NCUA LETTER TO FEDERAL CREDIT UNIONS

NATIONAL CREDIT UNION ADMINISTRATION
1775 Duke Street, Alexandria, VA 22314

DATE: **February 2011** **LETTER NO.: 11-FCU-02**

TO: **Federal Credit Unions**

SUBJ: **Duties of Federal Credit Union Boards of Directors**

ENCL: **NCUA Regulation §701.4**

Dear Board of Directors:

Certain provisions of NCUA final rule 701.4, *General authorities and duties of Federal credit union directors*, took effect on January 27, 2011. The purpose of this rule is to clarify and document the important duties of boards of directors of federal credit unions.

This letter provides general information about directors' duties, specifically focusing on the financial skills requirements which will take effect on July 27, 2011.

General Duties of Directors

The final rule contains the following six key provisions:

1. The board of directors is responsible for the general direction and control of a federal credit union. The board may delegate operational functions to management, but not the responsibility for the credit union's direction.

2. A director must carry out his or her duties in good faith, in a manner reasonably believed to be in the best interests of the membership, and with such care, including reasonable inquiry, as an ordinarily prudent person in a like position would use under similar circumstances.

3. A director must administer the affairs of the credit union fairly and impartially and without discrimination in favor of or against any particular member.

4. A director must have at least a working familiarity with basic finance and accounting practices, including the ability to read and understand the credit union's balance sheet and income statement and the ability to ask, as appropriate, substantive questions of management and auditors.

5. A director must direct the operations of the federal credit union in conformity with the Federal Credit Union Act, NCUA's Rules and Regulations, other applicable laws, and sound business practices.

6. A director may rely on information prepared or presented by employees or consultants the director reasonably believes to be reliable and competent and who merit confidence in the particular functions performed.

Basic Financial Skills Required

The board of directors of a federal credit union is charged with the general direction and control of the institution. Credit unions, however, are not like many other commercial entities in that they do not produce observable physical goods or services. Instead, credit unions receive deposits from the membership and, in turn, lend or invest these funds. The key measure of the credit union's success or failure is its financial statements. As such, a director must understand these financial statements to participate in a meaningful manner in the direction and control of the institution.

Accordingly, to be an effective director, an individual must have a certain base level of financial skills, consistent with the size and complexity of the credit union operation they serve. At a minimum, directors must have the ability to read and understand the credit union's balance sheet and income statement. If directors do not have the requisite skills when elected or appointed, they must obtain these skills in a timely manner, as discussed below.

What a Director Should Know

At a minimum, a director should be able to examine the credit union's balance sheet, income statement and be able to answer the following questions:

- What does this line item mean?
- Why is it important to the credit union?
- Is the value of the line item changing over time? If so, what does that change (either positive or negative) mean?
- Is the change important to the credit union?

A director must understand the specific activities in which his or her credit union engages. In particular, a director must understand not only how these activities generate revenue for the credit union but also, and perhaps most importantly, the various risks associated with these activities that could lead to financial loss.

To do their job in a meaningful manner, it is essential that directors understand the risks found in depository institutions -- that is, credit, liquidity, interest rate, compliance, strategic, transaction, and reputation risk. Moreover, directors must understand the internal control structures at the credit union that limit and control these risks.

Timetable for Acquiring Financial Skills

NCUA understands that directors are, generally, uncompensated volunteers who have other important demands that compete for their time. The decision to serve as a director, however, is a commitment which includes understanding the financial statements, risks and controls of the credit union so as to properly exercise authority over the credit union's direction.

Directors who were elected or appointed on or after January 27, 2011, and who come to the position without the requisite financial skills will have six months from the date of election or appointment to acquire the enumerated skills. Sitting directors who already understand their federal credit union's financial statements and risk controls will not have to do anything further to meet the financial requirements of NCUA's directors' duties rule. Sitting directors who were appointed or elected before January 27, 2011, and do not have these skills, have until July 27, 2011 to satisfy the minimum financial standards.

