Chapter 7

MANAGEMENT

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Chapter 7

MANAGEMENT

Examination Objectives

- Assess management's ability to recognize, assess, monitor, and control risk
- Assess whether the credit union board of directors has sufficient expertise to adequately plan, direct, and control the operations of the credit union
- Determine whether the board and management adequately plan for future conditions and developments
- Determine whether the board is appropriately fulfilling its responsibilities and duties
- Determine whether the board has adopted adequate policies and operating strategies to conduct prudent credit union operations
- Determine whether the board establishes appropriate limits and provides direction before offering a new service or product
- Determine whether operating management has developed procedures to implement board policy
- Determine whether management performs due diligence on new, existing, and planned products and services
- Determine whether management has implemented adequate internal controls to ensure the sound operation of the credit union
- Determine whether management appropriately reports credit union operations and risk information to the board
- Determine promptness of corrective action initiated by management when deficiencies or violations in policies, practices, procedures, or internal controls arise

Associated Risks

Management affects all six risks found in credit union operations – credit, interest rate, liquidity, transaction, compliance, and strategic. (The Risk-Focused Program chapter contains a description of the six risks faced by credit unions.) This chapter will focus on the following risks:

- Strategic risk occurs when management fails to (1) perform adequate due diligence for existing, new, and proposed products and services, (2) act on recommendations included in examinations

and internal/external audit reports, and (3) allocate the necessary resources to adequately manage the credit union in a safe and sound manner; and

- Compliance risk occurs when the credit union fails to adhere to applicable laws and regulations.

Overview

Management is responsible for identifying, monitoring, measuring and controlling (i.e., managing) the risks faced by the credit union. Their ability to manage these risks determine whether the credit union can correctly diagnose and respond to financial stress. Examiners should not assess management solely on the credit union's current financial condition, nor should the management rating be only an average of the other component ratings.

Meeting with Management

Examiners should complete the credit union update questionnaire for guidance in reviewing credit union management, especially when the examiner begins examining the credit union. Examiners may use the list of topics in this section to discuss, observe, and analyze the effectiveness of management. When acquainting themselves with the credit union's activities, the list may aid examiners in engaging the managing official (often the chief executive officer or CEO) and other management in discussions about their respective areas of responsibility. This may assist the examiner in assessing management's effectiveness.

Examiners should conduct a preliminary interview with senior executive officials to discuss items such as the credit union's operations, strategic plan, products, and services. Responses to certain topics or the examiner's observations may trigger expansion of examination scope and, if necessary, corrective action.

The following list is not all-inclusive. Examiners must use their judgment if their observations direct them toward exploring other topics. Depending on the size, complexity, risk profile, and organizational structure of the credit union, examiners will discuss or

observe the following or similar matters with the appropriate management staff:

- Key personnel changes since the previous examination and future plans;
- Significant new or planned programs or services, as well as the extent to which members use existing products and services;
- Due diligence performed by management on new and planned programs and services;
- Significant acquisitions of new facilities and future plans;
- EDP conversions, upgrades or material changes;
- Problems with the sponsors and the field of membership;
- Working relationship with the board of directors;
- Material change in the investment portfolio and future plans;
- Material change in the loan portfolio and future plans;
- Recordkeeping issues (e.g., balanced general ledger, balanced individual share and loan ledgers, cash reconcilements);
- Off-balance sheet risk areas;
- Lawsuits or other contingent liabilities;
- Material changes in key policies or procedures, and future plans regarding policies and procedures;
- Return on assets, capital accumulation strategy, meeting goals;
- Management succession plan;
- Systematic review of policies and procedures;
- Frequent need for borrowed funds;
- Ground rules for dealing with department heads and other staff; and
- Procedures for daily management discussions.

To review credit union management, examiners may consider the following procedures:

- Review the credit union's strategic and business plans and analyze management's integration of risk management with planning and decision making;

- Review responsiveness to examination and audit suggestions and recommendations, and assess corrective actions taken to address risks identified in prior examinations and audits;

- Review the minutes of regular and special board and committee meetings for significant items;

- Review policies and procedures in each area of operation (e.g., lending, investment, personnel, etc.) and ensure that the policies and procedures are updated at least annually;

- Review the credit union's budget, budget assumptions, and budget variance analysis (budgeted items against actual performance);

- Review documentation of management's due diligence regarding existing, new, and planned products and services;

- Review the adequacy of the allowance for loan and lease losses and other valuation reserve accounts;

- Review material contracts signed by management since the last examination; and

- Review and analyze the supervisory committee's annual work plan, including the audit and verification programs and internal control procedures, using the Supervisory Committee Audit and Verification Review questionnaire, to help determine the level of general ledger review. (Refer to the Supervisory Committee chapter.)

Board, Committees, Operational Management

The board of directors has the ultimate decision-making authority. It approves policies that direct daily operational management and delegate to staff the authority necessary to fulfill their job responsibilities. (Appendix 4A to the Internal Controls chapter contains a list of management conflicting positions.) The board of directors and management have fiduciary responsibility to the members to maintain high standards of professional conduct.

Evaluating the quality and the effectiveness of management is an important part of the total analysis process and a major examination objective. Examiners evaluate the quality of management by determining the effectiveness of the board of directors, the committees, and operational management. To evaluate board and committee

effectiveness, examiners can review various documentation including board and committee minutes, the credit union's policies, the strategic and business plans, management due diligence, and financial and operational results.

Red Flags

Examiners should be aware of any "red flags" which may indicate that the examiner needs to expand analysis and review of the applicable operations. Red flags as they relate to management may include the following:

- Overly dominant manager;
- Manager or key employee involvement in gambling;
- Manager or key employee not taking regular vacations or always working late hours;
- Nepotism on part of the directors or management;
- Other forms of insider abuse or preferential treatment;
- Limited personnel not conducive to segregation of duties;
- Lack of adequate segregation of duties when the credit union has adequate staffing to achieve such;
- Failure to provide, or delays in providing, standard reports, records, and documents;
- Records maintained at home and not in credit union's control;
- Management or staff provide copies of documents rather than originals;
- Inactive supervisory committee;
- Lack of, unacceptable, or non-independent audit or verification;
- Inadequate internal controls and information systems (IS) controls;
- No internal review of override of non-financial reports;
- Bank account frequently overdrawn;
- Large amounts of cash in transit;
- High volume of excessive transactions;
- Use of borrowed funds in spite of large cash balances;
- Lack of a fraud policy;
- Extravagant management or employee lifestyle relative to salary;
- Low return on assets or on various asset categories; and/or
- Payment of above market dividends to attract deposits.

