January 22, 2019

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

Re: NASCUS Comments on Notice of Proposed Rulemaking (Fidelity Bonds)

Dear Mr. Poliquin:

The National Association of State Credit Union Supervisors (NASCUS)[1] submits the following comments in response to the National Credit Union Administration's (NCUA's) request for comments on proposed changes to NCUA's rule Part 713, Fidelity Bond and Insurance Coverage for Federal Credit Unions. As stated in the rule's title, Part 713 contains detailed rules related to federal credit union (FCU) fidelity bond and insurance coverage. NCUA Part 741.201 only requires that federally insured state-chartered credit unions (FISCUs) possess the minimum fidelity bond coverage required for FCUs.[2] NCUA also proposes changes to Part 704.18, fidelity bond coverage for corporate credit unions. State-chartered corporate credit unions must comply with all of Part 704, in its entirety, as a result of an explicit reference to that effect in Part 741.206.[3]

NASCUS is concerned that the rule as proposed by NCUA is an unnecessary overreach by the share insurer with respect to state chartered credit unions that will weaken the dual charter system by preempting state laws related to fidelity bonds. The prescriptive nature of the proposal also runs counter to the current approach to mandatory bond coverage of federal bank regulators. If finalized, the proposed rule would likely increase costs for credit unions, insert the credit union board into matters best handled by management, and possibly encumber a credit union's ability to recruit board members.

Given those concerns, coupled with our view of the limited supervisory utility of the proposed changes, we cannot support the proposal as a whole. NASCUS does, however, support the codification of the 2017 NCUA Legal Opinion allowing for joint fidelity bond coverage between a credit union and its CUSOs in certain limited circumstances. We would also support the 10-year review of approved bond forms.

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[1] NASCUS is the professional association of the nation's 45 state credit union regulatory agencies that charter and supervise over 2,100 credit unions.
[2] 12 CFR Part 741.201.
[3] 12 CFR Part 741.206.

- **NCUA's proposal represents an expansion of FCU rules to FISCUs**

The application of NCUA fidelity bond coverage rules to state and federal corporate credit unions is fairly straightforward.[4] Part 741.206 of NCUA's rules for federally insured state-chartered credit unions states succinctly, and unambiguously, "Any corporate credit union insured pursuant to title II of the act shall adhere to the requirements of part 704 of this chapter."[5] However, for natural person FISCUs, the share insurance rules are plainly more circumscribed.

For FISCUs, fidelity bond requirements are applied by reference in NCUA's share insurance rules, Part 741.201(a), which reads in its entirety:

> Any credit union which makes application for insurance of its accounts pursuant to title II of the Act **must possess the minimum fidelity bond coverage stated in part 713 of this chapter** in order for its application for such insurance to be approved and for such insurance coverage to continue. A federally insured credit union whose fidelity bond coverage is terminated shall mail notice of such termination to the Regional Director not less than 35 days prior to the effective date of such termination.
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> \- 12 CFR 741.201(a) (emphasis added)

We note NCUA's clear specification of the nature of the applicable requirement ("minimum fidelity bond coverage") prior to a citation to the part of NCUA regulations where the requirement is located ("in part 713"). The positioning of the qualifying language referring to minimum coverage identifies the only requirement in Part 713 that applies to FISCUs: the amount of bond coverage required for them to obtain, and maintain, NCUSIF share insurance coverage. A plain reading of this regulatory text indicates that only a subset of Part 713, not the entire part, applies to FISCUs. Where NCUA rules apply FCU rules, or entire provisions beyond Part 741, to FISCUs, the text is clear. For example, corporate credit union are directed to comply with Part 704. FISCUs are directed to comply with Part 760, Part 707, and Part 750.[6]

The specific reference to possessing "the minimum fidelity bond coverage" thus distinguishes subsection 741.201(a) from other Part 741 provisions, where NCUA applies an entire FCU rule to FISCUs. The specific reference to possessing "the minimum fidelity bond coverage" is phrased restrictively, limiting the scope of the cross-reference. In contrast, when additional phrases are included in Part 741 provisions that apply entire FCU rules to FISCUs, the additional language is non-restrictive, generally describing the entire FCU provision being referenced. For example, Part 741.208 refers FISCUs to NCUA's merger rules in Parts 708a and 708b:

> Any credit union which is insured pursuant to title II of the Act and which merges with another credit union or non-credit union institution, and any state-chartered credit

[4] NASCUS continues to advocate for the reintroduction of meaningful dual chartering into the corporate credit union system by allowing states to enforce state-specific state rules over some aspects of the corporate system.
[5] 12 CFR Part 741.206.
[6] See 12 CFR 741.216, 741.217 and 741.224.

