Chapter 14

SHARE STRUCTURE

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Examination Objectives

- Determine whether the credit union has a realistic share product mix and pricing policy
- Determine whether the share program meets the needs of the members
- Analyze the share mix to determine whether it provides for adequate earnings
- Determine whether the share program incorporates adequate internal controls
- Evaluate the reasonableness of fluctuations in the shares and share mix
- Determine whether the share program meets all legal requirements

Associated Risks

- Interest rate risk - improper pricing of products constitutes the leading cause of interest rate risk;
- Liquidity risk - improper pricing and poorly timed duration can cause liquidity risk;
- Reputation risk – improper pricing and product mix, and illiquidity can result in reputation risk;
- Strategic risk - ineffective planning of the share product mix and pricing policies can result in strategic risk;
- Credit risk - allowing members to overdraw accounts can result in credit risk to the organization;
- Transaction risk – improper transaction processing and controls of share account types and processing failures can cause other risks (e.g., interest rate risk, liquidity risk); and
- Compliance risk – inadequate or ineffective compliance policies regarding account disclosures for interest rates, yields, or terms can result in loss exposure.

Overview

Share accounts are the primary source of funds for credit unions. As such, the share program should conform to the credit union's asset liability management policies. In determining the proper share mix, the credit union must consider the cost of funds, the matching of funds with corresponding assets, and the needs of the members. Management must monitor the share structure and make appropriate changes in a timely manner when needed.

The extent of the examiner's analysis depends on the complexity of the credit union's share structure. The examiner considers such factors as the following:

- Share policies (i.e., terms, dividend rates, fees, etc.); and
- Effect of the share policies on net income, short- and long-term goals, and funds management.

When examiners have concerns with the share program, they should perform sufficient procedures to address and resolve their concerns.

Examination Procedures

Most information systems provide management reports at the end of the members' trial balance. Although the number and types of reports vary with each information system, these reports should enable the examiner to verify the share account balances and confirm the breakdown of share types.

Share Draft Programs

Examiners may review share draft programs to determine the extent of the credit union's control over share draft processing, balancing, and posting. Credit unions must promptly (at least daily) review and process overdrafts and related loan advances, and clear processing exceptions. Examiners should expand their analysis when they encounter or have reason to suspect material risk factors.

Material operational problems (e.g., out-of-balance individual share draft ledgers, failure to promptly post share drafts, out-of-balance bank settlement accounts, and lack of proper control over overdraft activity including exception processing) can prevent a credit union's share draft program from functioning properly. Because share draft programs involve third parties, a credit union's failure to properly maintain internal operations over this program could damage its reputation resulting in increased reputation risk. Delays in processing drafts received for payment can increase credit risk and result in material losses.

Operational Flow

With share draft programs, members write drafts and present them to third parties, who present the drafts received to their own banks. The payee's bank forwards the drafts through bank clearing channels for presentation to the credit union's payable-through bank. The payable-through bank receives the drafts and makes provisional payment subject to payment or dishonor by the credit union. Upon receipt of the drafts, the payable-through bank presents the information on the drafts to the credit union. Normally, the payable through bank converts the information on the share drafts to an electronic medium (magnetic tape) transmits it to the credit union for payment or dishonor (the bank may also transmit the information directly to the credit union's information system process supplier.) The credit union then approves payment and posts the share withdrawals to the members' accounts.

Sound Operation

It is the board of directors' responsibility to establish sound operational and internal control procedures to safeguard the integrity of a share draft program. A credit union should obtain a written legal opinion that the program not only conforms with federal law and regulations, but also any state law requirements or other requirements, such as clearing house rules. A credit union may use its own routing and transit number (payable-at method) or the routing and transit number of the payable-through bank (payable-through method.) The board of directors should evaluate the cost and conveniences of the two methods before selecting one.

Overdrafts

When a credit union receives a share draft that overdraws a share draft account, it has several options available:

- Return the draft as not paid for lack of sufficient funds.