Board Responsibility

The board of directors has the following four basic responsibilities:

- Select qualified management and evaluate management's performance;
- Establish, regularly review, and revise as necessary business goals, standards, policies, and procedures;
- Review operating results and performance of new and existing activities; and
- Ensure compliance with applicable laws and regulations, and the credit union's own policies and procedures.

While fulfilling these responsibilities, board members should:

- Operate independently from management;
- Attend board meetings regularly;
- Avoid conflicts of interest and self-serving practices; and
- Ensure the credit union serves the credit and savings needs of its field of membership.

The board of directors and management should comply with all applicable laws and regulations. The board should consider obtaining an attorney's opinion on compliance when implementing new services or products. In addition, the board of directors and management must comply with laws and regulations that promote equal opportunity for all members regardless of race, color, religion, gender, national origin, age, or handicap.

Management must not use the credit union for private gain. They should restrict use of credit union property to authorized activities. Management must act impartially and not give preferential treatment to any individual.

Federal credit unions may not have fewer than five or more than 15 board members. A quorum for board meetings is the majority number (50 percent plus one) of directors that a credit union's bylaws prescribe, even if the credit union has not yet elected the prescribed number.

Board and Committee Minutes

Minutes of board and committee meetings are a primary source of information by which examiners evaluate a board and its actions. The minutes should support conclusions reached by the officials in the meeting. Analysis of the minutes should enable the examiner to evaluate how the officials and management interact and perform their job responsibilities. This information can help determine the adequacy of management and the effectiveness of the policies. Examiners may use the AIRES Board Minutes document to record information during the review of board and committee meeting minutes. By reviewing the minutes, examiners should be able to determine the following:

- Adequacy of management's reports to the board. Thorough and accurate minutes should cover all aspects of the credit union's operations and should document significant changes to capital, financial performance results, and major credit union activities. Likewise, the minutes should document supervisory committee reports presented to the board.

  A board's excessive reliance on benchmark financial statistics rather than on comprehensive financial analysis suggests that the directors may fall short in their oversight of the credit union's affairs. Undue reliance on only a few indicators may result in erroneous conclusions about the credit union's condition. Examiners should determine that reports to directors support complete, understandable, and accurate information appropriate to the size and complexity of the credit union.

  The minutes should also include significant actions such as the following (list is not all-inclusive):

  - Delegations to management;
  - Loan policy changes;
  - Increase or decrease to allowance accounts;
  - Agreements on collection problem loans;
  - Loan rate changes;
  - Recordkeeping problems;
  - Dividend declarations;
  - Consideration of new programs;
  - Investment activities;
  - Capital accumulation and maintenance policies;

- Approval of charged-off loans;
- ALM and budget review;
- Financial statement review;
- Material fixed asset purchases;
- Loans to officials;
- Progress in meeting goals;
- Review of audit reports; and
- Compliance with CUMAA requirements.

- Oversight of management. Minutes should reflect the board's discussion and approval of major strategic or operating decisions, degree of management's due diligence, and adoption of major operating policies and procedures. Management should obtain board approval before implementing new policies, offering a new service, or engaging in new activities.

- Attendance and participation. Minutes should evidence attendance by board members. Article VI, Section 8 of the *FCU Bylaws* states that if a director fails to attend regular board meetings for three consecutive months, or four meetings within a calendar year, or otherwise fails to perform the duties of a director, the board may declare the office vacant and may fill the vacancy in accordance with the Bylaws. Minutes should identify board members who ask important questions or make motions to indicate they actively participate in the meetings.

- Performance evaluations. Minutes should reflect the board's election of officers, its review of management's performance, and its deliberations regarding salaries and compensation for officers and fees for attorneys, appraisers, internal and external accountants, etc.

- Compliance with board directives. Credit unions should have internal systems to monitor operations and ensure that management takes appropriate actions that conform to board approved policies and directives.

If examiners find missing or incomplete minutes, they should advise the board that minutes comprise vital corporate records that document all board actions.

Annual Meeting

The credit union must hold an annual membership meeting, election, and a reorganizational meeting of the board in accordance with the §110, §111, and §112 of the *FCU Act* and Articles IV and V of the *FCU Bylaws*. Credit unions must adhere to the requirements contained in the specified sections of the Act and Bylaws. Additionally, credit unions should follow *Robert's Rules of Order* to ensure the annual meeting meets the standards of a properly run business meeting. The examiner should review the minutes of these meetings.

Board Appointment

The board must appoint a supervisory committee composed of not less than three, nor more than five, members who are independent of management and free from any relationship that would interfere with the exercise of independent judgment as a committee member. The supervisory committee's responsibilities include performing or causing to be performed the annual audit of the credit union and the biennial verification of member accounts. As such, the supervisory committee's independence from the board, management, and operating personnel is vital. (Refer to the Supervisory Committee chapter for more information.)

In credit unions that do not have an elected credit committee, the board may appoint a credit committee, which in turn, can appoint loan officers. The board appoints loan officers in credit unions that have no credit committee (see Article VI, Section 6 of the *FCU Bylaws*).

The board may also appoint a membership officer, if the board does not choose to act on membership applications themselves. The board should also appoint a security officer.

Depending on the size and complexity of the credit union's operation, the board may also hire an internal auditor (or in the case of a large credit union, an internal audit staff), who monitors and reports on the credit union's operations for compliance with applicable laws and regulations as well as credit union policies and procedures. Ensuring that the credit union has adopted adequate internal controls and that the officials, management, and staff adhere to these controls also falls within the purview of the internal auditor.

Operating Management

The board's most important responsibility involves selecting a capable, competent, and trustworthy manager or chief executive officer (CEO) for the credit union. Officials should define the CEO's duties and responsibilities in writing and then give the CEO the latitude needed to run day-to-day operations.

Ensuring continuity of operations requires an adequate management succession plan. A succession plan helps ensure continuity of the credit union's operation in the event the CEO or another key manager can no longer carry out the duties assigned. Adequacy of a succession plan depends largely upon the size and sophistication of the credit union. Credit unions need succession plans for not only the CEO, but also for other key personnel. An integral part of management succession plans involves cross training of both management and staff to ensure necessary backup for vacant positions.

