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THE ROLE OF THE BOARD

OK, so you're on your credit union's board of directors. Wouldn't it be nice if there was a set of instructions that came with the job? Or at least a job description?

As I talk to new directors, this issue pops up again and again. Is the board approaching an issue correctly? With so few duties spelled out in black and white, making important decisions can be daunting. The goal of this chapter is simple: to give you a broad overview of how boards function at credit unions.

THE BOARD

Many Americans have no idea that boards exist. They look at a corporation, a bank, a credit union, or their local charity, and they assume that the CEO is the main man or woman. That's what I always thought while growing up in Pennsylvania. GE was run by Jack Welch. And that was that. As I grew older and started studying corporate law and corporate governance, I learned about the role that boards play.

Boards are wonderful things, and very, very necessary. Most organizations have a big problem. The people that own the organization are not around to watch how the organization is run. And the management of the organization often doesn't have an ownership interest. So how do the owners make sure things go the right way?

Ah, the board. They are the bridge between ownership and management. Credit unions are no different. Members own the credit union. The board looks out for their interests.

NCUA has stated this over and over. The board of a credit union is responsible for the *general direction* and *control* of the credit union.[7]

Each word is very important. First, there's *general*. Should a board focus on the smallest of details? Should you approve the vendor that supplies your credit union's copy paper or toner? We'll discuss this in greater detail later, but I would say no. (*Soapbox Warning*) That's not *general*. And when you look at the other parts of your job, the more you focus on the minutia, the less you'll be able to provide the all-important control and direction.

The next word is *direction*. You set the course for your credit union. You may not do the rowing, but you set the destination. What is your credit union supposed to be? How should it look? What should it do for its membership? The answers to those questions, to a large degree, are provided by you.

Finally, there's *control*. You control your credit union, generally. If the credit union goes off course, you need to get it back on track.

So, how is this all done? It starts with strategic planning. Until you plan and determine your credit union's direction, risk tolerance, and reason for being, there's no way for you to effectively guide your credit union. Without a map, how can you give directions?

According to NCUA, strategic planning is nothing more than developing a long-term vision for the credit union. The strategic plan incorporates all areas of a credit union's operations and sets broad goals enabling credit union management to make sound decisions. The strategic plan should identify risks and threats to the organization and outline methods to address them. We'll discuss strategic planning in greater detail later.

Next, there's the management of the CEO. As a board, there's no way for you to do the day-to-day work for your credit union. For most directors, there is little direct contact with day-to-day operations. Boards set the agenda and then delegate implementation to a CEO. The CEO can then put in place a management team to help get the job done. For this reason, the hiring and management of a CEO is one of the most important jobs a board will do.

And how are the first two items accomplished? You'll do much of this via meetings. At meetings, you'll discuss important matters at your credit union. Decisions will be made via motions and board voting. This is the time when you can interact with your CEO.

Before your board meeting, you should have adequate time to review the board pack. This package of reports, proposed policies and other information should give you a snapshot of your credit union's performance. To perform adequately at your meeting, you need to review and understand your board pack. And if things jump out, favorable or unfavorable trends, new risks, etc., you can discuss them with your CEO or other members of the management team. In addition, credit unions have an annual meeting of the members. During this meeting, directors can be elected or election results can be made official. And don't forget this: while you manage the CEO, you represent the needs and desires of the membership.

So, how does someone get on the board of a credit union? Here's the official answer. As long as an individual is a member of a credit union, and has not been convicted of a crime involving dishonesty or breach of trust, that member is eligible for election to the board of directors. Your bylaws also permit a board of directors to set a minimum age requirement. That's it! There's no other requirement. The democratic nature of credit unions is the backbone of the entire system. NCUA, through a number of legal opinion letters, has consistently defended the right of members who meet the requirements listed above to run for board election.

