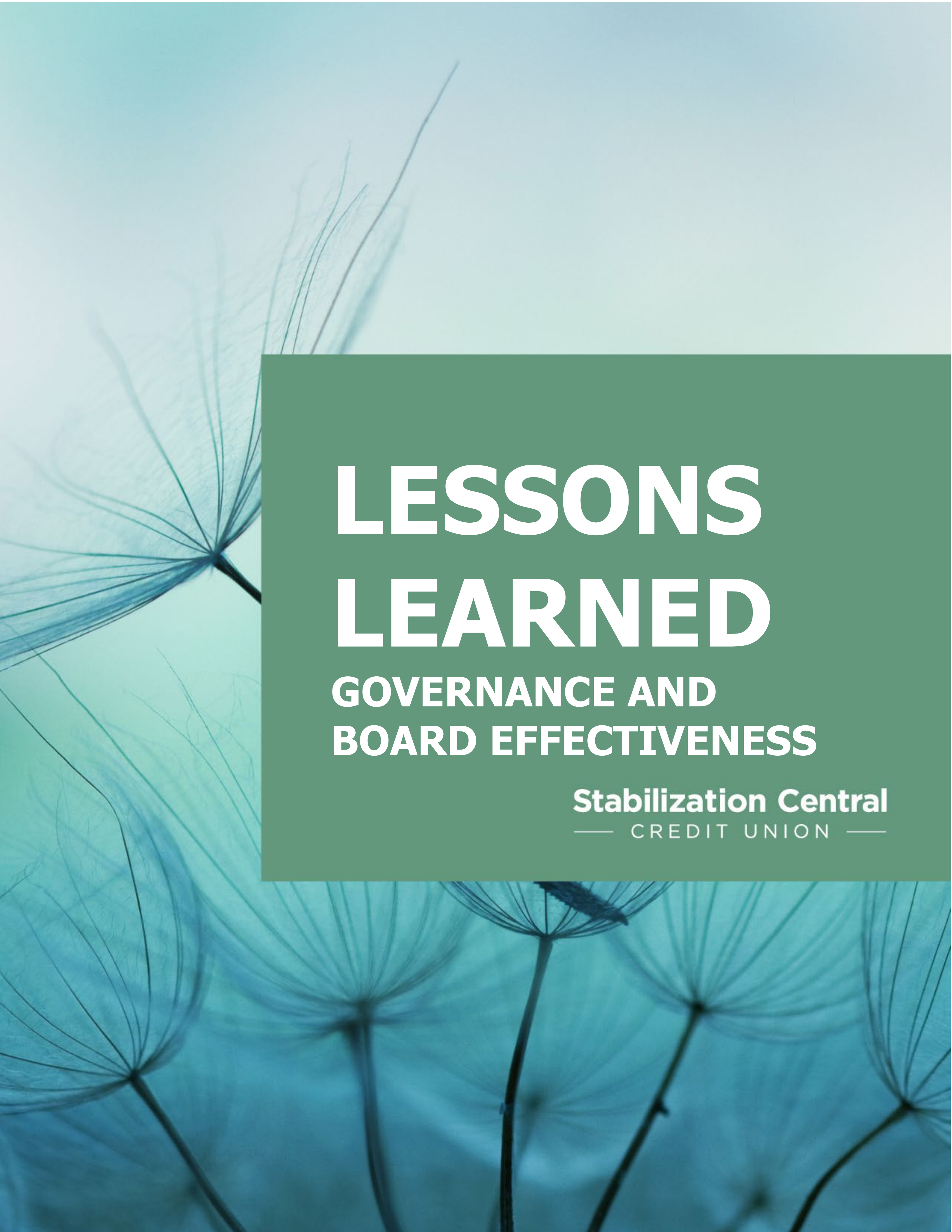

LESSONS LEARNED

GOVERNANCE AND BOARD EFFECTIVENESS

Stabilization Central
CREDIT UNION

Table of Contents

Introduction

Effective governance is one of several indicators of a healthy and resilient credit union, where its board makes decisions in the best interests of its members. Governance is also a critical component of a risk management system that ensures the board oversees the actions of management to protect the funds that members have entrusted to the credit union. A lack of effective governance has been identified as one issue underlying some of the operational and strategic challenges experienced by financial institutions.