Management contracts should not contain provisions that may cause hardship to the credit union (e.g., salary increases tied to asset growth, salary not commensurate with asset size, unreasonably long contracts, golden parachutes, and unreasonable termination provisions.) The board must implement and adhere to performance standards for the CEO and senior management and should provide written evaluations of performance at least annually.

Policies and Procedures

The board adopts policies to direct the credit union's activities. Procedures represent the methods by which the credit union implements the policies. Operating policies and procedures establish management's strategy for realizing the credit union's goals, and they provide a basis for gauging performance.

The board must provide a clear framework within which the CEO can operate and administer the credit union's affairs. This includes setting forth the credit union's business strategy in the business plan, investment and loan policies, capital planning, funds management, and risk management. The board must approve all major policies. Further, it should review and, if necessary, update those policies at least annually.

Board policies and procedures should meet the following parameters:

Exist for all major phases of the credit union's operations;

- Establish and provide guidance and direction for a credit union's operations;
- Suffice for the credit union's operations and risk profile; and
- Provide guidance and promote controlled and efficient operating practices.

Board Oversight of Operating Management

The board of directors must ensure that operating management has procedures in place to implement board-adopted policies. If applicable to the size, complexity and operation of the credit union, operating management's responsibilities include the following functions:

- Implementing the board's policies;

- Providing periodic reports and analysis to the board concerning policy compliance, such as interest rate risk (IRR) exposure reports, earnings projections, and capital projections;

- Reviewing the board's policies periodically and, when appropriate, suggesting changes;

- Managing the operations and staff to achieve the goals and objectives set forth by the board;

- Establishing operational procedures;

- Supervising investment portfolio management activities, including investing excess liquid funds in instruments that complement the credit union's overall risk/return profile;

- Maintaining an awareness of the economic and interest rate environment, particularly local economic conditions, prepayment trends, volatility, and related regulatory developments;

- Reviewing asset quality, including trends in delinquencies, non-accrual loans, real estate owned, charge offs, and recoveries. Also

reviewing the adequacy of reserves and quantifying the effect of non-performing assets on the risk/return profile;

- Developing, reviewing, and monitoring capital, business, and strategic plans, and ensuring integration of these plans into the budgeting function. Also, generating variance, rate, and volume analysis reports;

- Providing adequate support, planning, and oversight when the credit union enters new business ventures, CUSOs, or new products and services. Performing due diligence, including cost-benefit analyses of new products and services throughout the planning stages. Ensuring that product development activity and pricing coincide with the credit union's overall risk/return profile. Setting specific standards concerning risks and assumptions;

- Managing capital market activities, debt issuance, dividend policies, and merger and acquisition analysis within the credit union's overall risk/return profile; and

- Ensuring that the credit union's services, products and pricing support its overall risk/return objectives. Periodically performing due diligence, including cost-benefit studies of credit union's services, business ventures, and products and comparing the credit union's pricing to that of its competitors.

Risk/Return Tradeoff

The board and management must realize that the credit union can generate higher returns in any given economic environment only if it takes on greater risk; this is the risk/return tradeoff. The choice between these two alternatives relates to the management of all the credit union's financial functions. The board should analyze risk/return tradeoffs in both its planning and decision-making processes.

Examiners should not criticize management for merely taking risks. Rather, the examiner's role is to evaluate management's ability to identify, measure, control, and monitor the risk.

Financial Management

At the direction of the board and in conformance with the credit union's goals and strategic plan, management should develop, and the board should approve, financial and operational policies appropriate to the size and complexity of the credit union, including:

- An annual operating budget supported by specific written assumptions and a pro forma balance sheet;
- An investment policy complying with Part 703 of the *NCUA Rules and Regulations* (see the Investment chapter);
- Written lending and collection policies that comply with NCUA's Rules and Regulations, Federal Reserve Board regulations, and other applicable federal and state laws (see the Loans chapter);
- An ALM policy providing for adequate profitability, cash flow and monitoring (see the Asset-Liability Management and Liquidity chapters);
- Periodic cost-benefit analysis on major services including CUSO and branch operations;
- A growth policy consistent with the credit union's net worth needs and potential risks; and
- Procedures to address material risk presented by off-balance sheet items (e.g., letters of credit, bonds borrowing, CUSOs, any contingent liabilities).

The directors must review and give final approval to the policies and budget developed by management. Realistic policies and budget should contain adequate controls to safeguard the credit union's assets, and should correlate with the strategic plan. Examiners should review expenses, including salary increases and dividend payouts, in a credit union experiencing unstable or declining levels of capital or earnings.

Personnel Management

The examiner should determine that the board has approved the following, as appropriate for the credit union's size and complexity:

- Written personnel policies that address (and include a training program) among other things, sexual harassment, violence in the workplace, and dealing with the media;

- Written, detailed position descriptions and performance standards for all employees including top management;

- Carefully planned recruiting and screening of new employees;

- Appropriate training for credit union management and staff;

- Salary administration;

- Annual written performance evaluations of all employees, including top management;

- Internal controls for all key areas of operation including information systems, segregation of duties, audit program, recordkeeping, liquidity contingency plans, and disaster recovery;

- Written procedural manuals for all areas of operation;

- Provisions for communication;

- A fraud policy that includes appropriately filing necessary SAR forms;

- A management succession plan that addresses the steps necessary for finding a new manager or president for the credit union should termination, retirement, or resignation of the current manager/president occur; and

- An on-going concern plan that addresses possible alternatives that management will implement if the sponsor ceased or significantly reduced operations. Such a plan is especially critical in one-sponsor credit unions. Examiners should encourage management of one-sponsor groups to develop written contingency plans that include consideration of changing the credit union's charter to allow for expansion and diversification.

Service to Members

Management's efforts to educate the membership play a key role in the credit union's ongoing success. Educational materials discussing the history, philosophy, and uniqueness of the credit union industry may foster participation and loyalty by current and potential members.

The goals of credit unions are diverse. They include:

- Meeting the financial service needs of members;
- Providing access to low-cost lending programs; and
- Providing secure savings accounts.

Management must recognize demographic changes and the effect these changes have on the services needed to keep the credit union competitive. When reviewing service to members, examiners should consider the following areas:

- Loan to share ratio. Examiners should look closely at credit unions with low loan to share ratios (particularly where safety and soundness concerns are associated with low loan to share ratios) to determine management's efforts to promote and generate loan demand.