That being stated, your credit union may have a nominating committee. At least 30 days (or 120 days, depending on which voting option your credit union has chosen), your board may choose a committee of at least three members whose job it will be to nominate at least one board candidate for each vacancy on the board. You can even choose from your board and supervisory committee members. The board of directors of a credit union may establish policies for the nominating committee to follow. So, if your board thinks it is important to have someone with an accounting background, or perhaps at least one attorney on your board, your nominating committee

[7] *This is all spelled out in the Federal Credit Union Act.*

can seek out qualified candidates and nominate them. But always keep in mind that even with a nominating committee, members can run for your credit union's board on their own.

Where would a member find out how to run for your board? Much of the requirements are found within your credit union's bylaws. If you haven't seen your bylaws, pick up a copy. It covers issues surrounding many areas of credit union corporate governance, including elections. For example, you have the right to limit the number of paid employees that can sit on your board by your bylaws. The timing of election notifications, petition requirements, election procedures and eligibility requirements are all in there. There are four options for federal credit unions to choose from when setting up their election procedures. State-chartered credit unions should follow their own state requirements, which often are similar. It is important to know what option applies to your credit union and to ensure that you comply with its requirements.

How many directors can sit on the board of a federal credit union? Your board picks the number. It has to be an odd number, not fewer than five, and not more than 15. All of this is set by the Federal Credit Union Act and it is outlined in your bylaws as well. For state-chartered credit unions, this will be laid out in state law. A small or large board? Which is better? There's no way to answer that question. I've heard individuals praise boards of all sizes. And I've heard complaints about the governance structure of small and large boards. Regular terms of office for directors must be for periods of either 2 or 3 years as the board determines. All regular terms must be for the same number of years. Regular terms must be fixed at the first meeting, or upon any increase or decrease in the number of directors, so that approximately an equal number of regular terms expire at each annual meeting.

Occasionally, a director will not be able to complete his or her term. Any vacancy on the board must be filled as soon as possible by vote of a majority of the directors still holding office. For that reason, it's a good idea for your credit union to keep a list of interested members who might serve as a director in such situations. Perhaps it is someone on your supervisory committee or a former board member who remains interested in credit union affairs. Directors appointed to fill a vacancy will hold office only until the next annual meeting, when unexpired terms will be filled by vote of the members.

Finally, let's talk about compensation. One board member of a federal credit union may be compensated for his or her duties as a board member. Don't confuse this with paid employees that may sit on your board. Your credit union may have paid employees that sit on the board, but they are not paid to be a board member. They are paid for their day job – as a credit union employee. Few credit unions have a paid director, though. So for the rest of you, the position is that of a volunteer. (Keep in mind that some states do allow state-chartered credit unions to compensate their directors.) But even if you are purely a volunteer, the credit union can reimburse you for certain expenses, and they can pay for certain things on your behalf. For example:

- Your credit union is allowed to pay or reimburse you for expenses related to training. The flight, meals, and conference registration fees are not deemed to be "compensation" as far as NCUA is concerned. During training, you are on credit union business, learning so that you can do your job more effectively upon your return. Note that if your credit union pays for your guest to travel with you, those reimbursed expenses of your guest may be reported to the IRS as income. Don't blame your credit union – blame the IRS. The thought is this: you are on credit union business, while your guest is simply on a trip. Those reimbursed expenses may be treated as income to you if they exceed $600.
- Along the same lines, you may be reimbursed for reasonable travel costs for attending to credit union business. Mileage reimbursement or meals eaten while traveling to a board meeting might be examples.

Let's take a look at some of the responsibilities of the board. As we go through the list, don't panic. As the board, you won't necessarily be doing all of this. Rather, management may be coming to you with proposals for your review. Whether you handle these yourself, or you respond to management proposals, it is important to remember that the responsibility is yours.

Membership applications. Applications from the membership must be approved by the board. Again, don't panic. You are allowed to appoint membership officers to take care of this duty.

Filling vacancies. As we discussed earlier, it is your job to fill vacancies on your board, supervisory committee, or credit committees. Does your board or management have a list of viable candidates handy in case you need to go through this process?

Appointing supervisory committee members. As a board, you select the members of the credit union's supervisory committee. This is a big deal, as the supervisory committee plays a huge role at credit unions. Chapter 9 addresses what supervisory committees do, but for now, understand that they are the auditing arm of the credit union. A strong supervisory committee can spot problems and stop them before they get out of control.

