Governance Guideline

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DRAFT FOR COMMENT

BC CREDIT UNIONS

British Columbia
Financial Institutions Commission

www.fic.gov.bc.ca

INTRODUCTION

The Financial Institutions Commission[1] (FICOM) holds the Board of Directors[2] (board) accountable for the stewardship of a credit union. FICOM relies on the board as a core oversight function to ensure the safety, stability and sustainability of a credit union. The successful operation of a credit union contributes to enhancing confidence in the province's credit union system and the economy as a whole.

The Governance Guideline (guideline) outlines FICOM's expectations for sound governance practices at British Columbia credit unions. The guideline is intended to assist credit union boards in the exercise of their duties to protect the interests of credit union members, and is designed to recognize both the cooperative nature of credit unions and the differences in size, scope and complexity within the credit union system.

The guideline sets out both ***Principles*** and ***Standards***:

Principles
The foundation for good governance expected by FICOM through its guidance; principles communicate the spirit of FICOM's expectation without prescribing the form by which the principle is achieved.

Standards
The specific policies and procedures that underpin principles; in most cases standards are set at a level FICOM expects can be adopted and substantively implemented at every credit union.

FICOM'S APPROACH TO ASSESSING GOVERNANCE IN CREDIT UNIONS

Governance examination forms part of FICOM's overall risk assessment as set out in its Supervisory Framework[3]. Each board member should understand the supervisory process and the expectations placed on them as a director.

FICOM assesses the effectiveness of the board's oversight of the credit union's operations and ensures the board is fulfilling its role through continuous assessment, seeking evidence that the board discharges its duties with care and conscience. As with other areas of risk assessment, FICOM reviews a credit union's governance from two perspectives: characteristics and performance.

Characteristics
Demonstrate how a board structures, organizes and tasks itself to govern the credit union, including the policies and procedures it has in place to effectively exercise its responsibilities.

[1] References to FICOM may include the staff, the Superintendent and/or the Commission.
[2] References to the board may include its committees.
[3] More detail regarding FICOM's Supervisory Framework, including assessment criteria, can be found at FICOM's website: www.fic.gov.bc.ca.

These include whether:

- directors have the appropriate skills, knowledge and experience to govern the credit union;
- roles and responsibilities are clearly set out;
- the board's composition, structure and activities are aligned to its strategy and risks;
- the board has in place policies and procedures that contribute to effective identification, measurement and control of risks; and
- the board exercises an appropriate degree of transparency, reporting and self-assessment to ensure accountability to its members and stakeholders.

Performance
Measures the quality and effectiveness of the board's oversight of a credit union's risks and performance. Performance is a qualitative measure and necessarily requires a greater degree of judgment in its assessment. To assess performance FICOM will consider the board's:

- actions to control the risks associated with its chosen strategy and business model;
- willingness and ability to remain independent from management and exercise control through effective probing and questioning of key assumptions and decisions;
- success in establishing and maintaining a culture within the board and with senior management that supports its effectiveness;
- commitment to continuous improvement through learning and training; and
- demonstrated accountability to its members and to other stakeholders including regulators.

THE ROLE OF THE BOARD

A board's responsibilities include:

- defining the credit union's ***risk appetite***;
- setting the credit union's ***strategy*** and overseeing its ***planning process***; and
- ensuring the credit union has the ***capability and culture*** to support its risk appetite and implement its strategy.

To carry out these responsibilities, a board:

- approves and implements a ***risk governance framework*** that effectively monitors activities and progress related to these responsibilities and makes adjustments when necessary; and

- implements a framework for ***accountability and disclosure*** that effectively informs the credit union's members and other stakeholders of its risks and progress toward its objectives.

The board plays the key role of ensuring a credit union effectively manages and mitigates risk through policies and procedures at three levels within the credit union:

1. Operational staff[4] who understand and correctly carry-out their roles and responsibilities;
2. Oversight staff that monitor policies and procedures with regard to risk and compliance amongst operational staff; and
3. Internal audit and the board[5] who regularly review business operations and oversight functions to confirm they are performing at appropriate levels for risk tolerance and regulatory compliance.

