COMMENTARY ON FICOM DRAFT GOVERNANCE GUIDELINE – May 2013

We are pleased to provide the following comments on the draft Governance Guideline circulated by FICOM on March 21, 2013.

1. Professional Boards

The broad thrust of the guideline is one that places greater nominal expectations or responsibilities on directors and encourages recruitment of more 'professional' directors. This is at odds with the fundamental 'lay board' model of co-ops, as democratically controlled consumer owned enterprises. We do not see a strong case:

- The rush to promote 'professional boards' directly conflicts with the concept of 'governance boards'. Indeed the proposals start to confuse the roles of 'directors' with those of management, professional advisors, auditors, regulators, and market analysts. The role of the Board, in our opinion, is one of prudent stewardship representing the interests of the membership/owners. The guideline champions the Board as a more operationally involved risk management group that would intervene in territory that more correctly belongs with Management. We suggest 'Policy Governance' (see John Carver, "Boards That Make a Difference", and other books) presents the more appropriate set of responsibilities for directors.
- The rationale for 'professional boards' is at first tempting by withers upon investigation into the boards of the banks that failed in the US in 2008/2009. Many of the very prominent banks had skilled directors (see WaMu's Directors) but the presence of 'skilled' directors did not correlate with success. There is no empirical evidence that indicates 'professional boards' outperform lay boards.
- Experts in the field of governance are questioning this 'growing demand for expertise' and contending that the expectations are, on the one hand, too information intense for a generalist director, and, on the other hand, perversely positioning a board to be overly dependent on one or two 'expert' directors. (See The Journal of the Institute of Corporate Directors, Issue 166, Paul Cantor, Chair, Global Risk Institute in Financial Services.)
- The guideline's perspective implicitly discounts the proven success of lay boards, and transparent democratic director elections. The credit union movement is rooted in lay boards and they have performed very well. Fishermen, railway workers, printers and other ordinary people founded and built up the credit unions of BC into a formidable set of institutions.

- We note that the OSFI guideline does not include any similar proposals about board skills and recruitment. Why should Provincially Regulated Financial Institutions be pressed to meet standards not applied to FRFIs?
- The proposal related to director 'skills' is prospectively valid and applicable to elections for municipal councils, school boards and the legislature. These democratically elected entities also manage substantial risks on behalf of others. We note that these elected persons do not need to meet any 'skills' test or criteria.

2. Purpose and context

The introduction to the draft Guideline states that the guideline sets out "FICOM's expectations for sound governance practices". We take this to mean that these may be referenced when examinations are completed under Section 212 of the Financial Institutions Act:

> … the superintendent or other person must make reasonable inquiries respecting
>
> > (a) the financial institution's condition and ability to meet its obligations as and when they become due,
> >
> > (b) **the adequacy of the financial institution's business and financial practices and of its management procedures and standards, ….** (emphasis added)

We believe that the legislative context for the guidelines should be made explicit, by referencing the relevant duty and authority under the FIA.

The OSFI Corporate Governance Guideline (published January 2013) provides two further contrasts in presentation:

1. First, OSFI directly states that, "This guideline complements: Relevant provisions of the Bank Act…." This statement properly situates the guideline as subordinate and complementary to the legislation, and as an elaboration of the terms in the legislation.
2. Second, OSFI clearly states that the primary responsibility for good governance lies with the board and that, "As such, OSFI's reports and findings can provide useful input to the Board's own oversight of the FRFI." This posture properly acknowledges that governance practices may vary from one credit union to another, and that the policies, committees, and other controls to be put in place are within the purview of the Board. The draft FICOM guideline text, in the section "The Board's Relationship With FICOM", suggests something else. The text closes with, "For example, where a board believes a supervisory standard cannot be practically applied in a credit union, it should raise this with FICOM in discussion." This invokes a reverse onus principle; implying that the credit union needs to prove something. We believe this posture is most inappropriate. Our expectation, consistent with the OSFI text, is that the guideline (and

related assessment criteria) is the basis of FICOM's work, and that we can expect FICOM reports will identify concerns and provide recommendations.

We suggest that this guideline similarly be situated within the legislative context and, secondly, that the views of FICOM will be brought forward if FICOM is of the opinion that practices in a credit union do not meet standards that FICOM has advocated.

3. Scope

The guideline is published for "BC Credit Unions". It is not clear why FICOM governance guidelines are not set out for all provincially regulated financial institutions. We note that the OSFI guideline applies to 'federally regulated financial institutions'. Perhaps FICOM can explain why different expectations might be operative to other 'PRFI's. If other guidelines for insurance and trust companies are planned, please elaborate.

We suggest FICOM provide guidance for all Provincially Regulated Financial Institutions and matters particular to credit unions may be addressed through our self-regulatory organization, Stabilization Central.

Further, the guideline fails to even acknowledge the Credit Union Director Achievement program established under Section 84 of the Credit Union Incorporation Act.

4. Applicability

The guideline expectations provide a breadth and depth that clearly anticipates large operations, with sophisticated management teams, internal audit groups, comprehensive policy frameworks, and directors receiving remuneration. Many, if not most, credit unions do not conform to this profile. Hence, the interpretation and application of the principles and standards will vary. While this fact is only modestly acknowledged in the second paragraph of the draft paper, it is not adequately addressed.