Investments. A credit union may at times have funds in excess of its needs. The Federal Credit Union Act and NCUA regulations give guidance concerning investment activities. The board of directors is responsible to implement and monitor a sound investment program for their credit union. The scope of the program depends largely on the credit union's size, extent of its surplus funds, and management's expertise. If the board employs a brokerage firm or other investment professional, the board must satisfy itself as to the reliability and financial soundness of the firm and the individual. Also, the credit union must retain discretionary control over the purchase and sale of investments.

Loans, loan officers and lending policies. A sound lending program is essential to the financial future of a credit union. Your board must strike a balance between meeting the members' needs and meeting the needs of the credit union's financial objectives and resources. The lending program should consider the credit union's share structure and funds flow, its short- and long-range goals and objectives, and local economic conditions. At a minimum, lending policies should clearly reflect maximum limits on loans, limitations on loan maturities and repayment terms, and acceptable collateral. You could be responsible for reviewing loan applications, although most credit unions have a credit committee or appointed loan officers who take care of this task.

Hiring and compensation of officers and employees. As a board, you'll hire and work with your CEO. Usually, the CEO then hires his or her executive team. Finding the right person, and picking the right compensation is a big part of your job.

Share rates. Share and share certificate accounts are the primary source of credit union funds. Meeting the members' needs is a major consideration when establishing share policies. However, you must also weigh the cost of funds and match shares with assets of similar maturities. For example, NCUA recommends that if long-term loans comprise most of a credit union's assets, share policies should strive to offer share accounts and share certificate accounts with extended maturity and restricted withdrawal features. On the other hand, if short-term loans comprise most of the credit union's assets, you might offer only regular share accounts and short-term share certificates. The board must establish realistic dividend policies and rates. When setting dividend rates, the board should carefully consider the credit union's funding needs and the current market conditions.

Internal controls. Internal controls are checks and balances built into policies and procedures. Many internal controls are developed out of daily experience and sound business practices. Internal controls as prescribed by law, regulation or sound business practice include:

- Dividing duties so that no one person has sole control over any transaction and its recording;
- Establishing the flow of work so one employee, acting independently, automatically verifies the work of another without duplicating work already performed; and
- Providing physical facilities that support the maximum level of accuracy and work output.

To assure sound personnel and operational management, the board should establish the following:

- Personnel policies and procedures;
- Position descriptions for all employees;
- Performance evaluations at least annually for all employees (including top management);
- Training programs for officials and employees; and
- A screening process for new employees.

Now, do not panic! I doubt that you will develop these policies. In most cases, this will be done by your management team. But as you are ultimately responsible for the affairs of your credit union, you'll want to ensure that these controls are in place. Your supervisory committee can help in this area as well.

These are just some of the specific duties you have to manage, with your management team's help. Other areas include charitable donations, Bank Secrecy Act (BSA) compliance programs, information security programs, vital records preservation, strategic planning, business continuity planning, and setting the allowance for loans and lease losses.

Necessary and proper. Finally, it is important to note that the Federal Credit Union Act and state law note that you are responsible for doing whatever is necessary and proper to ensure the safety and soundness of your credit union. In other words, you need to do whatever it takes to get the job done, while working with management.

CORPORATE GOVERNANCE

What is corporate governance? As I stated earlier, it is the process (people, policies and procedures) that implements the goals and plans of your credit union. Corporate governance is what you will use to make sure things are done according to plan. There's no silver bullet for corporate governance, and many will say that the process is more of an art-form than a science.

THE CEO

How do you compensate your CEO and how much is right? You've heard me mention this before, but there's no one answer to that question. How large is your credit union? How much experience does your prospective CEO have? There are outside experts who can help you craft a compensation package. Remember this, though: management compensation policies should be supported. The board needs to ensure performance standards are in place for senior management and an effective formal evaluation process is used and documented.