- Accept the draft pending receipt of payment from the member to cover the overdraft. This is rare and usually involves small overdrafts. Credit unions should establish sufficient internal controls to prevent abuse.

- Accept the draft and create an overdraft, and then clear the overdraft by a transfer from another share account or by an advance from a line of credit, special loan plan or other arrangement established with the member.

Credit unions that offer a line of credit for share draft accounts should ensure the member signs two separate agreements: a line of credit agreement and a share draft agreement. The credit union must comply with any provisions for lines of credit in the NCUA Rules and Regulations. The share draft agreement may authorize the credit union to transfer the amount of loan advance to the share draft account.

Verification

Credit union officials do not normally review the share draft to determine if the member signed the draft presented. Members review the periodic statement for unauthorized drafts. If members find an unauthorized draft, they must notify the credit union.

When a credit union receives notice of an unauthorized draft, the credit union should retrieve the original draft or a copy of the original draft for comparison against the signature card on file at the credit union's office. The board of directors should determine that adequate insurance coverage exists for forged drafts.

Fees

Credit unions offering share drafts to their members may charge periodic fees or service charges to their members using share drafts (e.g., for the distribution of interim statements, processing stop payment orders, overdrafts, obtaining copies of paid drafts for a member, and the actual cost of each member's blank share drafts.) The board of directors establishes the fee structures.

Business Share Accounts

For credit unions offering business share accounts, examiners should assess the materiality of these accounts on overall operations. Examiners may need to expand the scope of the examination in this area based on the following:

- Numbers and amounts of the business share accounts;
- Degree and effectiveness of internal controls surrounding these accounts; and
- Increased risk resulting from offering these shares.

Determining the materiality of business share accounts may require that examiners review more than just a one-day balance of the accounts. If the credit union does not have available average daily balances, the balances for multiple periods, such as monthly or quarterly ending balances, may give a better insight as to the activity and materiality of these accounts in relation to total shares.

Business share accounts can increase the likelihood of Regulation D and Bank Secrecy Act violations. Examiners should ensure credit unions have in place the proper corporate resolutions supporting signature authorizations for business accounts.

Appendix 14A discusses various types of share accounts credit unions can offer.

Fraud and Forgery

Expertise in fraud and forgery detection is beyond the examiner's role. However, if red flags indicate a potential for forgery, examiners should consult with their supervisory examiner to discuss expanding the examination scope. Appendix 14B contains red flag indicators for share accounts.

Forgery of members' shares involves falsely and fraudulently altering a member's share account to one's own use. Establishing proper internal controls over share transactions reduce the opportunity for fraud on members' shares.

Management should develop and implement a fraud policy. The board of directors should adopt the policy and require that staff give written acknowledgment of receiving and reviewing the policy. A fraud policy sends a signal that officials will not tolerate forgery and other improper acts. The board can also request its bond carrier to conduct a risk management analysis audit. The risk management auditor may recommend additional internal control measures to deter fraud and forgery.

Internal Control Structure

The board of directors bears responsibility for establishing internal controls over share transactions. Those internal controls include administrative controls to establish clear lines of authority and segregation of duties to handle share transactions. Effective internal controls also include accounting controls to ensure accurate and timely share transaction posting.

Credit unions should view the internal control structure as a mechanism to prevent fraud and detect errors, as well as protect the credit union and its employees. Member confidence in the credit union's safety and soundness could diminish if management or staff has manipulated members' shares. The existence of fraud can result in high or increasing risk and a major area of concern. Credit unions rely on good member relations; however, small credit unions, where members personally know management, often depend heavily on member confidence.

The supervisory committee's responsibility includes reviewing the adequacy of the internal controls to safeguard members' share accounts. The supervisory committee should promptly investigate complaints and generate a written report on its findings.

