

Chapter 28

BOND COVERAGE

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Chapter 28

BOND COVERAGE

Examination Objectives

- Determine if the credit union has adequate bond coverage to comply with Part 713 of the *NCUA Rules and Regulations*
- Determine if bond claims were filed when appropriate

Associated Risks

- Compliance risk – Includes the risk that the bond coverage does not comply with the *Federal Credit Union Act* and *NCUA Rules and Regulations*; and
- Reputation risk – Includes the risk that bond coverage does not adequately cover losses resulting from employee or director fraud, dishonesty, theft or other similar activities, resulting in poor publicity or administrative action.

Overview

The *Federal Credit Union Act* §112, §113(2), and §120(h) set forth the statutory requirements for the bonding of credit union employees and appointed and elected officials. §120(h) requires that the NCUA Board approve bond forms and prescribe minimum bond coverage. The Act directs the NCUA Board to promulgate regulations setting forth both the amount and character of bond requirements for employees and officials. It also grants the NCUA Board the power to approve bond forms and to set minimum requirements for bond coverage.

Part 713 of the *NCUA Rules and Regulations* contains the NCUA Board's bond regulation, which is made applicable to state-chartered natural person credit unions by §741.201(a). Part 713 prescribes the form and the minimum schedule of bond coverage for natural person credit unions.

This chapter discusses the bonds used by credit unions, known as "fidelity" bonds, "blanket" bonds, "surety" bonds, or "discovery" bonds. Whatever the terminology, the bonds all provide the same type of coverage: primarily coverage against losses caused by fraud, dishonesty, theft, and other similar activities. The bond may provide

coverage for lack of faithful performance, but neither statute nor regulation requires that coverage.

Fidelity Bond Review

During the course of an examination, the examiner may (1) determine that the fidelity bond is in force in an amount at least equal to regulatory minimums; (2) document in the examination workpapers the bond type, bonding company name, amount of coverage, and any deductibles, riders, and other clauses; and (3) be alert to any unprotected areas of risk for the credit union.

Some writers of credit union fidelity bonds have a risk management division whose auditors will, upon request, perform a risk management audit designed to detect internal control weaknesses.

At times, examiners may determine that criminal activity or a bondable loss has occurred which may affect the bondability of an employee or an official. The examiner should provide details to the board of directors and obtain an agreement for immediate action. The board is responsible for notifying the bond company, federal and local authorities, the SSA, as appropriate, and the regional office. A credit union must complete a Suspicious Activity Report (SAR) whenever it reasonably suspects criminal activity. Examiners should determine that the credit union has filed a SAR within the required time, when necessary. If the board has not, or will not, complete the SAR the examiner should complete the SAR, file it in accordance with SAR instructions, and notify the regional office and SSA, as appropriate.

Background, Requirements and Approved Bond Forms

All credit unions must provide fraud and dishonesty coverage for employees and officials. NCUA mandates that each federal credit union board provide adequate coverage. The NCUA Board has the authority to require that a federal credit union obtain additional coverage when the coverage in force is not adequate (§713.7.) Adequate bond coverage may require coverage in excess of the prescribed minimums. The directors should review the extent of coverage at least annually (§713.2.) They should consider the credit union's loss exposure, internal controls, and financial resources when determining the amount and the type of coverage necessary. This determination is particularly critical since the credit union will need to

decide whether to purchase optional faithful performance coverage, if available.

The e-library and at www.ncua.gov under the Reference Information section, Credit Union Bonds, contain the list of currently approved bond forms for federal credit unions.

Undoubtedly, NCUA will approve additional bond forms in the future. The regional office has copies of each approved bond form. Examiners should check with the regional office if they have concerns about a form.

Endorsements and Riders

Bond companies issue endorsements or riders to the bond that add to, or delete from, the basic bond coverage. Examiners should carefully review any endorsements or riders that exclude coverage and determine if the endorsement or the rider reduces coverage below the minimum coverage in the approved bond form. If examiners cannot determine the effect of the endorsement or rider, they should contact their supervisory examiner and, if necessary, send a copy to the regional office with an accompanying memorandum. Riders that reduce coverage provided by the basic bond must have the approval of the NCUA Board. Riders that add coverage under the bond do not need NCUA Board approval.