Does your board regularly rate the performance of your CEO? What about rating one another on the board? Without feedback, how can you guide the performance of your management team?

To a large degree, much of this boils down to the relationship you have with your CEO. Can you have frank discussions with him or her? Are communication lines open? The better the communication between a board and a CEO, the better things usually go for the credit union.

I wish I could point to rules or to a set of recommendations here. But there are none. This is where experience proves its worth. And if you aren't experienced in the management of a CEO, talk to your fellow board members. And talk to other board members at other credit unions. Trade conferences are another place where you can gain valuable insight into the process.

STRATEGIC PLANNING

Strategic planning involves a systematic process to develop a long-term vision for the credit union. The strategic plan incorporates all areas of a credit union's operations and sets broad goals enabling credit union management to make sound decisions. The strategic plan should identify risks and threats to the organization and outline methods to address them.

As part of the strategic planning process, credit unions should develop a business plan for the next one or two years. The board of directors should review and approve the business plan, including a budget, in the context of its consistency with the credit union's strategic plan. The business plan is evaluated against the strategic plan to determine if the two are consistent. Examiners also assess how the plan is put into effect. The plans should be unique to and reflective of the individual credit union.

Information systems and technology should be included as an integral part of the credit union's strategic plan. Examiners assess the credit union's risk analysis, policies and oversight of this area based on the size and complexity of the credit union and the type and volume of ecommerce systems and services offered. Below are some questions and answers provided by NCUA following a training session on strategic planning.

Question: *Should supervisory committee members or the compliance officer participate in planning sessions?*

Answer. To be most effective, the planning process should be conducted by a planning team. The make-up of the team will vary from credit union to credit union, but the team approach brings a variety of perspectives together, creates a sense of ownership and facilitates cooperation to implement the plan.

Question: *How often should a credit union have a strategic planning session? Should the strategic plan be for a static period of time or on a rolling timeframe?*

Answer. 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 three to five years, on a rolling timeframe, and should be reviewed and updated on a regular basis, most often annually.

RISK MANAGEMENT

Another way to think of your job is to create a game plan for your credit union, and then protect it (manage it) from all the potential risks to its operations. This is much harder than you might imagine. In March of 2020, the COVID-19 crisis swept across America. As of this writing, our nation continues to deal with it. How many of you had addressed the possibility of a pandemic as part of your risk analysis last year? That being said, NCUA has organized risks into seven categories. What are those risks?

Credit risk. Every time your credit union makes a loan, there's a chance the member will not pay you back. And the same goes for investments. Credit unions must manage that risk, but not eliminate it. The only way to completely erase credit risk is to stop making loans. And that's not a good idea. Again, this year has shown how fast risks can shift. Within a month, the U.S. unemployment rate went from under 4 percent to more than 15% due to the COVID-19 crisis.

Interest rate risk. Interest rate risk is the risk to your credit union from changes in outside interest rates. While your credit union sets its share and loan rates, these rates are dependent on outside forces, such as certain key rates the Federal Reserve sets. These rates often determine how expensive it is for the credit union to borrow money. They indirectly determine share rates, and they also can affect rates for all types of consumer loans.

Liquidity risk. It is the risk to earnings or capital arising from the inability to meet obligations when they come due, without incurring material costs or unacceptable losses. In other words, this is the risk that the credit union could run out of liquid assets to make loans, cover payroll, pay vendors, etc.

Transaction risk. Transaction risk is the risk to the credit union from fraud or error that results in an inability to deliver products or services, maintain a competitive position and manage information. If you don't believe this is a large threat, please Google "credit union" and "embezzle." You'll be shocked.

Compliance risk. Compliance risk is the risk from not complying with laws, rules, regulations, prescribed practices, internal policies and procedures, or ethical standards.