The segregation of duties and independence between these levels enhances the effectiveness of the credit union's risk management system. These three levels safeguard the credit union by working together to ensure a credit union operates within its risk appetite and compliance requirements.

The standards set out in this guideline are organized around the responsibilities amongst these three levels within a credit union.

THE BOARD'S RELATIONSHIP WITH FICOM

FICOM gains confidence in the risk management of a credit union when the board demonstrates that it is fulfilling its role. During on-site reviews, FICOM meets with the board to assess how it meets supervisory principles and standards.

FICOM monitors and regulates quantitative and qualitative aspects of a credit union's performance with staff requiring a thorough understanding of a credit union's strategy, risk management practices, leadership and culture to accurately gauge the health of a credit union. Communication between the board and FICOM can improve FICOM's understanding of the credit union. For example, where a board believes a supervisory standard cannot be practically applied in the credit union, it should raise this with FICOM for discussion.

[4] Operational staff oversee the day-to-day operations of the credit union.
[5] References to the board may include the Audit Committee.

RISK APPETITE

PRINCIPLE

By approving a risk appetite, the board ensures a credit union only takes on risks that are within its capabilities to manage. A credit union's risk appetite outlines the amount and type of risk a credit union is willing to accept in order to pursue its strategic plan; it provides boundaries to the strategic planning and ongoing operations of a credit union. The risk appetite drives the credit union's culture by embedding itself in functions and business activities at all levels.

STANDARDS

1. When setting its risk appetite, a board should consider:
    - members' values and expectations;
    - its own capability to understand and oversee the credit union's risk;
    - internal constraints such as financial and operational capability; and
    - external constraints such as competitive and economic conditions.
2. The board-approved risk appetite forms the basis for a credit union's risk governance framework including its strategic, capital and liquidity plans.[6]
3. The board ensures the credit union has the systems, processes and capabilities to evaluate its overall risk profile and the interrelationship of the individual risks is understood.
4. The board annually reviews the key risks to the credit union, and satisfies itself that the processes to identify and manage risk are appropriate and effective.
5. The board and its committees review risks, the steps taken to manage risks, and the systems in place to monitor risks within a credit union's defined risk appetite. This includes reviewing the degree to which risk management is considered in decision-making.
6. The board ensures a credit union uses qualitative and quantitative analysis (such as stress testing) to determine how robust or vulnerable the credit union is to a variety of internal and external factors. The degree of stress testing is dependent on the nature, scope and complexity of the credit union's risk. The board reviews its testing outcomes on a regular basis and adjusts its risk appetite or strategy as necessary.
7. The board ensures that a credit union has a disaster management and recovery plan that is updated regularly.

[6] In addition to others as described in the Risk Governance Framework section of this guideline.

STRATEGY AND PLANNING

PRINCIPLE

The board approves a credit union's strategic plan. The approval process involves a thorough discussion of the advantages and disadvantages of possible strategic directions and includes challenging assumptions and identifying risks for each option. The strategic plan is connected to a credit union's risk appetite and sets out goals and objectives that are clear and specific enough to allow for effective monitoring and reporting of credit union performance to members and stakeholders.

STANDARDS

1. When setting its strategy, a board considers:
    - members' values and expectations;
    - internal constraints such as financial and operational capability;
    - external constraints such as competitive and economic conditions;
    - alignment with the credit union's risk appetite; and
    - any impacts of its strategy on the credit union system.
2. A credit union's strategy is forward looking and focuses on ensuring the credit union's long-term viability and success.
3. The board continuously monitors emerging issues or areas of concern, and adjusts the credit union's strategy as necessary. At a minimum, the strategic plan is reviewed by the board on an annual basis.
4. The board approves an operating plan, ensuring it aligns with a credit union's strategy. An operating plan has a shorter timeframe (typically one year) and identifies the activities and objectives necessary to achieve the credit union's strategic objectives.
5. The board ensures the credit union has the resources required to accomplish its goals. Its planning process identifies resources including capital investments, financing needs, staffing or other resources necessary.
6. Management regularly reports to the board on the credit union's performance, together with any actions to address areas of non-performance.
7. The board and management agree annually on a comprehensive set of performance measures for the credit union that reflect progress against the strategic and operating plans.

