Credit Union Directors NEWSLETTER

January 2023
Volume 49
Issue 1

6 key internal controls to watch

Supervisory committees play a crucial role in addressing risk.

One of the supervisory committee's most important responsibilities is to ensure their credit unions' internal controls are secure and strong.

Tim Harrington, president at TEAM Resources, defines internal controls as a system of checks and balances that prevent errors or fraud.

"Good people tend to do bad things when money is involved," says Harrington, who addressed CUNA's 2022 Supervisory Committee & Internal Audit Conference. "That goes for people both inside and outside the organization."

The supervisory committee's involvement with internal controls usually depends on the credit union's size, according to Harrington. Larger credit unions typically use third parties for this function.

"Supervisory committee members might need to simply ask questions on how to decide what's a good control and how you test those controls," Harrington says. "But in small credit unions, the supervisory committee may have to roll up their sleeves and do it because they don't have the budget to bring a third party in to do it for them."

Harrington outlines six key internal controls and their requirements:

1. Cash. This is an "inherently attractive" danger for credit unions, but the level of risk is actually low, he says. Problem areas include teller cash drawers, recycler cash, and vault cash.

Periodic cash counts are the best control for funds controlled by tellers. Credit unions should require dual controls for cash dispenser funds, vault funds, and key and combination access to drawers and vaults.

> "**GOOD PEOPLE** tend to do bad things when **MONEY** is involved."
>
> Tim HARRINGTON

Cash counts should verify the amount recorded with an emphasis on precision. Teller balancing sheets should agree with the general ledger.

The cash count should take place in the morning, and multiple credit union employees should observe the procedure.

Harrington says dual control is especially important at small credit unions.

"The possibility of fraud at small credit unions is much greater because so often there aren't enough people for dual control," he says.

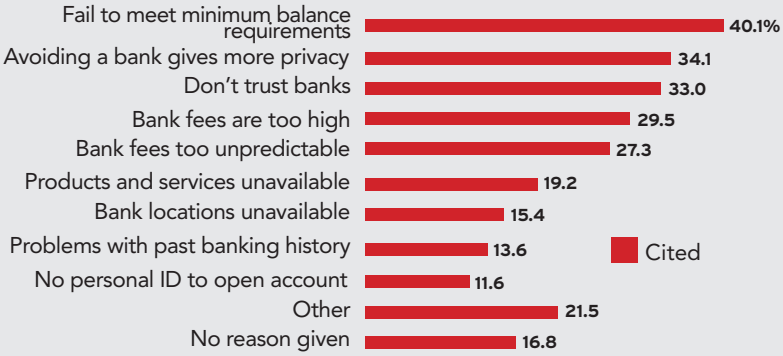
2. Loans and credit cards. The risk level with loans and credit cards is medium to high, with problem areas including employees setting up false or unauthorized loans, eliminating loan balances,

QUICK TAKE for your next board meeting

Mixed signals on the unbanked and cashless

The percentage of U.S. households lacking a checking or savings account fell to 4.5% in 2021, according to the 2021 FDIC National Survey of Unbanked and Underbanked Households. That's the lowest level recorded since the agency began tracking this information in 2009. The top reason for not having a bank account: not enough money to meet minimum balance requirements.

Unbanked households' reasons for not having a bank account



Source: 2021 FDIC National Survey of Unbanked and Underbanked Households

advancing due dates to avoid repayments, hiding delinquency, and changing interest rates and other terms.

Controls on loans and credit cards include blocking employees from accessing their own accounts, regular review of employee and family member accounts, regular review of exception and file maintenance reports, and proper segregation of duties.

Among the exception reports Harrington recommends for review: loans paid ahead, loans with low interest, loans with accrued interest exceeding payment, and loans with current balance exceeding original balance.

3. Share draft and savings accounts. The primary risks are employee actions such as manipulating their own or family members' accounts, depositing bad checks or falsifying accounts, depositing member funds in their own accounts, check kiting, or overdrafting their own accounts.

Internal controls with share draft and savings accounts include regular review of employee and employee family accounts, diligent member verification procedures, and regular review of negative share balance reports.