Strategic risk. This risk revolves around the compatibility of a credit union's strategic goals, the business strategies developed to achieve those goals, the resources deployed to accomplish these goals, and the quality of implementation. Is your credit union deploying a strategy that ensures its viability for years and decades to come? This is a tough risk to manage. Just think of Blockbuster Video, Circuit City and Blackberry. At one point they were on top of the world. Today? *Not so much.*

Reputation risk. As Mr. Benjamin Franklin put it, it takes a lifetime to build a reputation. And only a moment to destroy one. Reputation risk affects the credit union's ability to attract new members and keep the ones it has. This risk, which occurs in activities such as asset management decisions and transactions, can expose the credit union to litigation, financial loss or a decline in membership base. Reputation risk exposure appears throughout the credit union organization. The officials, management and staff must accept responsibility to exercise an abundance of caution in dealing with members and the community. I'll say this also about reputation risk: Today's world of social media heightens the possibility of a small issue growing into a major threat to your reputation. Many individuals and organizations learned this lesson the hard way.

Does NCUA want you to eliminate risk? No. They want you to manage it. Here's what NCUA expects:

First, you have to look for and identify risk. Only when you spot it can you do anything about it.

Next, try to measure that risk in some way. Once you know how much risk you have, you can then try to manage it. You could ignore it. A silly, yet useful illustration is the risk that your credit union will be destroyed by a meteor. The risk is minute. But I think you can ignore the risk because, well, there's not that much you can do about it. Other situations may beg for insurance. Your credit union can purchase a number of different insurance products that will help you if something goes wrong. Or you can use internal controls. Are you afraid of internal theft? You could implement dual controls, meaning that two people have to sign off of any important transactions.

Once you've identified, measured and managed risk, you should monitor it moving forward. Only then will you notice if risks increase or decrease.

THE BOARD MEETING

Your corporate governance will start with your board meeting. At board meetings, you'll meet with other directors to do official business. Actions will require a motion and a vote.[8] For example, you may approve a policy, an amendment to your bylaws, or something as simple as the minutes to last month's meeting. You may receive training at these meetings as well, as it may be the one time each month when all directors meet together.

Sometime before your meeting, you'll receive your *board pack*. This will contain information that you'll need for the board meeting. For example, you should have a copy of the minutes from last month's meeting. Or you'll have proposed policies that you'll need to approve or reject. The board pack will also contain a good deal of financial reports. These reports will show you a snapshot of your credit union's financial health. I refer to it as a "snapshot," because the reports may or may not show you trends.

With all of the financial data, credit union officials look to certain financial ratios to help them understand the state of their credit union. Here's an example of a ratio you may be familiar with: your debt to income ratio. Each month, a person pays a certain amount of money to service their debts. Let's assume you pay $1,000 each month to make all the minimum payments for all your loans. And each month, you earn $4,000. Your debt to income ratio would be $1,000/$4,000 or .25%. If that ratio goes up, you know immediately that a larger part of your income is going to service debt. If the ratio goes down, a smaller portion of your income is being spent on debt. Credit unions use this ratio to see how much debt a member has, and whether they can handle it.

Key ratios about your credit union:

Net worth ratio. This ratio reflects the amount of a credit union's net worth when divided by its assets. To understand this, you'd need to know what "net worth" means. Net worth is the number you get when you subtract your liabilities from your assets. This is how much equity your credit union has saved up. So, if you take that amount and divide it by your total assets, you'll get a good measure of how much *cushion* your credit union has. This number can go up two ways: you can increase your net worth, or you can decrease your assets. When credit unions go through tough times or write off major losses, they may see this ratio drop. NCUA regulates this ratio. If it drops below certain levels, the agency may order a prompt corrective action to increase reserves and raise this ratio. To be well capitalized, a credit union's net worth ratio must be at be at 7% or higher.

Delinquencies and charge offs. The delinquency ratio measures the percentage of loans that are delinquent. You may have one ratio that measures loans that are 30 days delinquent or more, or others that measure 60 or 90 days of delinquency. Management may also provide ratios that measure select portions of your lending portfolio, such as your real-estate loans. The higher the ratio, the greater portion of your loans that is delinquent. What is a good number? That's hard to say. For example, you may accept a higher delinquency rate in order to make higher-risk loans that pay a higher rate of return (in interest payments). These ratios are best seen over time. If the same type of loan sees higher and higher delinquency rates, something is happening. The economy may be weakening. A local manufacturing plant may have laid off workers. Or your underwriting standards may need to be tweaked.