This installment of Stabilization Central's Lessons Learned series explores the importance of an effective board and applied governance practices as key elements of a strong, stable credit union. It provides a brief literature review that details how a breakdown in governance was a key contributor to the bank failures in 2023, research on the connection between effective governance and organizational culture, an overview of a board's role and responsibilities in overseeing a credit union, and "dos and don'ts" of effective governance. It concludes with a case study about Stabilization Central's own governance journey.

Literature Review

Ineffective Governance as a Contributor to Bank Failures

The Basel Committee on Banking Supervision's (BCBS) *Report on the 2023 Banking Turmoil* cited a poor risk culture, as well as ineffective board oversight as two of the key factors in the banking upheavals of that year.[1] These findings applied to the failures of Silicon Valley Bank (SVB), Signature Bank of New York (SBNY), and First Republic Bank (FRB), and the rescue of Credit Suisse (CS).

Notably, the BCBS's report indicates that while critical issues (including governance) contributed to these financial institutions' downfall, there were also failings by the supervisory authorities that could have prevented some of the outcomes. For example, "supervisors were slow to downgrade supervisory ratings or to ensure that SVB's board and senior management took sufficient and immediate steps to compensate for those widespread weaknesses."[2] The report made an important recommendation for supervisors to "robustly assess banks' governance and risk management" as a foundational step in ensuring safety.

While the report was written from an international banking perspective, some of the lessons apply to provincially regulated credit unions:

- Credit unions need to prioritize the robustness of their risk management practices and governance effectiveness, because they lack the additional monitoring layers that oversee conventional banks (i.e., credit rating agencies, shareholders, etc.). The Board of Directors forms that critical oversight layer for credit unions.
- Credit unions may expect that the bank failures in 2023 have been reviewed by regulators around the world, including Canada (federally and provincially) and conclusions drawn from these failures. As a result, credit unions could anticipate more regulatory scrutiny of their governance and risk management.

Corporate Culture's Impact on Governance

Canada's federal banking regulator, the Office of the Superintendent of Financial Institutions (OSFI), is just one of several regulatory authorities in the world highlighting the impact that a financial institution's overall culture has on board-level and operational governance. The concept that corporate culture and governance are interrelated is not new. In July 2013, a Parliamentary Commission on Banking Standards (PCBS) was established to investigate professional standards and culture in UK banking. One of the key recommendations emerging from the Commission's final report, *Changing Banking for Good*, was that reforming institutional governance and risk management is critical for improving banks' safety, soundness, and culture.

In a recent 10-year retrospective paper about the UK's PCBS, Canada's Superintendent of Financial Institutions Peter Routledge, stated, "Culture can reinforce established rules and risk management disciplines, or it can lessen the effectiveness of them. Culture can be a competitive advantage, or a weakness. It can affect every aspect of an institution from its compensation practices to its control framework."[3]

The key is that a credit union's culture needs to be present throughout the organization, from the frontline tellers through to the board. Credit unions are in an advantageous position because their boards are closer to the staff than in larger financial institutions. Setting the tone for the organizational culture can start with the board and be emulated throughout the organization. This is where risk management can be established as a key cultural norm, influenced and driven from the top down as well as the bottom up.

Back to Basics

The BC Financial Services Authority's Governance Guideline (2013)[4] outlines a board's responsibilities, which include:

- defining and approving the credit union's risk appetite;
- setting, approving, and monitoring the credit union's strategy and performance and overseeing its planning process;
- ensuring that the credit union has the capability and culture to manage within its risk appetite and achieve its strategy, including:
- overseeing the credit union and executive team;
    - choosing and evaluating the CEO; and
    - recruiting and renewing the board.

Credit union boards must ensure they are sticking to their fundamental role and leaving operational matters to management.

Dos and Don'ts of Effective Governance

From a prudential supervision perspective, the regulator looks to assess whether credit union boards are doing their job effectively. Regulatory bodies "gain confidence in the governance and risk management of a credit union when the board demonstrates that it is fulfilling its roles and responsibilities."[5] The following section explains a few applied practices of what to do (and not to do) when it comes to the effective governance of a credit union.

Setting the Strategic Direction

Do:

- Understand the credit union's operating environment.
- Have a view to the future and, with management's advice, set the credit union's strategic direction.
- Consider bringing in an external facilitator for strategic planning sessions to encourage different thinking.
- Remember to revisit your credit union's risk appetite when exploring strategic options.
- Prioritize strategic conversations as a part of every board meeting.

Don't:

- Wait until your strategic planning sessions to talk about the strategic direction of your credit union.
- Expect management to determine the strategic direction — their role is to operationalize the strategic plan.