- Market penetration. The future success of the credit union largely depends on management's efforts to promote membership and services to all potential members.

- Rate structure. A credit union's future success also largely depends upon the board setting and maintaining competitive rates.

- Management due diligence. This includes cost-benefit analyses of new, existing, and planned products and services, including branch operations and CUSO activities. The cost-benefit studies should include whether an equitable assessment of fees to members for the various services exists.

Planning

To anticipate and address rapid changes that may affect a credit union's operation, effective management requires dynamic planning

that encompasses the officials' and management's shared perception of future actions.

Planning, which requires a structure and a process, falls within two classifications: strategic and operational. Strategic planning focuses on the long-term, extensive allocation of resources to achieve the credit union's goals and objectives. Operational planning (e.g., business plan) concentrates on shorter-term actions designed to implement the strategies outlined in the strategic plan. The operational plans flow logically from the strategic plan.

The credit union should carefully monitor and document the planning function, and periodically revise projections as circumstances change. Examiners should watch for deviations in strategic or operational plans that may potentially harm the credit union (e.g., excessive use of brokered funds; initiating higher risk lending or investment programs without proper planning, experience, or controls; failure to investigate and document extensions of credit; and willingness to forgo long-term stability for short-term profits.)

Following are some key elements of a successful planning process:

- Strong commitment from the board and management;
- Meaningful engagement in the process from key stakeholders;
- Development of measurable goals, including a series of short-term goals;
- Development of strategic objectives;
- Clearly defined responsibility, authority, and accountability;
- Efficient and effective operational processes;
- Necessary managerial, financial, technological, and organizational resources to achieve goals and objectives;
- Policies, internal controls, staffing, training, and management information systems to support each area of operation and overall objectives;
- Communication of goals, objectives, and detailed business plans throughout all levels of the organization; and
- Periodic reassessment of the progress and effectiveness of the strategic plan.

Strategic Plan

Consistent with the credit union's size and complexity, the board of directors should establish a strategic plan that documents management's course in assuring that the credit union prospers in the next two to three years. At a minimum, this plan should outline the credit union's future direction and the optimal capital position relative to share and asset growth.

The strategic plan encompasses all areas of operations and often sets broad goals. It enables the credit union to maintain a well thought out focus, make sound decisions, and may help identify risks or weaknesses within its operation that an economic downturn may magnify. An integral part of the strategic plan should include strategic goals addressing the credit union's information systems and technology. This assessment should address the following:

- Evaluating the types and volume of e-Commerce services the credit union offers or plans to offer (e-Commerce services include those a credit union provides, and members access, via electronic means including, but not limited to, internet and world wide web services, home banking services, online bill paying services, account aggregation, and account transaction processing services);

- Determining the importance of the e-Commerce systems and services to the credit union's operation (e.g., website systems, home banking or PC based systems, audio response or telephone based systems, wireless systems, and kiosk); and

- Determining proper levels of monitoring and oversight of the information systems area, given the size and complexity of the credit union.

Examiners should review the credit union's planning function and goals as they relate to the credit union's risk profile and operation, including its policies, procedures, and budget. They should also review the goals that address the information system as it exists and as the credit union plans for changes in its products and services.

Business Plan

Consistent with the credit union's size and sophistication, management should establish a business plan for the next one to two years that

implements the strategies outlined in the strategic planning process. Smaller credit unions with a simple balance sheet may have a short, concise, written business plan, while credit unions with more sophisticated operations should have an extensive and detailed business plan.

Before approving the business plan, the board should ensure its consistency with the strategic plan. Likewise, examiners should review the business plan in relation to the strategic plan to determine their consistency.

The business plan should incorporate the following five steps:

- An assessment of the environment in which the credit union will operate over the medium term. The credit union should evaluate its risk profile and the external and internal factors influencing its business, including (1) economic and regulatory issues, (2) its membership base, (3) its competition, and (4) its competitive opportunities. The credit union should plan for different scenarios such as high and low interest rate environments, full employment, and layoffs.

  Essential to this assessment is the credit union's charter type, which will fall within one of the following (see §109 of the *FCU Act* and IRPS 99-1 for further details of available charters):

  - Single common-bond – one group that has a common bond of occupation or association;
  - Multiple common-bond – more than one group, each of which has a common bond of occupation or association; or
  - Community – persons or organizations within a well-defined, local community, neighborhood, or rural district.

  From this assessment, officials define measurable key objectives and the acceptable level of risk that management is willing to assume in attaining the goals. Management documents the plan's assumptions and ensures consistency of the budget, policies, procedures, and resources with the plan's objectives. The examiner should determine that management knows of the different types of charters, and should assess management's effectiveness in

developing and implementing the business plan and achieving established objectives.

- A clear, written statement of key objectives. These objectives should have the following characteristics:

  - Consistency with the strategic plan, addressing the results of the credit union's analysis of external and internal factors;

  - Measurability, including details of the mechanism the credit union will use to measure progress against the established objectives; and

  - Expression in terms of income and expense paths, projected balance sheets, and other performance indicators, accompanied by a clear statement of the acceptable level of risk that the credit union assumes in achieving the plan and the need for sufficient capital to support any risk-taking.

- Consistency with federal and state laws and NCUA regulations.

- Communication of the plan's objectives to management and staff to assure adherence to both the business plan and strategic goals.

- Implementation of the plan. The credit union's policies, procedures, and resources (employees, capital, equipment, marketing, and member relations) must support achieving the business plan's objectives. Financial performance provides a strong indicator of the credit union's viability. Therefore, the credit union's performance in achieving its plans influences the management rating.

Examiners should evaluate the business plan in light of the strategic plan to determine consistency of the plans. They should also assess whether the credit union has implemented the plan and whether the plan operates as the board intends.

Net Worth Restoration Plan

The board must prioritize maintaining an adequate level of capital for the credit union. Prompt corrective action may require development of a net worth restoration plan (NWRP) when a credit union becomes less than adequately capitalized. A NWRP addresses the same basic issues as does the business plan. The board must consider the credit union's size, complexity of operations, and field of membership when developing its NWRP. The board should specify in the NWRP the steps the credit union will take to become and remain adequately capitalized. If the credit union requires a NWRP, the examiner will review the credit union's progress toward achieving the goals set forth in the plan. (See the Prompt Corrective Action chapter).