The charge off ratio is a similar tool. This measures, as a percentage, the amount of loans that your credit union is writing off as a loss. Charge off policies may vary from credit union to credit union, so it is always good to read this ratio with other information, such as your delinquency rates.

Return on assets (ROA). This ratio is calculated by dividing a credit union's annual earnings by its total assets. This is displayed as a percentage. This ratio can help you determine how efficient your credit union is at generating income. The higher the ratio, the more

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[8] *This is something I've always told to new board members. (Soapbox Warning!) A board is all-powerful within an organization. But an individual director is powerless. Only if a majority of directors vote to pass a motion, does a board actually accomplish anything. Let me give you an example. During a meeting, a director asks the CEO to include a new report in the board packet. A few other directors nod in agreement. Another board member mentions a different report that she would like added, and two that she thinks can be removed. The Chair says that these seem like a good idea. While this seems innocent, it puts the CEO in a tough position. Did the board ask for these changes? Or was it just these two directors? There was no vote, and no discussion on whether people were for or against it the changes. In addition, if this continues, other board members may be encouraged to directly ask the CEO for changes without going through the channels of a board meeting. Remember – the CEO works for the Board. Not individual directors.*

income that you've created, related to your assets. Seen over time, this ratio will help you determine whether your credit union's performance is improving or deteriorating. Earnings, however, can be affected by a number of factors. When the overall economy weakens, this ratio normally goes down. If a credit union sells a major asset, such as a building or a credit card portfolio, this ratio may increase greatly. However, if the ROA increases from a one-time event, the ratio will usually drop down to normal levels in subsequent periods. That's why ratios are best used over time. One final thought on ratios: no ratio will explain everything. But it may prompt you to ask questions when a change in a certain ratio raises a red flag.

Meeting rules. Are there official rules that govern how you conduct your monthly board meeting? Not really. Many credit unions use Roberts Rules of Order to govern activity during their meetings.

MORE GOVERNANCE

How much corporate governance is enough? This should be the million-dollar question. Why is that? Because if I had the answer to the first question, I'd be able to sell it for a million bucks. How much corporate governance is enough? How much board attention to a matter is sufficient? Should you spend your time focusing on regulatory risk or interest rate risk? Should you give your CEO and management team a wide amount of latitude, or should you monitor their every move? There's no right or wrong answer. But no one approach will work in every situation.

How much is enough? It depends. For example, when hiring a new CEO, you may never be able to do enough due diligence. But note that all the due diligence in the world will never guarantee the perfect hiring. Remember, your goal, your job, is to provide direction and control the credit union – generally. (*Soapbox warning.*) You should take a holistic approach to the credit union. Don't focus on any one area too much. If you are in the weeds too much, if you are second-guessing and micromanaging on every topic, you will run out of time before you can adequately review all the important aspects of your credit union. If you are too hands off, the opposite can happen. Ignore your board pack and never ask questions of your CEO, and you've just come up with a recipe for terrible corporate governance.

There is help. Your supervisory committee is charged with reviewing your credit union's financial data and internal controls. If they see weaknesses, they should notify you via the credit union's audit. Don't underestimate the worth of your supervisory committee. They may just end up keeping you out of a tight spot.

Finally, never forget the ability of the membership or the supervisory committee to call special meetings. If things get out of control, this is the "in case of emergency, break this glass." Special meetings can shine a spotlight on problems at your credit union. For that reason, do your best to never let things spiral out of control. Don't ignore problems. Deal with them. In the end, that's your one true job.

TO SUMMARIZE

In short, you are ultimately responsible for your credit union's success. Good boards, while accepting responsibility, know that they must delegate the day-to-day operations to a CEO. So what's the key to success? Think strategically and plan as much as possible. Choose a good CEO, and then delegate to them. But never forget to monitor their performance and the credit union as a whole. If you stick to these simple rules of thumb, you should have a successful and rewarding credit union career.