3138 10th Street North
Arlington, VA 22201-2149
703.522.4770 | 800.336.4644
f: 703.524.1082
nafcu@nafcu.org | nafcu.org

National Association of Federally-Insured Credit Unions

January 22, 2019

Mr. Gerard Poliquin
Secretary of the Board
National Credit Union Administration
1775 Duke Street
Alexandria, VA 22314

RE: Fidelity Bonds (RIN 3133-AE87)

Dear Mr. Poliquin:

On behalf of the National Association of Federally-Insured Credit Unions (NAFCU), I am writing in response to the National Credit Union Administration's (NCUA) proposed rulemaking on fidelity bonds. NAFCU advocates for all federally-insured not-for-profit credit unions that, in turn, serve over 115 million consumers with personal and small business financial service products. NAFCU and its members appreciate the NCUA's initiative in updating the regulations to ensure continued safe and sound operations. NAFCU suggests that the NCUA re-evaluate the additional oversight requirements to achieve an operationally efficient and cost-effective solution. NAFCU suggests that the NCUA maintain the current regulation requiring annual review by a federal credit union (FCU) board of directors (Board), and not require supervisory committee review. Further, NAFCU suggests that the NCUA conduct an impact study on the proposed bond contract requirement to ensure that it does not adversely affect FCUs. Lastly, NAFCU suggests that the NCUA provide clarification on the process for reapplying for bond form approval upon the expiration of the ten-year term.

General Comments

The *Federal Credit Union Act* (FCU Act) requires the bonding of employees and appointed and elected officials of FCUs, as well as approved bond forms and minimum coverage. Fidelity bonds serve the essential purpose of protecting FCUs against losses caused by fraud, dishonesty, theft, and other activities by employees, directors, officers, supervisory committee members, and credit committee members. If an aforementioned act occurs, the risks posed to the FCU can be severe and dire in circumstances where the financial loss is too great. Financial impacts on FCUs can ultimately affect the safety and soundness of the National Credit Union Share Insurance Fund (NCUSIF) if a bond carrier refuses to pay, or the activities that cause a financial loss are not covered by the bond policy.

The NCUA's proposed rule attempts to accomplish four objectives: (1) strengthen Board oversight of a FCU's fidelity bond coverage; (2) ensure that there is an adequate period to discover and file fidelity bond claims following a FCU's liquidation; (3) codify a 2017 Office of General Counsel

(OGC) Legal Opinion Letter that permits a natural person FCU's fidelity bond to include coverage for certain credit union service organizations (CUSOs); and (4) clarify the documents subject to NCUA Board approval and require that all bond forms receive the NCUA's approval every ten years. NAFCU supports the codification of the 2017 OGC Legal Opinion Letter.

The OGC Legal Opinion Letter allows fidelity bond insurance to include majority owned CUSOs, and those CUSOs organized by the FCU for the purpose of handling its business transactions and composed exclusively of its employees. NAFCU applauds the NCUA in providing FCUs with this cost-savings and administrative convenience. The NCUA Regulatory Reform Task Force’s first report suggested implementing the statutory requirements of the FCU Act in regards to fidelity bonds in the least costly way possible, and allow FCUs to make business decisions based on their own product and service needs. The proposed rule increases regulatory burdens on FCUs, which increases costs contrary to the suggestions from the NCUA Regulatory Reform Task Force, and should be re-examined.

The NCUA Should Maintain the Current Regulation Requiring Board Approval Only, and Not Require Supervisory Committee Review.

First, the proposed rule extends the Board′s oversight by requiring review of all applications for purchase or renewal of bond coverage, and the passage of a Board resolution with a rotating signatory that is not an employee. A Board currently reviews fidelity bond coverage on an annual basis to ensure the coverage is sufficient compared to the risk. The NCUA believes that this expanded oversight along with a Board resolution and rotating signatory ensures the Board is addressing the adequacy of the coverage at all stages, rather than just at the required annual review. Understandably, this proposed change also serves to bring any red flags for potential abuse to the Board′s attention. However, the proposed rule would impose this new requirement on all FCUs even though past problems arose from a small handful of unique cases, and fails to effectively mitigate the risk of fraud.