RISK GOVERNANCE FRAMEWORK

PRINCIPLE

The board's role is not to minimize risk, but rather to fully understand the credit union's risk exposure and to ensure the processes and systems that are in place to control risk are appropriate given the credit union's strategic plan and operating environment.

A risk governance framework is the set of tools, policies and processes that a credit union has in place to identify, measure and manage its risks. The board's role is to ensure a credit union's risk governance framework is:

- *comprehensive;*
- *appropriate;*
- *adequately resourced;*
- *effective; and*
- *monitored.*

> The risk governance framework addresses both risk governance and risk management:
>
> **Risk Governance**
> Involves setting the credit union's direction and tolerance for risk, providing oversight of risk management and ensuring that risk controls are effective. Risk governance is the role of the board.
>
> **Risk Management**
> Involves the identification, measurement, assessment, monitoring, reporting and mitigation of potential uncertain events or activities that could affect the ability of a credit union to achieve its strategic objectives. The risk management system is the responsibility of management.

STANDARDS

1. A risk governance framework reflects the unique business model and strategic plan of a credit union, and as such, the tools, policies and procedures within a framework vary among credit unions. At a minimum, a board ensures its risk governance framework includes:
    - a risk appetite statement;
    - a strategic plan;
    - an inventory and description of the credit union's risk exposures and a discussion of their interconnectedness[7];
    - a capital plan;
    - a liquidity plan;
    - an investment and lending policy;
    - a comprehensive set of performance metrics that will be used to measure progress towards the credit union's strategic goals and adherence to its risk appetite, capital and liquidity plan;
    - a capital and operating budget;

[7] This is typically included in an Enterprise Risk Management framework.

- an inventory of oversight and internal control functions, their purposes and who is responsible;
- an inventory of reporting requirements including frequency and responsibility;
- a plan to test assumptions, controls and impacts (stress testing) of key risks; and
- a business continuity and disaster recovery plan.

2. The specific operating policies and controls requiring board approval will depend on the board's risk appetite, a credit union's business model and the strategic plan. At a minimum, a credit union has in place policies that define the board's role in:

   - credit and investment limits and decisions;
   - internal audit;
   - pledging of the credit union's assets;
   - introduction of a new product or line of business;
   - introducing or changing pricing models, fees or charges;
   - acquisitions, mergers or divestitures;
   - controlling compensation;
   - reviewing and responding to member feedback and complaints;
   - enacting contingency, continuity or disaster recovery plans; and
   - responding to the media.

3. The board ensures the risk governance framework remains dynamic; tools, policies and processes are reviewed by the board, at least annually.

4. Each director is responsible for understanding the credit union's risk governance framework and how it links to the credit union's business model and strategic plan.

5. The board ensures that the risk governance framework articulates boundaries, controls and reporting requirements clearly so that the credit union operates within the board's defined risk appetite.

6. Reporting expectations are set out in writing. Directors receive, and understand, clear reporting on the credit union's performance and risks with relevant internal and external comparative data. The board discusses, in-camera, the quality of the reporting they receive on a regular basis and address any gaps with the CEO.

7. Where a credit union chooses to outsource any part of their business that is either strategically or operationally significant to a subsidiary or a third-party, it retains responsibility for the risks associated with that function and has sufficient oversight in place

to manage the risk. If the board cannot satisfy itself that adequate oversight can be achieved it is responsible for terminating or replacing the outsource relationship.

8. The board undertakes an annual review of the credit union's compliance with relevant laws, the requirements of any regulatory bodies and its own governing documents, including its rules.

9. Board committees can be an effective way to allow boards to more efficiently undertake oversight responsibilities. Credit unions are required to have an Audit Committee and an Investment and Loan Committee; however, boards should also consider additional committees that can support the board's oversight responsibilities.

