activities of federal credit unions and credit union service organizations. The questions, and answers in brief, are as follows.

1. Is it currently permissible for a federal credit union ("FCU") or its credit union service corporation ("CUSO") to offer warranty service contracts for new and used cars to its members? Yes, with some limitations.
2. Is it currently permissible for an FCU or its CUSO to obtain an automobile dealer license in order to offer service contracts? Yes.
3. a. Is it possible for an FCU (not the CUSO) to receive commission income from the sale of tax-deferred annuities to its members? No.  
b. Is it permissible for an FCU (not the CUSO) to receive expense reimbursement from an insurance company for the sale of tax-deferred annuities? Yes.
4. a. Is it possible for an FCU (not the CUSO) to receive expense reimbursement from an insurance company for a force placed collateral protection program for physical damage insurance on automobile loans? Yes.

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b. If the answer to Question No. 4a is yes, what are the guidelines for reimbursement, maximums, etc.? See the discussion below.

## ANALYSIS

### Question 1

Both FCUs and CUSOs may offer automobile warranty service contracts to FCU members. Although an FCU has no authority to enter into a warranty service contract under which the FCU would be liable for repairs, Section 721.1 of the NCUA Rules and Regulations (the "Regulations") (12 C.F.R. §721.1) allows an FCU to "make insurance and group purchasing plans involving outside vendors available to membership (including endorsement)" and to "perform administrative functions on behalf of vendors." Thus, an FCU may offer its members a third party's vehicle warranty service contract program.

The extent to which an FCU may be reimbursed for offering a vehicle warranty service contract program depends on how the program is classified. You state in your letter that the program is "not breakdown insurance, but rather a warranty product." We do not have sufficient information to determine whether the plan constitutes insurance. In either case, the FCU may receive some reimbursement. If the plan is regarded as insurance, Section 721.2(b)(2) of the Regulations (12 C.F.R. §721.2(b)(2)) indicates that an FCU may receive compensation in an amount not exceeding the greater of the "dollar amount" or the "cost amount" it incurs in providing the warranty service to its members. If, on the other hand, the plan does not constitute insurance, Section 721.2(b)(3) (12 C.F.R. §721.2(b)(3)) limits the FCU's compensation to the actual cost amount. Additional limitations may be imposed by state law. The "dollar amount" limitation is \$4 per single payment policy, \$6 per combination policy, or \$4 per annum for any other type of policy. (Section 721.2(a)(1), 12 C.F.R. §721.2(a)(1).) The "cost amount" limitation is the total of the direct and indirect costs to the FCU of any administrative functions performed on behalf of the vendor. The FCU must be able to justify the cost amount using standard accounting procedures. (Section 721.2(a)(2), 12 C.F.R. §721.2(a)(2).) In computing the "cost amount," the guidelines in the NCUA Accounting Manual for Federal Credit

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Unions, Section 5200.6 (November 1989) should be followed. A copy of those guidelines is enclosed for your information.

Generally, an FCU officer or employee may not receive commissions for products sold pursuant to Part 721. Section 721.2(c) of the Regulations (12 C.F.R. §721.2(c)) prohibits FCU directors, committee members and senior management employees and their immediate family members from receiving any compensation or benefit, directly or indirectly, in conjunction with vendor products. This prohibition also applies to other FCU employees unless the FCU's board of directors determines that the employee's involvement does not present a conflict of interest. (§721.2(d), 12 C.F.R. §721.2(d).)

Safety and soundness concerns mandate that the vendor and the FCU conspicuously disclose to FCU members that the vehicle warranty service contract products are provided and operated by the vendor and not the FCU, and that the vendor is solely responsible for all such products sold. Payout under a vehicle warranty service contract is guaranteed only by the private insurance underwriter and will require analysis of that underwriter's financial conditions and prospects. The FCU's sole connection with a vehicle warranty service contract sold to a member is as sales agent or other sales conduit; it is not responsible to the member for the underwriter's performance under the contract. It should also be disclosed to FCU members in writing that such vehicle warranty service contract products are not FCU shares or deposits and are not insured by the National Credit Union Share Insurance Fund.

FCUs marketing vehicle warranty service contract products must be in compliance with applicable state laws on licensing, receipt of compensation and insurance-related unfair or deceptive practices. In some states, a financial institution cannot be licensed as an insurance agent. Some of those states may allow an FCU official or employee to become licensed as an insurance agent for the institution. However, we can provide no opinion on the insurance laws in this area. Within the bounds of applicable law and safety and soundness, the NCUA permits each FCU's board of directors to determine the best method by which the FCU may provide its members with warranty services. The limits on compensation under Part 721 of the NCUA Rules and Regulations (12 C.F.R. Part 721) dis-

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cussed above apply regardless of the method chosen by the FCU's board of directors.