Material Contracts

As part of determining the safety and soundness of the credit union, examiners may review all material contracts entered into by the credit union during the examination period. The extent of analysis will depend on the effect on the credit union of the contracts, either singularly or collectively. Examiners should assess the credit union's ability to fulfill the terms of long-term contracts. Examples of material contracts can include management contracts, agreements with an information processing servicer, or long-term leases on land, building, or equipment.

The examiner must understand that management agreements are confidential documents. Examiners will not disclose the terms of such agreements to anyone outside NCUA, and will disclose management agreement terms to persons within the Agency only when necessary to promote the safety and soundness of the credit union's operation.

Examiners should discuss questions concerning legality with the officials, the supervisory examiner, or the regional office, as appropriate. Examiners should send unresolved legal questions to the regional office, accompanied by a copy of the contract.

Executive Compensation

Appropriate compensation policies and practices for management and staff include defining and implementing performance standards, and providing written annual performance evaluations prior to salary adjustments. The compensated director, senior management personnel, and staff should receive reasonable compensation commensurate with

their duties and responsibilities. Compensation includes any payment of money or other items of value in consideration of employment including the following:

- Base salary;
- Commissions;
- Bonuses;
- Pension and profit sharing plans;
- Severance payments;
- Retirement;
- Director or committee fees;
- Automobile; or
- Fringe benefits.

The *FCU Act* §112 only permits compensation for one elected official. Credit unions must specifically name this position (often the Treasurer or Chief Financial Officer) in the Bylaws. Other elected official positions are volunteers. Even though the credit union may not pay its directors (except for one), it may provide or reimburse them for items such as the following:

- Mileage;
- Insurance (including reasonable life, health, and accident insurance); and
- Travel expenses.

Officials should understand their fiduciary responsibilities when establishing reimbursements, fees, and benefits for themselves. Each director should understand the importance of their responsibility for establishing policies that protect the assets of the credit union.

Credit unions can enter into employment contracts with officers and other employees with the specific approval of the board of directors; however, credit unions may not enter into contracts that constitute an unsafe or unsound practice. Unsafe or unsound practices could lead to a material financial loss or damage.

Examiners review compensation expenses for reasonableness, just as they do other credit union expenses. Examiners usually defer to the board's decision concerning executive compensation arrangements.

However, if a troubled condition exists in the credit union or it experiences earnings problems that could present significant safety or soundness concerns leading to material financial loss or damage to the credit union, the examiner should address the problem.

Examiners should consider all of the CAMEL components in their review of employment contracts and other compensation arrangements. Examiners should ensure that the board annually reviews all employment contracts and compensation arrangements for senior management personnel. Board minutes should document justification and approval of these reviews. Likewise, renewal or extension of employment contracts requires board approval. Any director who has a personal interest in the compensation arrangements should not participate in the deliberations or vote on the arrangements.

Unsafe and Unsound Compensation Practices

While examiners generally should not require changes to compensation arrangements in healthy credit unions, they should note, when appropriate, unsafe and unsound compensation practices. The examples below (not all-inclusive) provide illustrations that may constitute unsafe or unsound compensation provisions:

- Compensation arrangements that provide incentives contrary to the safe and sound operation of the credit union. For example, compensation based primarily on short-term operating results may encourage unreasonable risk-taking to achieve short-term profits. The board should closely monitor compensation tied to current operating results;

- Compensation arrangements that significantly exceed compensation paid to persons with similar responsibilities and duties in other insured credit unions of similar size, in similar locations, and under similar circumstances, including financial health and profitability;

- Contracts that contain automatic renewals or extensions without providing for the board's explicit review and approval;

- Contracts that provide for an excessive term. Generally, a term should not exceed three years;

- Compensation arrangements that provide for excessive total compensation paid out upon the departure of an employee, regardless of the reason (e.g., three times the employee's average annual compensation for the prior five years.) Credit unions should not make any payment when termination is for cause. Total compensation includes payments for the remaining contract term, if applicable, as well as any severance payments;

- Contracts that do not adequately reflect or define the duties and responsibilities of the employee;

- Compensation programs (including deferred compensation, retirement, and insurance) not commensurate with the duties of the employee (e.g., vesting requirements that force an employee to forfeit previously accrued amounts if they do not serve for a minimum number of years);

- Contracts that the credit union collateralizes or otherwise guarantees, unless the terms provide that the contract is unenforceable if the credit union becomes a troubled credit union or the regional director approves the contract;

- Contracts that provide for employer reimbursement of costs that employees incurred seeking to enforce employment contract terms in the absence of legal judgment or settlement;

- Change in control provisions that provide for immediate vesting, particularly for credit unions in a troubled condition;

- Contracts that require payment upon the voluntary resignation of the employee; and

- Contracts that contain golden parachute provisions, including provisions such as:

    - The credit union makes a payment to a person affiliated with the credit union and contingent on this person's resignation; and
    - The credit union makes the payment while it is in troubled condition.

Directors' Conduct

Directors must continually remain aware of the credit union's obligation to serve its members. Examiners should recognize self-serving practices that include the following:

Gratuities to directors to obtain their approval of financing arrangements:

- The unauthorized or inappropriate use of credit union services;
- The use of credit union funds by insiders to obtain loans or transact other business; and
- Transactions involving a conflict of interest.

Conflicts of Interest

Conflicts of interest (or the appearance of such) can adversely affect a credit union's profitability and can undermine member confidence. Officials have a fiduciary duty to avoid advancing their own personal or business interests, or those of others with whom they have a personal or business relationship, at the expense of the credit union. Thus, officials must avoid conflicts of interest of any sort, or even the appearance of a conflict of interest. They should also avoid nepotism.

The sale of assets to insiders, including fixed assets, repossessed assets, OREOs, and foreclosures, can constitute a conflict of interest and may carry additional risks to the credit union and a potential cost to the share insurance fund. The sale of assets to insiders raises the possibility of negative public perception of such transactions. Insider sales may appear as sweetheart deals, even if economically sound. Credit unions must ensure that sales of covered assets occur as arms-length transactions.

The credit union should have a specific plan for dealing with conflicts of interest, including implementation of controls for avoiding abuses and procedures for dealing with policy violations. The examiner should determine if directors and management comply with the policy and, if not, comment in the examination report and take appropriate action on actual or apparent conflicts of interest.

On rare occasions, examiners may request additional information about related organizations or individuals, in order to properly analyze the financial situation of a credit union. If they do not receive the information, the examiners should contact the supervisory examiner for assistance in working with the regional office. If necessary, the Office of General Counsel may issue an order of investigation and an administrative subpoena.

