

October 14, 2004

William A. Raker, President/CEO
US Federal Credit Union
1400 Riverwood Drive
Burnsville, Minnesota 55337

Re: Permissibility of Item Processing Services Arrangement.

Dear Mr. Raker:

You have asked if it is permissible for a federal credit union (FCU) to obtain a routing and transfer (R&T) number for item processing through a Federal Reserve Bank for a credit union service organization (CUSO) to use to provide item processing services to other credit unions. Yes, as long as the CUSO is a member of the FCU, the FCU may provide access to an R&T number as a financial service to a member. You have also asked if, as part of its item processing services, a CUSO can provide collection, or deposit, item processing services. Yes, our view is that collection item processing services is a permissible CUSO activity under the arrangement the FCU and the CUSO propose. As the CUSO cannot and will not be a depository institution, we also conclude it is permissible for collected items to have the FCU's endorsement so that the Federal Reserve Bank will credit collected items to a subaccount of the FCU under an R&T number the FCU establishes for this purpose. We also recommend the FCU work with its NCUA examiner in drafting the final agreements for the arrangement, to address any safety and soundness, accounting, legal, and compliance issues, as described below.

The CUSO, owned by twenty credit unions, currently processes member drafts for credit unions and would like to provide collection item processing services through a Federal Reserve Bank under an arrangement with the FCU. The FCU would establish a subaccount with a Federal Reserve Bank in its name with an R&T number separate from the R&T number the FCU uses for its own deposits. Credit unions would send checks deposited with them to the CUSO each day and the CUSO would balance and reconcile all work, sort all checks and maintain all records and, as agreed with the FCU, endorse the FCU's name on each check with the subaccount R&T number for deposit. The CUSO will then remit the checks to the Federal Reserve Bank using deposit tickets for the special subaccount. Each credit union receiving services from the CUSO will be required to place its own endorsement on each check in the "Bank of First Deposit" (BOFD) area. As the checks are collected, the Federal Reserve Bank would credit the FCU's subaccount. The FCU would then wire the collected funds to the CUSO's account at various financial institutions, such as corporate FCUs, where the depositing credit unions hold their accounts.

First, we conclude that the CUSO's proposed activity is permissible because it is within the preapproved category of electronic transactions services identified in the CUSO rule as a permissible activity. 12 C.F.R. §712.5(e). We note that "payment item processing" is identified as a specific activity within this preapproved category and, further, that the CUSO rule states "specific activities listed within each preapproved category are provided . . . as illustrations of activities permissible under the particular category, not as an exclusive or exhaustive list." 12 C.F.R. §712.5.

Second, we conclude that the FCU may provide access to an R&T number to the CUSO, if the CUSO is a member, because we view this activity as providing a financial service to a member. Under our CUSO rule, a CUSO cannot be a financial depository institution. 12 C.F.R. §§712.5, 712.6. Because it is not a financial depository institution, the CUSO cannot obtain its own R&T number. As long as the CUSO is a member, we view the FCU's obtaining the R&T number for the use of its member, the CUSO, as in line with long-standing, prior legal opinions we have issued. For example, our office concluded over ten years ago that an FCU can provide a check clearing service for its sponsor if the sponsor is a member of the FCU. OGC 91-1105, dated December 3, 1991 (a copy is attached). In addition, we are also aware, and view as permissible, that FCUs act as a sponsor or intermediary to provide a member access to ATM networks or to establish an account with a Federal Reserve Bank dedicated to clearing the member's checks. For example, we are aware that FCUs have provided these financial services to a member that receives many checks or operates point-of-sale terminals, such as a grocery store.

Third, we have considered the legal significance and permissibility of the placement of the FCU's endorsement on the checks remitted to the Federal Reserve Bank. Since the CUSO is not a depository institution, the FCU's endorsement for processing through the Federal Reserve Bank is necessary. Essentially, the endorsement by the FCU represents the FCU's receipt of deposits from the other credit unions, some of which are presumably not members of the FCU. Nevertheless, natural person FCUs are authorized to accept deposits from "other credit unions," even nonmembers, under the Federal Credit Union Act. 12 U.S.C. §1757(6). Therefore, we conclude that affixing the FCU's endorsement to the checks the CUSO collects is permissible.

Item processing services require diligent attention to physical security controls, microfilming and data backup, contingency planning to provide backup facilities and the ability to address shifting volume, and proper management of the risks and legal liability the activity engenders. Safety and soundness concerns do exist with the planned service; however, appropriate agreements can address the concerns. You have stated that the agreements between the CUSO and the

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FCU would be constructed to distance the FCU from all risks. Under the proposed arrangement, returned items would be returned to the BOFD, the credit union depositor, and not the FCU; accounting charges for returned items would not be made to the FCU's subaccount but, likewise, made to the BOFD. You have represented that the CUSO would only offer these services to credit unions, that the proposed arrangement would have minimal impact on the FCU's operations, and the FCU would be appropriately compensated.

While we conclude the proposed arrangement between the FCU and the CUSO is legally permissible, we recommend you consult with NCUA's Region IV on any safety and soundness, accounting, legal, and compliance concerns in the due diligence process. Specifically, the FCU should continue to seek the NCUA examiner's input on this issue, and provide the examiner with draft final agreements for review. Regarding accounting issues, the parties must seek individual Certified Public Accountant (CPA) opinions on how to account for the transactions based on how the agreements are structured. In addition, the FCU will need to obtain its own legal review of agreements to ensure it is protected from certain compliance risks and liabilities, such as those involving applicable warranties and indemnifications under Check 21. Finally, we recommend the FCU and CUSO work closely with their district Federal Reserve Bank if it has any questions or concerns with the item processing operation.

Sincerely,

/S/

Sheila A. Albin
Associate General Counsel

OGC/RMM/SAA:bhs
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Enclosure