A CUSO may offer vehicle warranty service contracts pursuant to Section 701.27(d)(5)(ii) of the Regulations (12 C.F.R. §701.27(d)(5)(ii)). That section authorizes CUSOs to engage in the "provision of vehicle warranty programs." CUSOs are not subject to the restrictions of Part 721 of the Regulations. However, FCUs investing in or loaning to CUSOs must comply in all respects with the provisions of Section 701.27.

### Question 2

The Federal Credit Union Act (12 U.S.C. Sections 1751 et seq.) (the "Act") and the Regulations neither expressly authorize an FCU or a CUSO to hold an automobile dealer license, nor forbid the same. Although FCUs and CUSOs may not sell automobiles (except in the case of resale of repossessed collateral), both may engage in marketing services, FCUs under Part 721 of the Regulations and CUSOs pursuant to §701.27(d)(5)(i) (12 C.F.R. §701.27(d)(5)(i)); those marketing services may be related to the purchase and sale of automobiles. In the event that state law required an FCU or a CUSO to obtain an automobile dealer license in order to carry on such marketing services, nothing in the Act or the Regulations would preclude an FCU or a CUSO from doing so.

### Question 3

For the purposes of this letter, we assume that the annuity contracts in question are insurance and not securities products. We note that certain annuities may be regulated as securities by the United States Securities and Exchange Commission and state securities regulators. To avoid any potential violations of law, we recommend that you consult with local counsel and/or the appropriate regulatory authorities for information concerning applicable laws, including those regarding insurance, annuities and securities, before instituting any annuity program with credit unions.

On the issue of whether FCUs may receive commissions and/or expense reimbursement on annuity sales, we refer you to the discussion of Part 721 of the Regulations in our response to Question 1, above. Since an annuity is not related to the extension of credit or opening or maintenance of a share,

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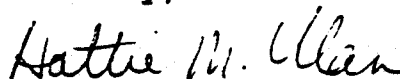
share draft or share certificate account, an FCU may receive only reimbursement for the greater of the dollar amount or cost amount incurred in making the annuities available to its membership. (§721.2(b)(2), 12 C.F.R. §721.2(b)(2).) The statements in our answer to Question 1 regarding safety and soundness, commissions to officers and employees, and state law issues also apply.

Question 4

It is possible for an FCU to receive expense reimbursement from an insurance company for a force placed collateral protection program for physical damage insurance on automobile loans. If the FCU makes the loan in question, the insurance sale is "directly related to an extension of credit by the credit union" and therefore governed by Section 721.2(b)(1) (12 C.F.R. §721.2(b)(1)). That section provides that FCU compensation in such a case is unlimited except as otherwise provided by applicable state insurance law. If the FCU does not make the loan, it may be reimbursed for the greater of the dollar amount or cost amount, under §721.2(b)(2) (12 C.F.R. §721.2(b)(2)).

In a telephone conversation with Martin Conrey of this Office, you suggested that the Magnuson-Moss Warranty Act had some bearing upon the issues raised in your letter. NCUA has no authority to interpret or enforce the Magnuson-Moss Warranty Act, and we offer no opinion as to its applicability or effect. We suggest that you contact local counsel or the Federal Trade Commission with any questions that you may have regarding the Magnuson-Moss Warranty Act.

Sincerely,



Hattie M. Ulan  
Associate General Counsel

GC/MRS:sg  
SSIC 3500  
90-1219

Enclosure

Administration Rules and Regulations govern to what extent a credit union may become involved in this activity and the extent of reimbursement. The amounts of such fees collected should be entered in "Miscellaneous Operating Income", (Account No. 151).

## 5200.5 REIMBURSEMENT FEES— COST OF HANDLING TRUST ACCOUNTS

Federal credit unions may act as trustees or custodians for pension plans in accordance with Part 724 of the National Credit Union Administration Rules and Regulations. If a fee is charged for this service, the right to assess such a fee should be contained in the written trust agreement. Such fees shall not exceed the direct and indirect costs incident to administering the trust account.

## 5200.6 GROUP PURCHASING AND INSURANCE ACTIVITIES

As provided in Part 721 of the National Credit Union Administration Rules and Regulations, a federal credit union may be reimbursed only for an amount not exceeding the direct and indirect costs to the credit union of any administrative functions performed on behalf of the vendor. In order to ensure that only costs associated with the activity are being reimbursed, documentation of the costs is necessary.