Use of Consultants

The board of directors must justify and approve contracts that the credit union enters into with third parties. The board may delegate this responsibility to the CEO. Hiring consultants to perform some functions does not remove responsibility for decisions regarding credit union operations from the board and management. The board should adopt a policy requiring management to obtain bids when contracting with third parties on behalf of the credit union. A cost-benefit study may help management determine if performing the job using consultants would result in more cost efficiency and benefit to the credit union than performing the job in-house. The board should reach agreements with the consultants on what output the consultant will provide and should develop reports that will track that output.

Management must use care in contracting with outside parties that propose to provide business plans or financial models at no direct cost to the credit union. These vendors often expect the credit union to transact business with them on an exclusive basis, and management may feel an obligation to do so. Contracting with such parties could lead to proposals or transactions that do not serve the credit union's best interest.

Management should guard against excessive reliance on outside consultants and should remain wary of overly simplistic assumptions. Credit unions sometimes hire third parties, such as consulting firms, investment brokers, lawyers, accountants, information systems and technology specialists, or other professionals to provide services not usually required in the normal course of business.

Due Diligence Over Third Party Service Providers

Credit unions frequently partner with outside parties to enhance member services. Use of third-party service providers may enable the credit union to offer programs such as leasing, indirect lending, and sub-prime lending. Third-party arrangements can provide the following benefits to the credit union:

- Enhance the cost effectiveness of applicable programs;
- Enable credit unions access to expertise they do not possess in-house; and
- Promote programs that they may find infeasible if entered into independently.

Conversely, third-party relationships implemented without proper planning, management due diligence, and internal controls can result in financial stress for credit unions due to unanticipated costs, legal disputes, and asset losses.

Due Diligence Review

The officials should require a due diligence review before entering into any arrangement with a third party. The following identifies minimum procedures a credit union should follow before entering into a third-party arrangement, however, information gathered from a third-party review may lead to further inquiries or fact-finding:

- Planning. The officials should determine whether the proposed activities comply with the credit union's overall business strategy and risk tolerances. Risks may include the potential loss of capital invested if the activity fails, the loss of member confidence if the program does not meet management's expectations, and the costs associated with attracting and retaining qualified personnel and investing in the required infrastructure (e.g., technology, space, communications).

- Background check. To understand how the third party has performed in other relationships, management should contact credit unions or other clients of the third party. Sources such as the Better Business Bureau and Federal Trade Commission maintain complaint histories on businesses.

- Legal review. The credit union's attorney should review all contracts. The officials must clearly understand the ownership, rights, and responsibilities of each party to the contract. Additionally, they must ascertain the implications in the event of dissolution of the third party. For example, the review should state which party bears the cost of collateral disposition, and whether recourse exists. When necessary, the credit union should exercise its right to modify contracts to make them fair and equitable. Further, a credit union should understand what actions it may take if the contract is breached, or services are not performed as expected.

- Financial review. Management should review the financial statements and audit report (preferably an audit prepared by a licences CPA) of third parties to determine their financial soundness. Poorly capitalized companies or those exhibiting weak earnings may not have the financial strength to continue as a going concern. Failure of the third party to remit funds due the credit union could result in disruptions in member service, uncollected payments on loans and leases, and potential losses.

- Return on investment. Management should scrutinize profit projections generated by prospective third parties and should fully understand all underlying assumptions. Management should project expected revenue, expenses, and net income on its investment under various economic conditions. For example, expected losses, collection costs, or the volume of activity could fluctuate depending on the economy or the members' employment stability.

- Insurance requirements. Third-party relationships can result in increased liabilities. They necessitate a thorough review of the credit union's insurance coverage, including the fidelity bond and policies covering items such as errors and omissions, property and casualty losses, and fraud and dishonesty.

Controls

Once the credit union enters into a third-party arrangement, management must establish controls to ensure the relationship meets its expectations and the third party meets its responsibilities. As part of

these controls, a credit union should develop and implement monitoring and reporting practices, including:

- Policies and procedures. The credit union should develop detailed policy guidance that sets forth responsibilities, authorities, and reporting requirements. Management should establish risk parameters including growth control. For example, a credit union may limit the number of leases initially granted so it can assess performance or identify problems before the leasing volume increases significantly.

- Monitoring. Management must monitor the performance of the program. For example, they should compare actual results to projections and review the third party's performance to determine compliance with expectations and contracts.

- Reporting. Reports submitted to management and the officials should include:

  - Significant findings, especially in areas of noncompliance;
  - Targets met or exceeded;
  - Limits breached; and
  - Other appropriate information the officials need to make informed decisions and take timely corrective action.

Partnering with a third party to expand products and services to members can lead to growth, improved profitability, and stronger member relationships. However, the credit union officials retain responsibility for establishing appropriate due diligence procedures and a system of controls to ensure the arrangement remains sound.

Political Contributions

The board of directors is responsible for authorizing any political activity by a credit union.

The Federal Election Commission (FEC) administers, interprets, and enforces the *Federal Election Campaign Act of 1971* (the Act) as amended (2 USC §431 et seq.) The FEC regulations, 11 CFR Part 100 et seq., contain implementing regulations that govern political

contributions of credit unions in connection with any election, whether federal, state, or local.

The FEC regulations generally prohibit a federal credit union from making political contributions and expending funds for political communications. However, an exception may apply when a federal credit union acts as a collecting agent for a separate segregated fund or political action committee. The FEC regulations, under 11 CFR §114, describe the rules and special restrictions for collecting agents. Federal credit unions that serve as collecting agents must also comply with reporting requirements imposed by the FEC under 11 CFR §102. Directors should consult legal counsel regarding questionable activities related to political contributions and loan expenditures on behalf of any political candidates or committees.

Besides the requirements of the Act and FEC regulations, state and local political activity laws may also govern credit unions engaged in such activity.

Examiners should report apparent violations and, when appropriate, forward them to their supervisor. NCUA may forward the referral to the FEC for enforcement action.

Credit unions may request an FEC advisory opinion from the:

Federal Election Commission
Office of the General Counsel
999 E Street, N.W.
Washington, D.C. 20463

Other Areas of Review

Examiners should include in the review of management:

- Management Official Interlocks. §711 and §741.209 of *NCUA Rules and Regulations* address management official interlocks. These sections generally prohibit a credit union management official from serving two nonaffiliated depository organizations in situations where the management interlock would likely have an anticompetitive effect.