The supervisory committee or internal auditor should document the review of testing the validity of share accounts. The audit steps may include the following:

- Reviewing insiders' statements of accounts for unusual deposits and withdrawals;
- Reviewing the check register for unusual withdrawals (i.e., withdrawals of inactive accounts);
- Reviewing dormant account reports for validity of transactions; and
- Reviewing canceled checks for unusual payees, unusual dollar amounts, or questionable endorsement signatures.

Some credit unions may transfer undeliverable and returned account statements to a dormant share account status. Unless staff reviews dormant account activity regularly, this practice may present a significant risk for fraud.

Advertising and Disclosures

A federal credit union must accurately represent the terms and conditions of its share, share draft and share certificate accounts in all written and oral advertising, disclosures, or agreements (see NCUA Rules and Regulations §707.8.)

Workpapers and References

- Workpapers
  - Review Considerations
  - Share Analysis
  - Share Greater Than $100,000
  - Shares Less Than $0
  - Shares Detail
  - Share Internal Controls
- References
  - *Federal Credit Union Act*

    107(6) Receipt of Funds
    117 Dividends
    207(k)(2) Insured Account

  - *Federal Credit Union Bylaws*

    Article III Shares of Members
    Article XII, Section 1, Loans to Members (Organizations)
    Article XIV, Dividends
    Article XVIII, Section 2(b), Organizations of Such Persons

  - *NCUA Rules and Regulations*

    701.19 Retirement Benefits for Employees of Federal Credit Unions
    701.32 Payment on Shares by Public Units and Nonmembers
    701.34 Designation of Low-Income Status; Receipt of Secondary Capital Accounts by Low-Income Designated Credit Unions
    701.35 Share, Share Draft and Share Certificate Accounts
    701.37(a)(1) Treasury Tax and Loan Accounts
    701.37(a)(2) Government Depositories and Agents
    707.8 Advertising
    724 Trustees and Custodians of Pension Plans
    748 Suspicious Activity Report

TYPES OF SHARE ACCOUNTS – APPENDIX 14A

Neither the FCU Act nor the NCUA Rules and Regulations restrict a federal credit union in the types of member share accounts it can offer. Generally, share types fall into the broad categories of regular shares, share drafts, share certificates, money market shares, and retirement plan accounts. Other less commonly used accounts include escrow, nonmember, and public unit accounts.

Regular Shares

Every federal credit union offers a share account that does not require a minimum balance greater than the par value of a share, which provides for continued membership in the credit union. However, federal credit unions can offer variations of the regular share account (e.g., Christmas Club accounts, vacation accounts, no-dividend accounts.)

Share Drafts

By traditional definition, a share draft account is an account from which the authorized holder can withdraw shares by means of a negotiable or transferable instrument or other order. Share draft accounts may differ from regular share accounts. Before establishing a share draft program, the board should determine the economic and operational feasibility of the members' use of share drafts. Written operational and program specifications, available at the credit union's principal office, should support the program.

Settlement Accounts

In order to make settlement for drafts that a payable-through bank provisionally pays, credit unions normally maintain a deposit account in the payable-through bank. Other alternatives for settlement include use of an investment account, such as an account with a common trust, a savings and loan association, or a corporate credit union, through which funds are transferred to the payable-through bank using preauthorized agreements. The payable-through bank writes drafts against these accounts. The bank may also accept drafts in an account receivable clearing status and at the end of each day draw a draft against the credit union's checking account in a bank where the credit union does business.

Internal Accounts

The *FCU Bylaws* require that federal credit unions deposit all funds except petty cash or change funds; therefore, credit unions may not establish their own in-house accounts on which they draw drafts.

However, a federal credit union may draw drafts upon itself. Although a federal credit union may not issue cashier's checks, it may issue "treasurer's drafts" to make credit union payments. These drafts equate to a cashier's check, which is a draft drawn by a bank against its assets. The bank acts as both the drawer and the drawee of the instrument. It becomes the bank's primary obligation, and constitutes its written promise to pay on demand. Therefore, while a federal credit union may draw drafts upon itself, assuming proper accounting procedures and an awareness of any liability it may incur by doing so, it may not have its own internal share draft account.