Faithful Performance Coverage

The credit union's board of directors make a business decision regarding whether to purchase faithful performance coverage, although state law or regulation may require state-chartered, federally insured credit unions to maintain such coverage. The contract between the credit union and the bonding company determines the definition of the term "faithful performance." Not every company will sell faithful performance coverage.

Principles and Obligations for Fidelity Losses

While a fidelity bond represents a contract between the credit union and an insurance company, the act of a third party (employee or official) invokes the duties under the contract. The three party nature of the contract distinguishes it from other insurance contracts. (See the section on Insurance Losses for further discussion.)

The credit union should comply strictly with the terms of the bond to recover from the bond company. The time limits for filing a notice of loss, proof of loss, or filing of a lawsuit against the company should strictly adhere to those specified in the contract, unless the company waives these time limits in writing. If not, the credit union's rights may be prejudiced. Bonding companies measure most of the time limits from the date of discovery of either a wrongful act or a loss.

"Discovery" usually means specific knowledge, but more than mere suspicion, by a responsible person (manager, official, board member.)

A credit union owes a duty of good faith to the bond company. This includes disclosure to the bond company of acts of employees, of which it has knowledge, which increase the bond company's risk. Since the question of whether a reportable loss has occurred will often arise during an examination or supervision contact, the directors will frequently ask the examiner to help them arrive at a decision as to reporting or giving notice of loss to the bond company, to the recovery of the funds, or to the filing of a claim.

The board of directors must ultimately make decisions regarding these factors. The examiner may guide the directors in protecting the credit union's interests under the bond. The bonding company could hold directors personally liable for losses suffered by the credit union when they fail to file a claim in accordance with the requirements of the bond. If the directors disagree with the examiner that they should report an act, that a loss occurred, or that they should give a notice of loss to the bond company, the examiner should follow the guidance provided in the Shortages chapter of this Guide.

**Insurance
Losses**

Bonds authorized for use by credit unions also may contain insurance coverage for direct loss of property. This coverage protects the credit union against the direct loss of property caused by such things as larceny, burglary, robbery, mysterious disappearance, outside forgery, and the damage or destruction of property due to these incidents. These examples are not all inclusive, and each bond does not include all of them. Under these insurance clauses, the bonding company does not require the credit union to determine the identity of wrongdoers to recover losses, as it must do to recover for a loss of property caused by acts of its employees. However, the credit union should file insurance

type claims in a manner similar to claims for fraud or dishonesty (i.e., by filing a notice of loss followed by a proof of loss within the time frames called for by the policy.)

Covered Losses

The approved bonds cover only direct losses of property. For example, if an employee steals \$10,000 by creating a fictitious loan, the \$10,000 is a direct loss of property, which the bond covers. However, the bond does not cover the interest income that the credit union might have earned on this \$10,000.

For this same reason, the bond usually does not cover expenses of recovery such as legal fees, although the bond or a purchased endorsement to the bond often separately provides for audit expenses. The examiner may review the audit expense coverage, if purchased, for adequacy to protect the credit union from the unexpected expense of documenting a claim by outside auditors. The minimal audit expense coverage often seen in credit union bonds probably will not cover the costs of a proof of loss audit. Examiners may find it appropriate to suggest that the board of directors consider a higher audit expense limit.

Claims Under the Bond

The credit union needs to inform the bond company of the facts in all cases where fraudulent or dishonest conduct occurred, or, if it has purchased faithful performance coverage, in all cases which might meet the definition of faithful performance contained in the bond. Examiners should use caution in developing the facts and in making recommendations to the directors. Good judgment in making decisions in this respect is essential.

It is important to distinguish between the reporting of fraudulent or dishonest acts and the filing of a claim. The credit union need only file a bond claim when it has suffered a loss. For example, if a credit union has faithful performance coverage, and the manager knowingly makes several mortgage loans without getting appraisals, checking titles, or making credit checks, this might constitute a lack of faithful performance. Nevertheless, if the borrowers make the contracted payments on the loans, then the credit union has not yet suffered a loss and cannot file a bond claim.

The credit union should report fraudulent or dishonest acts, or conduct amounting to a lack of faithful performance (if the credit union has such coverage), whether or not the credit union has suffered a loss. If a loss has not yet occurred, the credit union should inform the fidelity company that it will file a bond claim at the appropriate time. Subsequently, when the loss occurs, the credit union should file a notice of loss, although it need not wait until it knows the exact amount of the loss.