- Indemnification Payments. A credit union may indemnify its directors, officers, and current and former employees (see §701.33(c)) for liabilities or legal expenses when the director, officer or employee is subject to an enforcement proceeding as a result of their official duties.

  A credit union that elects to provide indemnification must specify whether it will follow applicable state law or the relevant provisions of the *Model Business Corporation Act*. Indemnification and the method of indemnification may be provided for by charter or bylaw amendment (must be approved by NCUA), contract, or board resolution, whichever state law or the *Model Business Corporation Act* permits.

  The rule permits credit unions to buy commercial insurance on behalf of its officials and employees to cover liabilities and expenses resulting from performance of their official duties if applicable state law or the *Model Business Corporation Act* permits such insurance.

Internal Controls

The *FCU Act* gives the board responsibility for the general direction and control of the credit union. This responsibility includes the proper and profitable conduct of credit union operations, the safety of credit union assets, and the accuracy and adequacy of financial statements. Since the directors do not normally perform the work resulting from these responsibilities, the employees normally act for them. Thus, it is crucial that the board establish internal controls sufficient to ensure that management and staff carry out the organizational plans and operating procedures according to the board's expectations.

Sound internal controls mitigate the credit union's risks by enhancing the safeguards against system malfunctions, fraud, and errors in judgment. Although a credit union's controls often receive careful review and evaluation, they remain an area of major concern. Without proper controls in place, management cannot identify and track its exposure to risk. Controls also enable management to ensure that staff operates within the parameters established by the board and senior management.

The following aspects of internal controls deserve special attention (see the Internal Controls chapter for additional information):

- Information systems. Credit unions need information systems that can quickly and efficiently sort and assemble information. Effective controls will ensure the integrity, security, and privacy of information contained on the credit union's computer systems. A tested contingency plan provides protection in the event of a failure of the credit union's information system.

- Segregation of duties. Ideally, credit unions have adequate segregation of duties and professional resources in every area of operation; however, the number of employees in smaller credit unions may limit this control.

- Audit program. Examiners should review the credit union's audit program to determine the credit union's compliance with board policy. A sound audit function and process requires independence, with the auditors reporting to the Supervisory Committee without conflict or interference from management. An effective annual audit plan ensures examination of all risk areas, with those of the greatest risk receiving priority. The auditors (both internal and external) normally issue their reports to management for comment and action, then forward the reports to the board with management's response. The auditors follow up on unresolved issues (e.g., examination exceptions) and cover these issues in subsequent reports. The Supervisory Committee's responsibilities also include performing a verification of members' accounts at least once every two years.

- Recordkeeping. Credit unions with assets of $10 million or greater must file their call reports in accordance with generally accepted accounting principles (GAAP), which means most will keep their books and records consistent with GAAP. The records and accounts should reflect the credit union's current financial condition and results of operations, and provide an audit trail containing sufficient documentation to follow a transaction from its inception through its completion. The credit union's subsidiary records should balance with the general ledger control accounts.

- Protection of physical assets. Safeguarding assets requires limiting access to those assets to authorized personnel. Credit unions can protect assets by developing and implementing operating policies and procedures for cash control, joint custody (dual control), teller operations, and physical security of equipment.

- Staff education and training programs. Credit unions should implement training programs for staff in specific daily operations, as well as in credit union industry philosophy. Credit union training programs should meet management's needs and cross-train staff.

- Succession planning. The ability to fill key management positions in the event of resignation or retirement could affect the credit union's ongoing success. A detailed succession plan that provides for trained management personnel to step in at a moment's notice enhances the credit union's long-term stability. A succession plan should address the CEO and other senior management positions.

Fidelity Bond and General Insurance

Credit unions must maintain adequate fidelity bond and directors' and officers' insurance coverage. Management is responsible for assessing the credit union's insurance and bonding needs; however, the board must formally approve the coverage, including any riders or endorsements. The board should evaluate the adequacy of the credit union's insurance coverage at least annually. In determining insurance and bond requirements, the board should consider items including the following:

- The size of the credit union's asset portfolio and share base;
- The effectiveness of the internal controls;
- The amount of cash, securities, and other property that the credit union normally holds;
- The number of employees, their experience level, levels of authority, and turnover rate;
- The reliability and security of the information system (IS); and
- The types of services offered.

If the credit union's office is located on the sponsor's property, the sponsor's insurance policies may cover risks related to property and liability. However, management should maintain written evidence of

current insurance coverage, including the types of insurance, the benefits provided, and the limits on coverage. The credit union may need to supplement existing insurance. If the credit union has relocated since the last contact, the examiner should determine that the credit union identified and properly insured any new risks.

Bond coverage provides protection against loss resulting from employee or director dishonesty or lack of faithful performance. Generally, a bond covers losses from burglary, robbery, larceny, theft, mysterious disappearance, forgery, counterfeit money, and other perils. Various optional endorsements to the bond include directors' and officer's liability, audit expenses, safe deposit box, consumer legislation, plastic cards, ATM, EFT, ACH, IRA, errors and omissions, and officer and staff coverage. (For additional surety bond information, refer to the Bond Coverage chapter in this Guide.) Safety and soundness concerns may arise if a credit union with minimal reserves or high exposure to risk lowers its bond coverage in efforts to reduce expenses.

Listed below are the most common types of insurance coverage (often included in the credit union's "package of protection") that a credit union might need:

- Property and Related - coverage protects against physical loss to buildings, business property, information processing equipment, mechanical equipment, etc.;

- Financial - coverage for financial records (destruction), real estate errors and omissions, single interest-financed property, chattel lien non-filing, etc.;

- Liability - coverage for bodily injury and property liability exposures of the credit union arising from the use of the premises, building, or business activities;

- Worker's Compensation - coverage, if required by state law, to indemnify employees who are injured or killed in the course of their employment;

- Group Accident - coverage for qualified employees and credit union officials, which pays a specific sum in case of death, dismemberment, or permanent disability;

- Insurance for Members - coverage includes various group or individual programs such as loan protection, life savings, credit disability, and accidental death and dismemberment;

- Employee Benefits - coverage provided for employees such as group life, health, and retirement. Appropriate fidelity bond coverage for pension and retirement programs administered by the credit union should exist; and

- Fiduciary Liability – coverage required if the credit union acts as a fiduciary in connection with an ERISA-covered plan when providing pension and deferred compensation plans for their compensated employees and officers (§701.19(b)).