10. Each committee has a clear statement of responsibilities and the board members serving on the committee are selected using a process that matches skill, experience and personal attributes to the responsibilities of the committee.

11. Where the board or committee of the board determines that it does not have the appropriate knowledge, expertise or experience to fully evaluate risks, it should seek advice or analysis from an independent third party. Approaches include retaining consultants, advisory boards, or non-voting directors. The board has processes in place to make resources available to retain external resources, such as consultants, advisory boards or non-voting directors.

12. The board also periodically commissions independent, third-party reviews to assess the effectiveness of oversight functions in the credit union with results reported directly to the board.

ASSEMBLING AN EFFECTIVE TEAM

PRINCIPLE

A credit union's success is determined by its talent and its culture. Talent is a function of education, skill and experience, and culture is a function of values and behaviors. Talent and culture at the staff, management and board level reinforce each other to develop a strong credit union.

STANDARDS

1. The board ensures that the talent and the culture of the credit union support its risk appetite and the achievement of its strategic plan. The board carries out this responsibility through:
    - recruitment, development and evaluation of the board;
    - recruitment, selection, development and supervision of the Chief Executive Officer[8] (CEO); and
    - selection and oversight of other key senior staff who have a direct responsibility to the board.
2. A board is deliberate in its own recruitment, development and succession planning by considering:
    - skills and experience that are most relevant to advancing the credit union's business model and strategic plan and to controlling its risks;
    - personal attributes, values and behaviors that will make the board functional;
    - leadership requirements of the board such as the board and committee chairs;
    - diversity of backgrounds, perspectives and problem solving approaches needed to be most effective;
    - willingness and ability of the board to think and act independently; and
    - degree to which the board composition reflects the credit union's members and its community.
3. The board[9] takes an active role in the director recruitment process by:
    - identifying required and desirable skills, experience and personal attributes that are directly aligned to the credit union's strategic plan and to its needs for risk oversight;
    - ensuring candidates with the necessary skills and qualities are actively recruited;
    - establishing a transparent evaluation process to compare candidates to the necessary skills and qualities;

[8] References to CEO may include references to a General Manager (GM).
[9] Either by committee or as a whole.

- communicating both the necessary skills and qualities and the evaluation process to members clearly, and in advance of the election process; and
- recommending any number of candidates to vacant positions so long as each candidate meets the requirements established by the board.

4. Each director is expected to:
   - be financially literate as demonstrated by his or her ability to understand and interpret the credit union's financial performance and the relationship between its strategic plan and financial outcomes;
   - understand risk as demonstrated by his or her ability to identify and describe the range of risks the credit union is exposed to and how they are controlled;
   - understand the cooperative business model and its unique strengths and limitations particularly as it applies to financial services;
   - understand the business of delivering financial services, the risks, the competitive forces and industry trends;
   - demonstrate integrity by acting ethically and in the interest of the credit union and its members at all times;
   - be familiar with the regulations that the credit union operates under; and
   - think critically and independently, as demonstrated by his or her willingness to ask questions and challenge assumptions.
5. The board, as a whole, is expected to:
   - possess specific skills and experience in those areas of strategic importance to the credit union's business model, strategic plan and risk profile[10];
   - have specific financial skills and experience in the area of accounting, preparation of financial statements and audit;
   - have current and relevant knowledge of or experience in the markets and businesses that the credit union serves;
   - recognize when it needs additional expertise or third-party advice; and
   - operate as a highly functioning team, demonstrating the willingness and ability to deliberate on key decisions, challenge each other constructively and reach consensus wherever possible.
6. The Board Chair and each committee chair is expected to:
   - possess the facilitation and leadership skills to ensure the board carries out its responsibilities effectively;

[10] For example: credit, insurance, wealth management, leasing, technology, etc.

- manage the board's meeting schedule, agendas and information requirements to ensure it uses its time effectively and addresses its core responsibilities;
- in the case of the Board Chair, act as the primary liaison between the board and the CEO; and
- in the case of committee chairs, act as the primary liaison between the board and the committee.