The NCUA cites to three recent cases where fraudulent activity occurred and the bond insurer denied the claims based on rescinded fidelity bond coverage. When reviewing recent cases of fidelity bond litigation one cannot help but notice the lack of internal controls. For instance, in the case of *St. Francis Campus Credit Union*, the fraudulent activity was performed by one single employee, the CEO, who on her own accord disbanded the credit committee allowing herself the sole authority to approve loans without further scrutiny. Besides the lack of internal controls, a conflict of interest existed with the lack of an independent party performing the external audit. Lastly, the NCUA examiners failed to identify the fraudulent activity that had been taking place for years. The proposed rule imposes new requirements on the entire industry, punishing everyone for the acts of a select few.

Furthermore, the NCUA′s justification for the proposal′s requirement of passage of a Board resolution with a rotating signatory that is not an employee does not necessarily mitigate instances of fraud. A Board member who is not an employee and not involved in the day-to-day operations does not guarantee that they have no knowledge of fraudulent activity, or that they would be more apt to disclose information if it existed. Although the signatory rotates, to what extent is the liability

negated when that signatory is no longer a Board member, but the agreement is still in place until its expiration? The proposed rule places a patch on an issue that has arisen in recent years, but the fix does not mitigate the root cause of the problem. In order to effectively mitigate the threat of fraudulent activity, there must be concrete internal controls and subsequent external audits. The proposed rule suggests that a FCU without a supervisory committee should implement controls or procedures for conducting their own analysis of fidelity bond coverage instead of relying upon the Board′s recommendations. NAFCU agrees that this would be more effective, and ultimately better protect the NCUSIF and afford FCUs with operational flexibility in the least costly manner. Additionally, the NCUA should focus on and enhance their review of fidelity bond information during examinations, so cases of fraud can be identified and mitigated proactively before the losses become too great. The proposed rule shifts the burden from the NCUA to FCUs to mitigate future litigation risks when NCUA examiners should be acting as the secondary level of review. In addition, the scope of fidelity bond applications may be outside the expertise of the Board, and may be better left to the upper management involved in the day-to-day operations of the FCU.

Second, the proposed rule adds a new requirement of supervisory committee review of all applications for purchase and renewals of fidelity bonds. Currently, a supervisory committee is not involved in the review of fidelity bond coverage. This proposal creates a two tiered review process, duplicating a required task to both the Board and the supervisory committee. Supervisory committees consist primarily of appointed credit union members who are tasked with auditing the FCU to safeguard its assets and protect the interests of its members. The proposed requirement falls within the purview of the supervisory committee′s duties, as set forth in the FCU Act, but it appears only in the context of an audit function and not as a function of making the fundamental decision of whether or not to purchase or renew. Presumably, if you hold an audit function, then you should not also be involved in the decision-making process. Audits are intended to be objective and independent. Allowing a person to weigh-in on making the fundamental decision on purchase, renewal, or modification of a fidelity bond and subsequently conduct an audit tips the scale of checks and balances. Further, the requirement of dual control could lead to internal power struggles between the Board and the supervisory committee if differing opinions develop, and FCUs would then need to implement procedures to resolve differences of opinions between the two if an agreement cannot be met. This could also lead to a destabilization of leadership within the FCU if the Board and Supervisory Committee cannot agree.

Therefore, NAFCU suggests that the NCUA leave the regulation as is, and allow FCUs flexibility in determining whether they prefer to have a secondary level of review conducted by their supervisory committees for all applications for purchase and renewals of fidelity bonds. Although the intent of the proposed rule is to add a second layer of review, this additional layer does not necessarily mitigate the chances of catching fraudulent activities, and NAFCU suggests moving away from a one-size-fits-all approach.

The NCUA Should Conduct an Impact Study to Ensure the Proposed Bond Contract Requirement Does Not Adversely Affect FCUs.

The proposed rule requires bond contracts to include a provision allowing the liquidating agent to purchase an extended discovery period to find any claims that may be brought to the bond insurer. NAFCU members understand that there are instances when a liquidation occurs quickly, and that an adequate discovery period cannot be conducted. It is understandable that the liquidating agent wants the maximum amount of time possible to discover claims. Moreover, in cases where the NCUA acts as the liquidating agent, it is reasonable that the NCUA seeks to protect against financial impacts to the NCUSIF. Protection of the NCUSIF is a priority for NAFCU and the industry. In any case, fraudulent activity should be identified and mitigated proactively. Presumably, the winding up of the FCU will be prolonged as the NCUA conducts an investigation during the discovery period. The FCU will be stuck in a state of limbo until the expiration of the discovery period.