One of the board's fundamental accountabilities is to set the credit union's strategy. Management takes direction from the board and executes the strategic plan. With the amount of change occurring in financial services, global markets, and the housing market, this role becomes ever more important when thinking about the sustainability and resiliency of credit unions. Boards need to engage in regular conversations about the credit union's strategy to ensure they are looking ahead and adapting to meet the evolving requirements of their members, employees, and communities.

Board Reporting

Do: Request consistent report formats, concise reporting that focuses on key issues, and plain language reporting.

- Demand that management make information more straightforward if it is not presented clearly.

- Ask questions and request clarification to better understand.

Don't: Fall into the trap of "this is the way it has always been done."

The complexity and amount of information that management provides can be daunting and time-consuming, particularly when board members are part-time, as is the case with credit union boards. These challenges make the flow of information from management to the board critically important for directors to play their roles effectively. The use of plain language and concise board reporting allows for effective communication and informed decision-making at the board level. Being clear on what reports are intended for helps the reader focus their time and energy on what is critically important. Although management is accountable for reporting, the board must clearly convey its expectations around receiving information from management.

Board members are made up of the credit union's membership and bring with them diverse backgrounds and expertise, some of which may not be in financial services and/or risk management. This makes it even more important that the reporting the board receives can be easily understood by all directors. To fulfill their governance and oversight responsibilities, management needs to distill complex concepts and information succinctly, to ensure the directors can clearly understand key risks and how these are being managed and thereby make well-informed decisions.

Provincial and federal regulators across Canada are making a conscious effort to write communications, guidelines, and expectations in plain language for similar reasons as mentioned above (i.e., the OSFI's plain language commitment[6]). From regulated industries to the public, governments want to ensure they are refining the clear communication of complex information to allow for a common understanding of what is required.

Effective Challenge

Do: Ask questions of the management team, challenge assumptions, and document the discussions and outcomes.

Don't:

- Rely solely on management opinions and perspectives when making decisions.
- Shy away from stating that you don't understand something.
- Don't assume that someone else on the board understands if you don't.

The board's ability to effectively challenge relies in large measure on the information it receives. "Without an adequate understanding of the business, a director's ability to prepare well and apply judgement is constrained, leaving him or her unwilling or unable to challenge or contribute."[7] One of the best ways to evidence this is through minuting the discussions with and questions asked of management. Minuting board discussions takes finesse, and a good rule of thumb is to follow the fairy tale of "Goldilocks and the Three Bears," where the level of detail is not too much, not too little, but "just right." Stabilization Central's Governance Toolkit contains a module focused on Best Practices for Board and Committee Minutes.

Additionally, establishing a board culture that enables discussion is paramount. Board chairs should be taking a leading role in establishing a culture of openness and respect that enables directors (new or tenured) to ask questions. The chair can help ensure directors are prepared for the discussion by prereading and managing the agenda to allow sufficient time for discussion and questions. They can also facilitate broad discussions and encourage input or questions from directors who may not be as vocal on a particular topic.

Role in Risk Management

Do:

- Review your Risk Appetite Statement regularly, taking into account constantly evolving regulatory expectations, market conditions, and the financial services landscape.
- Question the assumptions that underlie the Risk Appetite Statement.
- Establish a dedicated Risk Committee to engage in more detailed risk discussions and bring recommendations to the board.

Don't:

- Underestimate the importance of the risk appetite.
- Assume that the risk appetite doesn't need to change.

Risk management underpins everything the credit union does to fulfill its strategic objectives. The risk appetite forms part of an enterprise risk management (ERM) framework that attempts to "bring focus and an enterprise-view of activities that may otherwise be done in silos, in isolation from other parts of the organization."[8]

The board's responsibility for the risk appetite establishes the guard rails for management to gauge how much risk the credit union is willing to take on. The regulator will look to indicators of effective board governance to guide its judgement during its supervisory activities. These indicators may include the board's ability to objectively assess, on a regular basis, the appropriateness of the overall risk tolerance, major business activities, and risks of the provincially regulated financial institution.[9] Boards need to continually prioritize their role in and accountability for risk oversight.

Board Education and Training

Do:

- Use training to foster skills development in areas that may be lacking in your board's directors.
- Encourage collective learning opportunities to receive training as a whole board.
- Create an accountability mechanism for directors to complete annual education and training.
- Treat education as an ongoing journey.

Don't:

- View development and education as solely an individual director's journey.
- Ignore existing or emerging risk areas of the business as education topics.
- Treat specific topics as "one and done."