7. The board approves standards for ethical and sound business conduct for itself, as well as the employees of the credit union. The standards provide guidance in the areas of confidentiality, integrity and responsibility at the individual and credit union level and include provisions that provide for fair treatment of members by the credit union, its intermediaries and its partners.

8. Selecting a CEO is one of the board's most crucial decisions and it should consider the same attributes essential to board recruitment as well as:

   - ability for the board and CEO to build mutual trust;
   - development of an environment where the board is comfortable and encouraged to challenge and probe the CEO and management; and
   - confidence to support the CEO and management in its decisions.

9. The board is responsible for attracting, selecting and retaining a CEO that can implement its strategic plan. The board is also responsible for supervising the CEO and should set out performance expectations and complete a performance evaluation at least annually.
   This includes:

   - establishing the overall compensation of the CEO including pay, bonus or incentive compensation and any benefits and perquisites. CEO compensation is reviewed and approved on an annual basis, concurrent to the CEO's performance evaluation; and
   - having in place a succession plan that accounts for both the planned and unplanned departure of the CEO or other key persons in the credit union.

10. The board exercises oversight of the selection and compensation of other key executive positions, particularly those positions that have a direct responsibility to the board such as executives with responsibility for risk oversight, compliance and internal audit.

Role of the CEO

The role of the CEO is critical to good governance; the board relies on the CEO and management team to prepare and present information in a way that enables the board to exercise sound judgment and make thoughtful decisions.

A good CEO brings forward the right issues at the right time with enough information and analysis to allow the board to exercise its judgment and make sound decisions. A good CEO empowers the board to do its job well.

11. The board exercises oversight of the overall compensation program in place in the credit union and pays particular attention to any variable or incentive compensation programs used by credit union. The board ensures compensation programs are aligned with the credit union's risk appetite and strategic plan and do not incent behaviors or outcomes that are not in the interest of the credit union or its members.

12. The board has in place policies and procedures, as well as a supporting budget, to address its own performance, development and succession, including:

    - minimum orientation and education and experience requirements;
    - continuing education requirements;
    - standards for attendance and performance of directors;
    - regular performance evaluation at the board, committee and individual level
    - defined terms for directors and executive positions of the board; and
    - a director compensation policy.

ACCOUNTABILITY & DISCLOSURE

PRINCIPLE

Credit unions are unique among financial institutions in the cooperative principles that underpin their formation and inform their decision-making. Among these principles democratic values, member accountability and community engagement are balanced with economic priorities to ensure a strong credit union. A credit union's democratic control structure can either create or reduce risk depending on the degree to which the members engage with the credit union as owners. The board plays an important role instilling ownership values in members and encouraging them to take an active interest in the safety, stability and sustainability of the credit union.

STANDARDS

1. The board ensures that member accountability is demonstrated by:
    - addressing member needs and values when setting the credit union's risk appetite and strategic direction;
    - communicating with members at a frequency and in a format that provides for meaningful comparison and evaluation; and
    - disclosing to members information that, as owners, they should reasonably expect to receive.
2. A credit union's annual report to members includes the following:
    - a management discussion and analysis report that provides information on the credit union's financial and operating results including meaningful comparative data, its principal risks and mitigation strategies and a commentary on the credit union's expected future performance;
    - director attendance records;
    - for each director, total compensation paid by the credit union, total expenses including education and other costs paid by the credit union and a list of other board appointments held in his or her capacity as a director of the credit union;
    - the total amount of compensation paid to the CEO; and
    - a breakdown of profit allocations.
3. The credit union provides members with the opportunity, at least annually, to participate in a forum with directors and senior management to ask questions about the credit union.
4. The credit union has a policy in place to address member feedback and complaints that clearly defines the role of the board in this process. This policy is made available to members.

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Financial Institutions Commission
Box 12116
Suite 2800, 555 West Hastings Street
Vancouver, BC V6B 4N6
www.fic.gov.bc.ca

Reception: 604 660 3555
Toll Free: 866 206 3030
Fax: 604 660 3365
General email: FICOM@ficombc.ca