4. Dormant or inactive accounts. These carry a high level of risk because of the possibility of employees using the accounts to make unauthorized transactions or initiate loans. The best controls are consistent policies and regular review of dormant and inactive accounts.

5. General ledger accounts. Risks include embezzling funds, hiding withdrawals, and failing to reconcile affected accounts, which leaves embezzlement undetected.

The best control is to require regular and timely reconciliations every month that are approved by someone senior to the preparer.

6. Repossessed collateral. The biggest risk here is selling collateral to friends and family members, employees taking possession of the collateral at a reduced cost, or selling the collateral to dealers at a reduced cost. The written policy should specifically prohibit these actions and require the review and documentation of all sales.

Ready for CECL? 5 questions to consider

Check with management about their approach to the new standard.

Dean Rohne and Tanya Medgaarden, principals at CLA, gave an overview of what supervisory committee members can expect from the upcoming implementation of the current expected credit losses (CECL) standard during CUNA's 2022 Supervisory Committee & Internal Audit Conference.

CECL is a principles-based, rather than a rules-based, standard for determining allowance for loan and lease losses (ALLL), Medgaarden says. As such, it's a forward-looking requirement for determining expected losses over the life of a loan rather than over a single operating cycle.

The standard's effective date for most credit unions is Jan. 1, 2023. NCUA released a simplified CECL tool for small credit unions in September.

> "From a call report standpoint, the initial adjustment is going to hit the net-worth calculation over a three-year period."
>
> Tanya Medgaarden

NCUA implemented a three-year phase in for net worth, Medgaarden notes. "From a call report standpoint, that initial adjustment is going to hit the net-worth calculation over a three-year period."

The most common methodologies credit unions are expected to use in calculating CECL are loss-rate methods, such as the weighted-average remaining maturity method (WARM). Both NCUA and the Federal Reserve offer Excel-based WARM tools.

One challenge for credit unions under CECL will be the qualitative and environmental (Q&E) factors in their ALLL calculations, Rohne says. "Hopefully, the three-year phase in will ease some of those challenges over time."

Among the Q&E factors credit unions must consider include portfolio trends and concentration, economic and market trends, changes in lending practices, changes in loan review systems, geographical considerations, and other factors such as national emergencies.

Medgaarden and Rohne offer five questions for supervisory committee members to consider:

1. Has management identified a CECL methodology or approach?

2. Can management explain how the models function?

3. Has the credit union run different scenarios to assess model performance?

4. Is there a process to support Q&E factors?

5. What process will you implement for model validation?

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CPA brings financial acumen to board duties

'I'm passionate about helping my clients achieve their goals.'

Tina Makoff, board chair at $50 million asset Hawaii First Credit Union in Kamuela, shares insights on her credit union's strategic imperatives and how she advocates for Hawaii First in her community.

Credit Union Directors Newsletter: How did you become involved with credit unions?

Tina Makoff: My involvement began as a child. My dad was a career railroad engineer and was a member of different credit unions. My first account was at Bismarck (N.D.) Railroad Credit Union and my first loan was at Glenwood (Minn.) Railroad Credit Union. The $1,000 loan was for a very used car while I was in high school. My parents felt it was important to establish credit and begin a loan history.

My board involvement began 10 years ago. The previous chairperson and I had a working relationship as her certified public accountant (CPA) and fellow finance team member at church. She recruited me to get involved as a board member. Upon her retirement she asked me to become the chairperson.

> "The greatest benefit of membership is becoming part of an organization that truly invests in your financial health."
>
> Tina Makoff

Q: How does your full-time job inform your board role?

A: I'm a CPA and own my own firm. In addition to tax preparation, I perform consulting and financial planning. I'm passionate about helping my clients achieve their goals personally and in business. This fits well with the credit union motto of "people helping people."

Q: What do you find most rewarding about being a board member?

A: The most rewarding aspect of being a board member is hearing the success stories of helping our members. Success can mean a member achieving home ownership or becoming a first-time borrower, or watching an employee advance in their career and become an ambassador of the credit union movement.