> union which voluntarily terminates its status as a federally-insured credit union, or converts from federal insurance to other insurance from a government or private source authorized to insure member accounts, shall adhere to the applicable requirements stated in section 206 of the Act and parts 708a and 708b of this chapter concerning mergers and voluntary termination or conversion of insured status.
>
> \- 12 CFR 741.208

In this instance, the inclusion of "concerning mergers and termination or conversion of insured status" follows the incorporation by reference of Parts 708a and 708b in their entirety. The language merely describes, in general terms, the subject of Parts 708a and 708b. This structure differs entirely from the fidelity bond rule reference in Part 741.201 where the qualifying language is not generally descriptive, but rather restrictive, preceding the citation to clarify what applies.[7]

If NCUA intends to expand the scope of Part 713 to apply in full to all FISCUs, it should invite specific stakeholder comment on such a proposal. NCUA should also propose changes to Part 741.201 to more clearly identify fidelity bond provisions apply to FISCUs. NASCUS does not believe it necessary to apply such detailed bond provisions to FISCUs. We note that the Federal Deposit Insurance Corporation (FDIC) focuses its requirements for deposit insurance on the amount of bond coverage:

> (d) Fidelity insurance, policies, and audit coverage--An insured depository institution should maintain sufficient fidelity bond coverage on its active officers and employees to conform with generally accepted industry practices. Primary coverage of no less than $1 million is ordinarily expected. Approval of the application may be conditioned upon acquisition of adequate fidelity coverage prior to opening for business.
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> \- FDIC, Statement of Policy on Applications for Deposit Insurance[8]

- **<u>NCUA's proposal fails to adequately address likely increased costs to credit unions</u>**

NCUA proposes changes to both the natural person credit union and corporate credit union bond rules requiring fidelity bonds to provide an option allowing the liquidating agent of a credit union to purchase an extension of the discovery period in which to file a claim of loss with the insurer.[9] NCUA notes that between 2006 and 2013, the NCUSIF was paid $1 million in claims identified during extended discovery periods. However, NCUA further notes that in the time since 2013, insurers have routinely removed discovery provisions from bond contracts or reserved sole discretion as to whether an extended discovery period may be purchased. NCUA asserts that, in response to the insurers' actions, changes in NCUA regulations are necessary to provide legal certainty of the agency's right to purchase an extended discovery period and mitigate potential losses to the insurance fund.

[7] NCUA has issued legal opinions in response to specific questions regarding fidelity bond coverage in which the agency has asserted, generically, that Part 713 applies to all insured credit unions. However, the scope of part 713's application to FISCUs was not itself the issue of the legal opinions and the opinions lack any discussion of that assertion.
[8] Available at https://www.fdic.gov/regulations/laws/rules/5000-3000.html.
[9] 83 FR 59318, 59320 (November 23, 2018).

NASCUS does not question the value to the insurance fund of guarantying the liquidating agent's ability to purchase a two-year discovery period within which to identify losses and claims. However, we do have concerns about the cost to credit unions of mandating these contractual provisions.

Because NCUA, as the liquidating agent, would purchase the extension of discovery at the time of liquidation, the NCUA Board states in the proposal that it does not expect the requirement to result in any "additional cost or burden" to credit unions.[10] Unfortunately, the proposal as published lacks any additional information as to how NCUA concluded there would be no cost to credit unions.

While it is true that NCUA as the liquidating agent would purchase the discovery extension pursuant to the bond contract, the purchase price at the time of extension is likely not the only cost to be involved with the implementation of this provision given the real-world practices involved in underwriting insurance. NCUA itself notes the potential dollar amount of losses uncovered during extended discovery periods between 2006 and 2013. If the extended discovery clauses become mandatory, as proposed here, then the bond companies will have to calculate the cost of potential losses over the extended discovery period and factor those into pricing. However, it is possible that the cost of extending the discovery period might exceed state law caps on standard lines of insurance. In other words, whatever price is attached to the purchase of the extension by the liquidating agent may not satisfy underwriting criteria because of non-credit union specific state insurance laws. In that case, bond companies will likely move to recapture those costs through higher base premiums on the bond coverage when it is first purchased by the credit union, resulting in generally higher premiums throughout the life of the bond coverage irrespective of whether the credit union is ever liquidated, and the discovery clause executed.

Before this rule is finalized, it would be helpful to stakeholders for NCUA to provide more information as to why the agency believes the additional costs of extended discovery periods would be borne solely by the liquidating agent as asserted in the proposal. If that is the case, then NASCUS' concerns with this provision of the proposal would be mitigated.

- **<u>NCUA's proposed board review and board signature of bond applications are problematic and unlikely to yield much supervisory benefit</u>**

Current Part 713.2 requires "[t]he board of directors of each Federal credit union must at least annually review its fidelity and other insurance coverage to ensure that it is adequate in relation to the potential risks facing the credit union and the minimum requirements set by the Board."[11] This FCU requirement is prudent, and can be found in some state credit union bond requirements.[12] To this existing provision, NCUA seeks to add requirements that the board and supervisory committee review every application for bond coverage, and that a

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[10] 83 FR 59318, 59322 (November 23, 2018).
[11] 12 CFR 713.2.
[12] See North Dakota N.D.C.C. 13-03-24-02, or Texas Tex. Credit Union Code 91-510(d),

member of the board sign the bond agreement and all attachments.[13] Both proposed additional provisions are problematic.