Share Certificates

A share certificate account earns a dividend at a specified rate (either fixed or variable) if held to maturity. Credit unions may assess a penalty for the early withdrawal of all or any portion of the principal amount before maturity. Share certificates usually require a minimum balance. Credit unions design this account to attract and retain larger share deposits. Generally, accounts having greater restrictions also have higher dividend rates.

Money Market Accounts

A money market account, a short-term insured draft account, pays competitive money market rates. The credit union determines terms and conditions according to competition and its own resources.

General characteristics of a credit union money market account include:

- Competitive yields (money market rates);
- Short-term or no maturities;
- Frequent dividend compounding (e.g., daily);
- Minimum balances and deposit and withdrawal requirements as determined by the credit union;
- Draft access; and
- Penalties, as determined by the credit union, if the account falls below the minimum balance requirements.

Due to the nature of money market accounts (i.e., short-term, rate-sensitive), a credit union offering them should have in place an effective asset-liability management program. To ensure adequate liquidity, credit unions should have in place a program that relates these accounts with assets of similar characteristics. (See the Asset-Liability Management and Liquidity chapters for further information.)

Individual Retirement Accounts

Part 724 of the NCUA Rules and Regulations authorizes a federal credit union to act as trustee or custodian of individual retirement accounts (IRAs) for its members or organizations of its members. IRAs act as trusts or custodial accounts, which requires (1) a written instrument creating the trust, and (2) investment of the funds in share accounts or share certificate accounts of the federal credit union. The credit union chooses the design of IRA share and share certificate accounts, without any maturity or dividend restrictions. The National Credit Union Share Insurance Fund (NCUSIF) insures these accounts separately up to a maximum of $100,000.

Credit Union Employees' Retirement Plans

A federal credit union can provide retirement benefits for its employees and compensated officers. Except for IRA and Keogh accounts, credit unions have no authority to act as a trustee over any trust accounts. Therefore, for employees and compensated officers, a federal credit union can only offer the following types of pension plans:

- As the sponsor of an employee pension benefit plan with a named trustee other than the credit union; and
- As the trustee or custodian for IRAs for employees and compensated officials of the credit union.

401 K Plan

Part 724 of the NCUA Rules and Regulations provides for development of pension plans that qualify under 401(d) or 408 of Internal Revenue Code. As a result, credit unions have begun to offer services in the deferred compensation field. Most major corporations offer 401K Plans, known as "pay conversion plans," deferred pay plans, or salary reduction plans to their employees. In some credit unions, the growth in this program is offset by a reduction of payroll deduction deposits in credit unions. Advantages of 401K plans over IRAs include a greater per year maximum and the improved availability of the funds. These accounts reduce current tax obligations by reducing gross wages.

Organizational Accounts

Only organizations composed exclusively of persons who are within the field of membership may open organizational share accounts. The examiner normally determines eligibility on the basis of information obtained from the organization. If questions arise whether the organization meets the Bylaw definition, the credit union could apply for a charter amendment to specifically add the group to its field of membership.

Escrow Accounts

Credit unions normally establish an escrow account as a limited access share account in conjunction with real estate loans. "Escrow account" means either a special limited withdrawal share account or an accounts payable account for the accumulation of funds to pay for taxes, assessments, insurance premiums, construction proceeds, or other charges that could affect the credit union's first lien position.

Nonmember Accounts

Nonmember accounts consist of shareholdings of other federally insured credit unions and, in a credit union designated "low income" (i.e., serving predominantly low-income members), the shareholdings of nonmember individuals or organizations (see §701.32 and §701.34 of the *NCUA Rules and Regulations*.)