Officials should always examine the bond itself to determine the scope of coverage. If examiners have questions about the coverage the bond provides, they should contact their supervisory examiner. Nevertheless, whether or not a particular set of circumstances represents a claim under a particular bond, the officials should notify the fidelity company of all fraudulent or dishonest acts, or acts indicating a lack of faithful performance (if the credit union has such coverage) to ensure continued coverage for the employee involved and to protect the credit union in the event a loss occurs.

Acts That May Terminate Bond Coverage - Letter of Notification

The credit union should report only facts to the bond company in a notice of improper acts by an employee or any other communication to the insurer. The credit union should not engage in speculation about how a loss or potential loss occurred. The following items can be included in the letter of notification (the bond itself contains specific requirements):

- Description of the act;
- Name and position of persons whose acts may have terminated bond coverage as it applies to them;
- If possible, specific law, bylaw, rule, regulation, policy, or standard of conduct violated;
- An explanation of the acts, which indicates whether they were fraudulent, dishonest, or unfaithfully performed;
- Action taken to correct the acts;
- Action taken to prevent recurrence of the acts; and
- Request to bond company for a statement of its willingness to continue bond coverage on persons whose acts are in question.

The examiner should encourage the credit union to specifically mention the names of all responsible persons in the letter when it can clearly determine responsibility. The examiner may assist the officials in drafting the letter, but should bear in mind that the credit union, not the examiner, writes the letter. In the event the credit union refuses to notify the insurer, then the examiner should follow the guidance contained in the Shortages chapter.

**Notice and
Proof of Loss**

The notice of loss is usually very short, factual, and contains no speculation or guesses. Credit unions need not know the exact amount of the loss before giving the notice. In fact, a delay until determination of the exact amount could jeopardize collection of the claim.

The following are items that the credit union should include in the notice of loss (refer to the bond for specific requirements):

- Statement specifying discovery of a loss;
- Date of discovery of the loss;
- The amount of the known loss at the time of the notice;
- A brief statement of the circumstances surrounding the loss;
- Name, position, and address of the person responsible for the loss;
- Information as to whether the responsible person was removed from office;
- Request for acknowledgment of the notice of loss; and
- The SAR, if filed, should not be included as an attachment to the notice.

The notice of loss puts the fidelity company on notice that a loss has occurred and that a claim may follow. Each bond requires filing of a proof of loss or claim within a specified period of time after the notice of loss. The proof of loss will usually require a more detailed and documented explanation of the loss suffered, the acts causing the loss, and why the credit union believes the bond covers the loss. As with the notice of loss, the credit union should refer to the policy to determine the specific requirements for the proof of loss.

**Bond Claim
Follow-up**

Bonds generally specify that the bond company has a certain number of days after a credit union files a proof of loss to investigate the loss.

Unless the directors receive payment within a short time thereafter, they should follow up and request prompt settlement. If the bond company denies a claim, it should do so promptly and advise the credit union of the reasons for the denial.

Examiners should keep in close contact with any credit union in their district that has filed a claim with the bond company. If the bond company delays paying a valid proven claim, the examiner should urge the directors to follow up promptly.

Since most bonds require the credit union to bring a lawsuit against the bond company within a specified time after discovery of the loss, the examiner may wish to recommend that the credit union engage legal counsel to help it in negotiating payment of the claim or to determine the advisability of filing suit to collect on the claim. If the credit union appears to be making progress in negotiating and settling the suit, but may not meet the deadline for filing suit, the credit union may wish to secure an extension of the time for filing suit from the bond company.

**Workpapers
and
References**

- References
 - *Federal Credit Union Act*
120(h) - Powers of the Board and Administration
 - *NCUA Rules and Regulations*
713 - Fidelity Bond and Insurance Coverage for
Federal Credit Unions
NCUA Letter No. 96-CU-3, Suspicious Activity Report
NCUA Letter No. 00-CU-04, Suspicious Activity Reporting
NCUA Regulatory Alert 96-RA-3 SAR Software Program
NCUA Regulatory Alert 01-RA-11 Suspicious Activity Report