1) Proposed Part 713.2(b) and Part 704.18(b)(2) board and supervisory committee review

   Our primary concern with requiring the credit union board and supervisory committee to review "all applications for purchase or renewal" of the credit union's bond is that it injects the strategic leadership and oversight body of the credit union into the management-decision making role: a role which properly belongs to the professional staff of the credit union. The board's decision making should focus on policies, not such detailed decision making as choosing the bond provider. By injecting the board into a management decision, NCUA's rule could potentially create confusion as to the proper relationship and roles of board and management: confusion more damaging to the credit union than any de minimus benefit achieved by the board involvement.

   NCUA's proposal is also technically flawed. The new provision for natural person credit unions reads "The board of directors, **and, if applicable, the supervisory committee** of each federally insured credit union, must review all applications for purchase or renewal of its fidelity bond coverage." (emphasis added). It is unclear what the wording "and, if applicable, the supervisory committee" means. Does NCUA mean to include the supervisory committee if the credit union's board has delegated the responsibility? If so, can the credit union board delegate that responsibility to some other board committee other than a supervisory committee? Perhaps NCUA means to include the supervisory committee as part of the mandatory review, if the credit union has one. However, not all credit unions have a supervisory committee. In some states, there is only an audit committee, and some states have no requirement for either an audit committee or supervisory committee. NCUA's proposed amendment to part 713.3 is convoluted and confusing. We urge NCUA to drop this proposed change, but if the agency does finalize the rule, its meaning must be clarified.

2) Proposed Part 713.2(b) and Part 704.18(b) alternating board director signature of bond agreement

   The proposed changes would require a member of the board who is not an employee of the credit union, sign the bond agreement or renewal. NCUA proposes this change to attempt to thwart the bond company from rescinding the policy based on the knowledge of wrongdoing, or the even wrongdoing by the management signatory.

   We remain unconvinced of the necessity, utility, and practicality of this approach. We are also concerned that even after explaining to a director that signing the bond contract would not impute any sort of liability, the requirement for a director signature will hamper the ability to recruit qualified individuals to the board.[14]

[13] 83 FR 59318, 59325 (November 23, 2018).

[14] This chilling affect may be somewhat mitigated in states where FISCUs have the option to compensate directors.

With respect to the need for this provision, we note that the wrongdoing of the manager that signed the bond contract may not be enough to allow the insurance company to void the bond.[15] Furthermore, having a director sign the bond contract is no panacea, as the insurance company will likely assert imputed knowledge to all directors of fraudulent activity that they either should have known, or, based upon board minutes, suspected.[16] NASCUS appreciates that NCUA, as administrator of the NCUSIF, has a great deal of familiarity with the practices of the various bond companies used by the credit union system (and as a party to the fidelity bond related credit union litigation). NASCUS would welcome further discussion with NCUA regarding these issues. However, at this time, based on the information provided in the November 23 proposed rule, we cannot support this provision.

- **NASCUS supports codification of the 2017 NCUA Legal Opinion regarding "individual policy"**

Existing Part 713.3(a) requires FCUs to purchase an individual bond policy.[17] NCUA proposes to amend Part 713 to codify a 2017 NCUA General Counsel legal opinion that the individual policy requirement does not prohibit a credit union from having a fidelity bond that also covers its CUSOs, provided the credit union owns at least 50% of the CUSO or the CUSO meets the definition of a nominee (organized by the credit union for the purpose of handling certain of its business transactions and composed exclusively of its employees).[18]

NASCUS supports this proposed amendment. Codifying the 2017 legal opinion will provide clarity to credit unions with respect to bond coverage for the credit union and for some of its CUSOs.

- **Reviewing bond form approvals every 10 years makes sense**

NCUA proposes adding a new provision to Part 713.4 that would sunset the agency's approval of bond forms after 10 years.[19] So doing will provide consistency and certainty that bind forms are compliant with applicable regulations. We support the promulgation of a 10-year review process.

Thank you for the opportunity to provide comments and recommendations on proposed changes to NCUA share insurance rules and fidelity bond requirements for FISCUs. NASCUS, state regulators, and state credit unions share NCUA's commitment to a safe and sound credit union system. We do not believe this proposed rulemaking will contribute to those goals. To the contrary, if finalized in its entirety, this proposal will burden FCUs and FISCUs, confuse directors' understanding of their proper role, increase operating costs, and discourage qualified candidates from serving on credit union boards. While NASCUS cannot support the

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[15] *See* *National Credit Union Administration Board v. CUMIS Insurance Society, Inc.*, No. 16-139, 2017 WL 1047256 (D. Minn. Mar. 17, 2017).
[16] See *National Credit Union Administration Board v. CUMIS Insurance Society, Inc*., 2016 WL 165379 (N.D. Ohio)
[17] 12 CFR 713.3(a).
[18] OGC Legal Op. 17-0959 (Sep. 26, 2017).
[19] 12 CFR 713.4(d).

rule as proposed, we remain ready to work with NCUA to identify a better supervisory path forward to address NCUA's concerns with fidelity bond rules and the issues raised by this proposal.

Sincerely,

- signature redacted for electronic publication -

Brian Knight
General Counsel