Public Unit Accounts

A credit union may receive payments on shares from member or nonmember units of federal, state, and local governments. Because public unit accounts usually consist of large amounts of funds subject to immediate redemption, examiners must carefully analyze them. The term "public unit" means the United States, the District of Columbia, any state of the United States, the Commonwealth of Puerto Rico, any territory or possession of the United States, any county, municipality, or political subdivision thereof. The term "political subdivision" includes any subdivision or principal department of a public unit if state statute:

- Expressly authorized the creation of the political subdivision;
- Delegates to the political subdivision some functions of government; and
- Allocates funds by statute or ordinance for the exclusive use or control of the political subdivision.

Treasury Tax and Loan Accounts

Subject to the U.S. Treasury regulations, a federal credit union may:

- Serve as a Treasury Tax and Loan (TT&L) depositary; a depositary of federal taxes, a depositary of public money, and a financial agent of the U.S. Government;
- Deem funds held in a TT&L Remittance Account, a TT&L Note Account, a Treasury General Account, and a U.S. Treasury Time Deposit-Open Account (§701.37) as deposits of public funds; and
- Exempt funds held in such accounts from the 60-day notice requirement of Article III, Section 5(a) of the *FCU Bylaws*.

A credit union can hold funds in a TT&L Remittance Account established for receipt of payments of federal taxes and certain U.S. obligations. The Federal Reserve Bank (FRB) may withdraw the funds immediately upon receipt of supporting advices. Funds held in a TT&L Remittance Account and a TT&L Note Account are added together and insured to a maximum of $100,000.

A TT&L depositary may credit funds to its note representing payments for U.S. Savings Bonds issued by the credit union in its issuing agent capacity and payments for U.S. Savings Bonds subscribed for through the TT&L accounts, and may enter into such custodial arrangements as necessary to meet Department of Treasury requirements for collateral on a TT&L depositary. The examiner should determine that copies exist of the application and board of directors' resolution authorizing the credit union to be a TT&L depositary regarding compensation owed and payments due the Treasury. The statement will include:

- The number of federal tax deposit forms, which comprise the basis for the compensation;
- The fee factor;
- The total compensation due; and
- Interest on late fees due the Treasury.

The district FRB or Financial Management Service of the U.S. Treasury can answer specific questions about TT&L accounts.

Depository and US Agent Account

A federal credit union may act as a depository or financial agent of the U.S. Government under the provisions of Title 31, C.F.R. 202 of the Department of Treasury Regulations, which permits federal credit unions acting under this authority to:

- Maintain accounts as specified by the U.S. Treasury in which balances may exceed the insurance coverage provided for in §207(k)(2) of the *FCU Act*.

- Maintain accounts in the name of the U.S. Treasury. Such accounts may include:

  - A Treasury General Account, which may carry a zero balance and from which the depositor may immediately withdraw the entire balance, under all circumstances except the credit union's closure;

  - A U.S. Treasury Time Deposit-Open Account, which is non-dividend bearing and which generally, may not be withdrawn until the expiration of 14-days after the date of the U.S. Treasury's written notice;

- Accept deposits to these accounts for the credit of the U.S. Treasury;

- Furnish drafts in exchange for collections in these accounts; and

- Pledge specifically identified assets as collateral to secure public funds under provisions specified in 31 C.F.R. 202.6.

Public unit accounts include funds in a Treasury General Account and the U.S. Treasury Time Deposit-Open Account. As such, funds in a Treasury General Account and a U.S. Treasury Time Deposit-Open Account are added together and insured up to a maximum of $100,000 in the aggregate.

Funds held in a U.S. Treasury Time Deposit-Open Account do not constitute borrowings for purposes of §107(9) of the *FCU Act*, and are not subject to the 60-day notice requirement of Article III, Section 5(a) of the *FCU Bylaws*.