How to Acquire Necessary Financial Skills

It is NCUA's intent to ensure that all federal credit union directors have a basic understanding of their credit union's finances. It is **not** NCUA's intent to increase examiner scrutiny of the financial skills of particular directors. Rather, examiners will evaluate whether the credit union has a policy in place to make available the appropriate training to enhance the financial knowledge of the directors. The policy should provide:

- Opportunities and funding for directors to acquire the skills needed to evaluate the credit union's finances. Some directors may come to the director position with the necessary financial knowledge. Other directors may obtain the necessary financial skills through internal credit union training, external training, self education, on-the-job experience, or a combination of these activities.

- Education alternatives for directors commensurate with the size and complexity of the credit union. Alternatives could include, but not be limited to, training provided by vendors or trade associations; college courses or other opportunities at colleges or universities; NCUA's Office of Small Credit Union Initiatives (OSCUI) training program presented at various workshops across the country beginning March 5, 2011; and NCUA's Office of Examination and Insurance (E&I) internet-based training. We will distribute additional information when the development is complete.

- The timeframes noted in the *Timetable for Acquiring Financial Skills* section.

Guidance on Other Director Duties

Obtaining the necessary financial skills will enable directors to exercise the general control and direction of credit unions and carry out the other, associated duties summarized above. Some of those duties deserve additional discussion and emphasis.

Paragraph 701.4 (a) Management of a Federal Credit Union

Paragraph 701.4(a) provides, in part, that "while the board may delegate execution of operational functions to [management], the ultimate responsibility for [the credit union's] direction and control is not delegable."

The board may delegate management functions to senior management. The board, however, must directly exercise its authority to hire, fire, determine duties, set compensation, and discipline senior management. The board must also ensure that appropriate policies are in place to guide senior management in the execution of their duties.

To properly exercise the control and direction of the credit union, directors must ensure they are properly informed about what is happening in the credit union. Directors should not rely solely on the reports of senior management, but also consider the reports of the supervisory committee and internal and external auditors. Where necessary, the board may also request credit union employees provide information directly to the board, and not through senior management. The board may also hire consultants that report directly to the board, and not to senior management.

Paragraph 701.4(b) Duties of Federal Credit Union Directors

Paragraph 701.4(b)(1) provides that "[a] director must carry out his or her duties in good faith, in a manner reasonably believed to be in the best interests of the membership of the credit union, and with such care, including reasonable inquiry, as an ordinarily prudent person in a like position would use under similar circumstances."

"Good faith" means, generally, that directors should take care not to violate the law, and also not be involved in decisions that benefit the director personally. When in doubt, a director should look carefully at the conflict of interest provisions in the credit union bylaws and NCUA regulations and seek legal counsel if unclear how to proceed on a particular issue.

Directors must always focus on the best interests of the membership as a whole. Credit unions are not-for-profit cooperatives designed to provide financial services to their member-owners. As such, a credit union's primary purpose is not to seek the biggest possible profit or return on assets (ROA); nor is it appropriate to seek asset growth just for the sake of growth. The primary purpose of a credit union is to provide quality, low-cost financial services that the members need.[1] When making important decisions, directors should always keep in mind the following questions:

- What financial services do my members need and want? How do I know this?
- Will my decision today help the credit union provide these member services in a quality manner and at low cost to the members?

The requirement for "*reasonable inquiry"* means that the more complex a decision, and the more important the decision is to the financial interests of the members, the more due diligence the directors need to do in an attempt to make a good decision.

Paragraph 701.4(b)(4) provides that a director must "direct management's operations of the Federal credit union in conformity with the requirements set forth in the Federal Credit Union Act, NCUA's rules, other applicable law, and sound business practices." When making a decision, a director should consider applicable laws and alternative business practices. If unsure, a director should ask questions and gather information before voting on a proposal.

If you have any questions related to this letter, you should contact your regional office or district examiner.

Sincerely,

/S/

Debbie Matz
Chairman

[1] Of course, a credit union must have sufficient net worth to 1) meet its statutory prompt corrective action (PCA) requirements; 2) facilitate borrowing and the engagement of third party vendors, where necessary; and 3) facilitate the absorption of possible future losses associated with reasonably foreseeable risks. The credit union should also seek some positive ROA to maintain and protect an appropriate net worth ratio. But maximizing growth, simply for the sake of growth, is not an appropriate goal for a credit union.