Bond insurers will primary be affected by this proposed requirement, however, FCUs are secondarily impacted and may be adversely affected. Previously, bond insurers permitted contractual language allowing for a "reasonable period" of discovering and filing a claim, but subsequently removed this language. The proposed changes could lead to limited competition as bond insurers may no longer offer as many fidelity bonds to credit unions due to the requirement and additional risks posed. If this occurs, FCUs are left with little bargaining power. If bond insurers do not allow for the proposed required provision, FCUs are stuck with limited options for fidelity bond purchase, or the potential inability to be covered at all. Bond insurers may also choose to increase the price of fidelity bonds due to the extended discovery period. Although the proposed rule states that this change will have no cost effect on FCUs, and instead will be borne by the liquidating agent, the NCUA did not take into account that premiums may increase. This is a two-year extension of claims that could potentially be filed with the bond insurer, therefore it is highly likely that a bond insurer would cover the potential future risks by increasing premium payments. Increased premium payments would likely affect an FCU's overhead, and have the trickledown effect of limiting an FCU's ability to pay out dividends to members, as well as to give back to their communities.

NAFCU suggests that the NCUA ensure that FCUs will have access to the same quality and number of options from bond insurers, and will not be subject to increased premiums as a result of the proposed rule's requirement. This can be achieved by either an impact study after speaking with FCUs and bond insurers, or a cost-benefit analysis. Because bond insurers previously allowed for this provision and subsequently removed it, there should be historical data available on the associated costs. The proposed rule assumes that this change will have little impact on FCUs but does not explain what research was done to assure that the proposal's impacts would be limited. NAFCU requests that, before finalizing this rule, the NCUA conduct and publicly release the results of an impact study or a comprehensive cost-benefit analysis to present the industry with concrete evidence that the increased costs to credit unions are justified by the potential benefits.

The NCUA Should Clarify the Process for Re-Approval of Bond Forms.

The proposed rule sets forth an expiration date of ten years after the NCUA approval or re-approval. Currently, there is no expiration date set in the NCUA's regulations. Although the NCUA believes that the regulatory burden on credit unions is low, NAFCU anticipates that the proposed change would cause a substantial regulatory burden on credit unions. First, the proposed rule does not state how the process for re-approval would operate. If the reapplication for fidelity bond forms is anything like the current process for bylaw amendments, then FCUs are in for a slow, arduous process just in order to maintain compliance. In addition, the proposed rule would require the NCUA's initial bond form approval and then, if a revision occurs during the ten-year period, the FCU must go back to the NCUA for approval; however, the clock does not reset at this renewal period. Therefore, a FCU may have to request the NCUA's approval multiple times during the ten-year period depending whether a bond carrier revises an approved form. Between the internal processes required for a two-tiered review and consistently seeking approval and re-approval from the NCUA, fidelity bonds will now be taking up a larger portion of a FCUs compliance activities. It would be more beneficial for the ten-year period to start over if the NCUA approves an amended bond form. Additionally, the proposed rule sunsets all current approved bond forms in 2029. This blanket sunset could pose an issue for the NCUA in terms of approving bond forms in a timely manner. The NCUA may not have the resources to handle the volume of approval requests, therefore it may be wise to explore other options such as a rolling sunset date. These proposed changes increase the regulatory burdens on FCUs that already face limited resources. NAFCU suggests that the NCUA clarify the process for seeking re-approval of the bond forms as well as implement a process whereby status is communicated to the applicant FCU.

Conclusion

NAFCU appreciates the opportunity to share its members' views on this matter. NAFCU suggests that the NCUA re-evaluate the additional requirement of Board oversight to achieve an operationally efficient and cost-effective solution. In addition, NAFCU suggests that the NCUA maintain the current regulation and not require a supervisory committee to review all applications or renewals of fidelity bonds, but instead allow FCUs to decide whether they want to add a second layer of approval. The NCUA should conduct an impact study or cost-benefit analysis to ensure the proposed bond contract requirement does not adversely affect FCUs by increasing costs or decreasing purchase power. Lastly, NAFCU suggests that the NCUA provide clarification on the process for reapplying for bond form approval at the end of the ten-year expiration term. Should you have any questions or require additional information, please do not hesitate to contact me at (703) 842-2249 or kschafer@nafcu.org.

Sincerely,

Kaley Schafer
Regulatory Affairs Counsel