Further, the document sets out that the Board has the primary responsibility for governance practices, frameworks and procedures. Therefore, we note that it is up to the Board to consider and interpret this guideline; as well as FIA, CUIA and other statutory requirements; member needs; other stakeholders interests, etc. – seeking recommendations from management, legal counsel, FICOM, Central 1, Stab Central, and others.

From the perspective of a small credit union, the guideline appears conceptual and onerous, as we are relatively simple savings and loan operations. There are limited managerial resources in a small credit union, often stretched to sustain the business, refining information and banking systems, and deploying staff. Interpreting and applying the standards, working with directors to nurture good governance, and developing policies all takes time. This time is at the expense of member service, marketing, and other demands.

While the principles may still be applicable, the manner in which standards are addressed in small credit unions will be shaped to suit each operation.

We suggest that the FICOM statement more clearly recognize the applicability may vary according to the complexity of the operations, and also that the expectations of volunteer directors will have to be realistic and balanced. Directors have to meet expectations of shareholders and other stakeholders, not just the regulator.

5. Principles and Standards

The draft guideline proposes five 'principles'. These are simply asserted and it is not clear how they were derived or how they may compare to similar governance principles. On review of other governance principles we observe:

- The principle statements are not simple and direct. They are not stated in plain language. And they proceed, in some cases, to provide elaboration which should either be labeled discussion or be included in standards. We suggest that you review the principles published by the Australian Stock Exchange in 2003, as these provide a good example of clearly stated principles.
- These principles are narrow in so far as they focus largely on the issues of note from a regulatory perspective. This is not a comprehensive list. Risk management is important, but other similar governance guidelines and principles recognize the importance of ownership rights, other stakeholders, and other matters of principle such as gender representation. In many other corporate governance contexts there is a principle that owner/members must have an open and unfettered right to elect directors. We suggest the document be prefaced in a way that acknowledges the bias of the regulator.
- The 'Governance Standards' set out in the BC Credit Union Standards of Sound Business and Financial Practices (ERM Version 2004) are a good contrast insofar as they make excellent distinctions between governance and management roles. We suggest this approach would be more helpful.
- Some fundamental principles, embedded in the legislation, are absent (for example, the prudent person principle and the principle that related party transactions). If the principles are to supplement the legislation, this is fine, but the text may better explain this.

Two areas within the draft standards merit comment:

- Disclosure of management compensation should be balanced with a right to privacy.
- The primary leadership role for a staff team lies with the CEO/GM, not the Board.

6. Regulator's Role

In proposing these expectations of directors, in a way that appears to expand the role of a board, FICOM has raised the question of what credit unions should expect of the regulator. The OECD Principles of Corporate Governance starts with a standard that relates to legislative and regulatory structures. That principle is:

I. Ensuring the Basis for an Effective Corporate Governance Framework

The corporate governance framework should promote transparent and efficient markets, be consistent with the rule of law and clearly articulate the division of responsibilities among different supervisory, regulatory and enforcement authorities.

A. The corporate governance framework should be developed with a view to its impact on overall economic performance, market integrity and the incentives it creates for market participants and the promotion of transparent and efficient markets.
B. The legal and regulatory requirements that affect corporate governance practices in a jurisdiction should be consistent with the rule of law, transparent and enforceable.
C. The division of responsibilities among different authorities in a jurisdiction should be clearly articulated and ensure that the public interest is served.
D. Supervisory, regulatory and enforcement authorities should have the authority, integrity and resources to fulfill their duties in a professional and objective manner. Moreover, their rulings should be timely, transparent and fully explained

The OECD principle is rooted in the 'rule of law' and clarity of responsibilities. As we note earlier in this document, we believe this guideline (and others) should set out where the guideline fits within the legislative and regulatory scheme. We also suggest the distinct roles of the Superintendent be defined more clearly in FICOM statements.

One of our concerns is regulatory burden. The text of subsection A notes that regulatory activity should not undermine efficient markets and economic performance. As a small credit union, we see increasing regulatory requirements substantially adding costs, lessening competition, and deterring innovation:

- Onerous regulation (and heightened governance expectations is only a part) is one more factor causing small credit unions to merge with larger ones; reducing the number of service providers in BC communities. The rationalization will tend to create market oligopolies to the detriment of consumers and small businesses.
- Regulatory requirements also pose a significant barrier to entry into a market, with the consequence of reduced competitiveness. No new credit unions have been authorized to do business in BC in 20 years, despite significant new immigrant communities and other likely common bonds evolving.
- The shadow or 'ghost' financial services sector is growing, largely to avoid the strictures of a regulated sector; but consumers are then exposed to additional risks. We note the abundance of pay day lenders, private payment schemes, private money transfer arrangements, and the growth of 'prepaid' services/cards related to various enterprises.
- The increasing consolidation of credit unions results in a concentration of risk to the deposit insurance scheme and to the credit union system. The implied strategy of the FICOM paper is to rely more heavily upon good governance rather than a diversification of risk, for example.

Just as FICOM has proposed performance standards for credit unions, we would suggest that credit unions, and regulators, should ask how well the Provincial government, the commission, and the Superintendent are performing relative to this fundamental OECD principle.

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