The examiner should determine if management meets its responsibilities by reviewing the board minutes and insurance policies. Examiners should discuss any insurance inadequacies with the officials. The examiner should comment in the examination report on the absence of prudent risk management by the officials.

Examiners should inquire about any self-insurance programs that the credit union offers its employees or members. Generally, NCUA considers self-insurance programs impermissible, unsafe, and unsound. However, federal credit unions may enact partially self-funded employee benefit health plans if the plans meet certain conditions. The examiner should follow the provisions of NCUA Instruction No. 4062.1 (May 30, 1996) and, after obtaining regional concurrence, consult with NCUA's Office of General Counsel for further guidance.

Credit unions frequently buy life insurance policies for the benefit of employees. Credit unions may also obtain key-person protection. If the beneficiary of the policy is the employee, the credit union will treat the cost of the coverage as compensation. The board should annually review and approve the policy for reasonableness.

NCUA has long prohibited federal credit unions from entering into the business of insurance on several grounds. First, the *FCU Act* does not grant federal credit unions express insurance powers. Second, insurance powers do not meet the test for a permissible federal credit union incidental authority. The Office of General Counsel has issued prior opinion letters restating NCUA's position on self-insurance (See OGC Opinion Letters #95-1148, #97-0632, and #99-0447).

FIRREA Requirements for New or Troubled Credit Unions

Any federally insured credit union chartered in the last two years or in a troubled condition (CAMEL 4 or 5) must give NCUA written notice of any addition, replacement, reassignment or change in the board of directors, committee members, or senior executive officers. The NCUA regional director must receive written notice at least 30 days before the effective date. NCUA may disapprove the addition, replacement, or employment of the individual within a 30-day period (may be extended an additional 30 days) if it finds that the competence, experience, character, or integrity of the individual would not serve well the members' or the public's interests. Federally insured, state-chartered credit unions will also file a copy of the notice with their state supervisory authority.

Credit unions need not give prior notice for new members elected to the board of directors or credit committee at a meeting of the members. However, credit unions must file a completed notice within 48 hours of the election. Federally insured state-chartered credit unions must also file a copy of the notices with their state supervisor.

The notice should contain, at a minimum, the following information for each individual:

- Identity;
- Personal history;
- Business background;
- Experience, including material business activities and affiliations during the past five years;
- Any pending legal or administrative proceeding in which the individual is a party; and
- Any criminal indictments or convictions of the individual by a state or federal court.

In addition, the individual on whose behalf the credit union files the notice must attest to the validity of the information filed and authorize performance of a credit check.

After receiving a complete package of information requested, the regional director has 30 days in which to issue a written notice of approval or disapproval to each individual and to the credit union. If the credit union and individual have submitted all requested information and the regional director has not issued a written decision within the applicable time period, the regulation specifies that the individual is approved (§701.14(d)(1).

Incompetent or Inefficient Management

The examiner should never recommend the termination of credit union management or personnel to the directors. Rather, the examiner should fairly and accurately present findings concerning management's effectiveness.

When the examiner believes that management's incompetence or inefficiency has or will have a material effect on the credit union's risk profile, the examiner should contact the supervisory examiner before discussing the issue with the credit union. To avoid misunderstandings, the examiner should consider having a second person present (the supervisory examiner or another examiner) when discussing sensitive issues with management.

The examiner should adhere to the following guidelines when discussing incompetent or ineffective management with a board of directors:

- The examiner should document in the file and furnish to the officials specific facts that support the conclusion of management's ineffectiveness. Examiners should ensure thorough documentation exists of conversations with officials regarding management.

- If material weaknesses in management exist, normally the examiner and officials jointly develop a plan (Document of Resolution) to correct these deficiencies. Such action could take the form of:

- Clearly communicating the board's expectations for the managing official;
- Conducting periodic performance appraisals;
- Hiring additional management personnel to bolster supervision in high risk areas;
- Providing outside remedial training for the manager or official; and
- Seeking remedial assistance from outside sources (e.g., leagues, accounting services, etc.)

However, if the corrective action takes the form of replacing management, this is solely the decision and responsibility of the board of directors.

- If the manager chooses to resign, the credit union should obtain a written resignation. The board of directors has sole responsible for deciding whether to accept it.

- If the board terminates the manager, the examiner should fully document this action, emphasizing that the decision to terminate was the board's and not the result of an order or recommendation of the examiner.

The officials should consider what effect termination of management (including the effect of an employment contract) may have on the credit union. The board of directors should not consent to "hold harmless" the manager in exchange for the manager's written resignation. Such an agreement might impair the credit union's ability to recover on a bond claim. The examiner should encourage the board of directors to consult with their attorney on these issues.

Criticism of management by the examiner does not relieve the credit union of its contractual and other legal obligations. If the credit union board does not take steps to deal with management ineffectiveness, the examiner should consider recommending administrative action (see the Administrative Actions chapter for additional information.)

Workpapers and References

- Workpapers
  - Management Review
  - Board Minutes
- References
  - *Federal Credit Union Act*

    §110 - Members' meetings
    §111 - Management; board of directors; credit committee; supervisory committee; compensation
    §112 - Executive officers; general manager
    §113 - Board of directors; meetings; powers and duties; executive committee; membership officers; membership applications
    §114 - Credit committee; meetings; powers and duties; loans and lines of credit; security
    §115 - Supervisory committee; powers and duties; suspension of members; passbook
    §206 - Termination of insured credit union status; cease-and-desist orders; removal or suspension from office; procedure

  - *Federal Credit Union Bylaws*

    Article IV - Meetings of Members
    Article V - Elections
    Article VI - Board of Directors
    Article VII - Board Officers, Management Officials and Executive Committee
    Article VIII - Credit Committee or Loan Officers
    Article IX - Supervisory Committee

  - *NCUA Rules and Regulations*

    §701.14 - Change in Official or Senior Executive Officer in Credit Unions that are Newly Chartered of are in Troubled Condition
    §701.21 - Loans to Members and Lines of Credit to Members
    §701.33 - Reimbursement, Insurance, and Indemnification of Officials and Employees
    §702 - Prompt Corrective Action
    §711 and §741.209 - Management Official Interlocks

§747 - Administrative Actions, Adjudicative Hearings, Rules of Practice and Procedure, and Investigations