Several alternatives are available to document costs:

- a. The credit union can track direct and indirect costs of the activity through its standard accounting system.
- b. The credit union can establish a formal cost accounting system to track costs.
- c. The credit union can continuously track direct costs related to the activity and allocate relevant indirect costs on a rational basis.
- d. The credit union can determine the direct and indirect costs on a sampling basis and use the results of the sample to determine reimbursable direct and/or indirect costs.

To provide some guidance as to what the National Credit Union Administration deems an acceptable method of determining reimbursable costs, the following three-step procedure is offered:

a. A federal credit union, through intermittent sampling or continuous tracking, should determine the direct costs related to an activity.

b. A computation should be made of the ratio of total indirect costs to total direct costs. Figure 5-45 is a sample form for computing this ratio.

c. Using the ratio developed on Form FCU 2000, the federal credit union should determine the amount of indirect costs which can be allocated to that activity.

d. Any onetime costs for studies and/or special analyses can also be reimbursed.

The left side of Figure 5-45 outlines the historical data for direct and indirect expenses. As previously stated direct expenses are costs that apply to a specific service, department, operation, segment or unit of output within a credit union. These are sometimes referred to as traceable, specific, or separable costs. For example, salaries of credit union employees assigned to insurance or group purchasing activities would be considered direct costs. Indirect or allocated costs are incurred as a part of an entire building, section, or division, and allocated within the respective service, subdivision, or subsection. They cannot be traced to individual departments, operations, segments or units of output. For example, costs for building depreciation, rent, insurance, electricity and etc., are indirect costs. Indirect costs are often referred to as nontraceable, common, general, or joint costs.

The Statement of Income (Form FCU 109B), lists certain known direct and indirect expenses. Space for capturing those costs are on Figure 5-45, Federal Credit Union Computation for Reimbursable Costs for Services. Such costs could be applicable to an insurance or group purchasing activity. Additional space has been provided on the sample format for listing any other direct and indirect annual historical costs relating to such activities. Once the ratio of indirect versus direct expenses is established for the previous calendar year, it can be multiplied by the amount of actual direct operating expenses for the current period to arrive at indirect costs. The direct and indirect costs are summed and added to the amount of the one time costs, studies, and/or investigations incurred by an activity. That total is the amount of reimbursable expenses for the current period. (NOTE: The ratio of indirect to direct costs should be reviewed annually.)

**Figure 5-45: Illustration of a Computation of Maximum Reimbursable Costs for Services**

FINANCIAL DATA			COMPUTATION OF THE MAXIMUM REIMBURSABLE EXPENSES	
As of 12/31/81			(4) Total Actual Direct Operating Expenses (As of 6/30/82)	\$4,024.80
Acc't No.	Acc't Title		(5) Ratio of Indirect Versus the Direct Expenses (3) = 1.03 X amount of (4)	\$4,145.54
<b>Direct Expenses:</b>			(6) Amount of Reimbursable Expenses for Providing the Service: [(4) + (5) = (6)]	\$8,170.34
210	Compensation	\$1,000,000		
	Other Direct Expenses			
(1)	Total Direct Expenses	\$1,000,000		
<b>Indirect Expenses:</b>			Plus:	
250	Office Occupancy	\$ 400,000	(7) One Time Cost of Studies and/or Investigations (list)	\$ _____
260	Office Operations	460,000		
270	Educational and Promotional			
290	Professional and Outside Service	150,000		
320	Operating Fees			
360	Miscellaneous Operating Expenses	20,000		
	Sub-total	\$1,030,000	Total	\$ _____
	Other Indirect Expenses (list)		(8) Total Amount of Reimbursable expenses [(6) + (7)]	\$8,170.34
(2)	Total Indirect Expenses	\$1,030,000		
(3) Ratio of Indirect Versus Direct Expenses = (2) / (1)		1.03		

Note: Use the reverse side of this form to explain the method that was used to determine the amount of current direct costs that were incurred in providing this service.

**5200.6.1 ILLUSTRATION OF A FEDERAL CREDIT UNION COMPUTATION OF MAXIMUM REIMBURSABLE COSTS FOR SERVICES**

Assume that DMR Federal Credit Union began to provide a group purchasing service for consumer goods on January 1, 19X1. A credit union employee is assigned to provide the service 4 hours a day every Monday, Wednesday, and Friday of each week. Direct labor costs are allocated by labor hour costs devoted to providing the service. The one assigned employee

earns \$6.45 per hour and is employed 40 hours per week. The direct compensation costs of providing the service as of June 30, 19X2 were as follows:

Direct Compensation Costs = No. Hours devoted to service x wage cost per hour

or

Direct Compensation Costs = 624 Hours x \$6.45

Direct Compensation Costs = \$4,024.80

The computation of the maximum reimbursable costs for services is as shown on Figure 5-45.