Business Share Accounts

Examiners need to consider the following when reviewing business share accounts:

- Rules and Regulations/Bylaws;
- Advantages/Disadvantages;
- Type of Account
- Internal Controls; and
- Recommended Examination Procedures (if applicable.)

When the membership needs business share accounts and the credit union has the ability to effectively offer them, this service can provide several advantages, including:

- Retaining the business of sponsor organizations, small entrepreneurs, and that segment of the membership requiring business accounts; and

- Providing the credit union with growth potential beyond individual-member accounts. Offering business share accounts could increase credit unions' shares and improve net earnings (depending on cash flows and fee structures).

Disadvantages can also exist, including:

- Large balance accounts in relation to the asset size of the credit union may result in undue influence on the officials and management. Most vulnerable are small credit unions. Examiners may need to focus loan reviews towards large business-account members and related members' accounts for the possibility of preferential treatment;

- Low average daily balances and a large number of transactions can render business accounts unprofitable. If credit unions cannot restructure these accounts to at least a point of break-even, other services must subsidize this service; and

- Large business accounts can distort the credit union's trend analysis. Examiners should recognize the effect of major balance shifts in assessing the total analysis process.

Other possible disadvantages include:

- Excessive involvement by sponsor organizations in the credit union's operations;
- Need for comprehensive cash flow analysis;
- Cost of special access to services (i.e., coin processing, check cashing, etc.); and
- Inadequate controls regarding compensating balances.

In general, businesses may request business savings and share-draft accounts (e.g., sole proprietorships, small corporations, and small partnerships.) Credit unions offering business share accounts must implement adequate controls to ensure large business accounts, in either volume or dollar amount, do not pose a safety and soundness concern. Credit unions do this by requiring written policies and procedures, and establishing adequate internal controls and oversight.

Policies and procedures must specify the various business-related share accounts and the credit union's objective in offering these accounts. Examiners should encourage management to establish objectives that include quantifiable financial goals consistent with the credit union's capital goals and long-term business plan.

The policy must ensure employees adequately document membership eligibility. Credit unions should identify and monitor business accounts separately from other share accounts. Internal controls should include data processing controls for pledged shares or compensating balances, if applicable.

SHARE ACCOUNT RED FLAGS – APPENDIX 14B

Red Flags

Examiners should remain aware of the following red flags (not an all-inclusive list) when reviewing share accounts.

- Failure to set restrictions on employees processing transactions on their own accounts, the accounts of their family members, and those of their relatives;
- Failure to set computer access controls on authority levels to post transactions;
- Failure to require passwords or a teller ID number for each staff person to identify accountability;
- Employees' failure to produce records or to delay access to records;
- Long-standing problem of records not posted currently or being out-of-balance;
- Employee salaries and fringe benefits substantially below those of other credit unions providing equivalent services. Employees may reason the board is shortchanging them and may attempt forgery to overcome their perception of being under-compensated;
- Employees who live beyond their standard of living on their visible income, often indicated by luxury cars, expensive hobbies, gambling, or heavy drinking;
- Employees who resist taking vacations or resist attempts for someone else to perform their work during vacation;
- Employees who resist giving up control of certain records to another employee when promoted to a new position (e.g., performing the bank reconcilement);
- Failure to review negative Share and Share Draft Reports;
- Failure to review Dormant Share Reports;
- Cost of funds exceeds dividend rates;
- Credit union share growth not commensurate with above market dividend rates paid;
- Print command coded to suppress printing of statement of accounts;
- Numerous statement of accounts delivered to the same P.O. Box;
- Member complaints on accuracy of their statement of accounts;
- Failure to mail statement of accounts;

- Share trial balance report header shows not all share accounts were selected for printing on the share trial balance;
- Missing or incomplete membership cards; or
- Failure to correct internal control weaknesses identified in examinations, supervisory committee audits, internal audits, and risk-management analysis audits.

Examiners should use their professional judgment in questioning high-risk practices involving share accounts.