Q: What are your credit union's greatest challenges?

A: The cost of compliance is staggering. The cost of education for both our members and our employees is high. Our niche income stream is dependent upon our county planning department and their permitting process. Over the past couple of years, it's been significantly delayed, which affects our income stream.

Q: What do you convey as the greatest benefit of membership?

A: The greatest benefit of membership is becoming part of an organization that truly invests in your financial health. Between our credit union and the community resource center nonprofit arm we offer, we have the tools to assist members in achieving their dreams. Our employees are creative. They seek to review the full financial picture and get each member the financial tools they need.

Q: What advice do you have for new board members?

A: Three things: Invest time in getting to know employees of the credit union, learn the culture and the products your credit union offers, and be patient with yourself as you learn the reports, trends, people, and community of all things credit union.

Read the full interview at *news.cuna.org/directors.*

Resources

CUNA Governmental Affairs Conference, Washington, D.C., Feb. 26-March 3, 2023: *cuna.org/gac*

CUNA board and committee solutions: *cuna.org/board*

CUNA Board of Directors Community: *community.cuna.org*

CUNA events and training: *cuna.org/events*

Onboarding: more than a welcome dinner

Introduction process requires technical and cultural information.

The onboarding process for new supervisory committee members should include information about the technical, regulatory, and legal aspects of the financial services industry, says David Reed, principal at Reed and Jolly PLLC.

"The three biggest regulated entities in the U.S. are medical, education, and financial," says Reed, who addressed CUNA's 2022 Supervisory Committee & Internal Audit Conference. "Every product, service, and delivery method is governed by laws, rules, and regulations. You don't need to be experts, but you should be familiar with rules such as Fair Lending and the Bank Secrecy Act when you see it on an audit report."

Industry-specific information should address credit unions' unique attributes. "It's not OK to say we're a bank," Reed says. "We're owned by the end users, and we're not for profit. That's important to everything we do. Everyone in your organization should know this, from the teller line to the supervisory committee."

New supervisory committee members should be formally introduced to NCUA Regulation 715, which covers the committee's general duties, he says.

New committee members should also gain familiarity with the credit union's bylaws. "Every credit union's standard bylaws list the duties of the supervisory committee," Reed says. "The regulatory blueprint for these bylaws is either the Federal Credit Union Act or state act."

The credit union industry is also rife with acronyms. Reed advises credit unions to develop a glossary supervisory committee members can reference.

Every credit union has a unique culture. "Why was your credit union founded? Almost assuredly it happened because a group of people didn't feel the community's financial services were meeting their needs," Reed says. "We can always look back and ask ourselves if we're serving with that same spirit today."

Board and committee members should learn about the credit union's culture, such as what behavior is rewarded and what is frowned upon.

Also valuable is information about the credit union's products and services, how they relate to each other, the risks involved with each, as well as why the credit union doesn't offer certain products.

"This is a great opportunity to introduce new supervisory committee members to the credit union's approach to risk management," Reed says. "Risk isn't bad, but it must be managed. You can't operate a credit union or make loans without a certain level of risk. Regardless of size, more credit unions are moving toward enterprise risk management."

A welcome packet is another valuable tool. This packet should be a mix of information about the credit union and the industry, an organizational chart, meeting schedules, and marketing swag.

Mentoring programs can be an effective way to set ground rules, learn about committee members' preferences, and provide an opportunity to ask questions, Reed says. "It's somebody the new volunteer can talk to. They can ask questions about all this new information they're confronted with. But most of all it's about accountability for the committee and the new volunteer."

"Every credit union's standard bylaws list the duties of the supervisory committee."

David Reed

CREDIT UNION DIRECTORS NEWSLETTER
(ISSN 1058-1561) is published monthly for $100 per year by the Credit Union National Association, 5710 Mineral Point Road, Madison, WI 53705-4454. (Multiple-copy discounts available.) Also available as a downloadable PDF for an annual subscription rate of $773. Periodical postage paid at Madison, Wis.

POSTMASTER
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