A board may lack expertise in certain areas, so it is important to identify these and seek appropriate training. One way of better understanding skills gaps is by creating a Board Competency Matrix. The board can utilize this tool to understand training opportunities for existing directors as well as help with recruiting new directors. Training and education will allow the board to challenge effectively and help avoid an overreliance on senior management that could result in the credit union engaging in higher-risk activities without the appropriate controls and oversight in place.

It is important that for complex and higher-risk areas of a credit union's business (i.e., commercial lending, IT/digital and cyber security, treasury), the board considers additional training to provide a better knowledge foundation and allow for more effective oversight. Research indicates that a board's competency in the governance of enterprise information and technology (GEIT) is "potentially as important as the game-changing technologies boards must oversee."[10] Some boards consider GEIT a core competency rather than a "nice-to-have." Similarly, new emerging risk areas such as climate risk may become focal points for collective board training.

Looking Inward: Stabilization Central Case Study

After an unprecedented and challenging year in 2020, Stabilization Central's Board of Directors took a step back to reflect on the effectiveness of its own governance. The board undertook a comprehensive review of its governance practices and policies to ensure these were reflective of the leadership role that Stabilization Central has in the system, and to assess whether they were "walking the talk" to set an example for our members about the importance of strong governance practices. With the support of management, the board reviewed its current state and identified areas for improvement.

Governance is a continual process, and every organization is at a different stage of its governance journey. Together, the board and management developed a roadmap prioritizing key areas and taking into consideration resource capacity (human and financial). The roadmap outlined a multi-year and continuous improvement journey.

The following areas were prioritized by Stabilization Central's Board and supported by the Corporate Secretary and Governance Officer:

- **Director Orientation Program:** Onboarding new directors is critically important to ensure a new member of the board can quickly gain a solid understanding of the business to fulfil their role in the oversight of the credit union. Although Stabilization Central had an orientation process in place, it was not documented, and the cadence was compressed. Ideally, information and learnings should be presented in a way that sets new directors up for success. The current orientation program includes one-on-one sessions with the Board Chair, committee chairs, and the management team. A cadence has been set up to provide information on each aspect of the business, with regular check-ins both in person and online. A balance of written materials, presentations. and informal chats is key to avoiding overwhelm. New directors sit in on all committees to learn first-hand the issues each committee is addressing, which encourages a holistic view of the organization.

- **Board Communications:** The amount of information going to the board and its committees every quarter is significant. Providing clarity to the board on why information is being presented and whether a decision or approval is required is important. Some reports will be provided for information purposes only. Appending a briefing memo to **every** report, summarizing the report's purpose and contents and clearly defining what management is requesting of the board, makes for more efficient meetings and better communication. Presentations should also be concise and encourage elevating the discussion around strategy and risk, keeping the board focused on their oversight role versus operations.

- **Strategy-Forward Agendas:** The board meeting agendas were replete with both strategic and operational items. However, the operational updates came first, with strategy at the end. A strategy-forward agenda meant that agendas were flipped, so strategy discussions came first and commanded the bulk of the meeting time. Strategic discussions and the resulting decisions and guidance for management are critical for achieving long-term strategic goals. Creating agendas that allow sufficient time for these discussions is a good governance practice. It ensures directors have the most energy for these critical topics, and it can increase engagement at board meetings while respecting the directors' time.

- **Terms of Reference and Workplans:** Terms of reference and workplans guide the work of the board and committees, rebalance workloads, and calibrate the overall responsibilities of board members and each of the committees to ensure the organization remains compliant with regulatory requirements and expectations. Stabilization Central conducted a comprehensive review of best practices and updated all the committee terms of reference and workplans to reflect these. It is a good governance practice for the board to review and update terms of reference and workplans annually.

- **Board Diversity and Skills Matrix:** Stabilization Central evolved and enhanced its board matrix so that it focuses not only on directors' skills and experience but also on diversity, community involvement, and character traits. Additionally, a new ratings scale was implemented, which includes clear definitions for the various levels of expertise and more accurately reflects the board's composition. The matrix will continue to evolve and will serve as a valuable tool to identify gaps and desirable criteria for recruiting directors.

- **Directors' Job Descriptions and Expectations:** Most credit unions have a board mandate or terms of reference that outline the role of the board as a whole, their fiduciary duties, and their oversight responsibilities; however, a job description and expectations for individual directors are not as common. Stabilization Central's board approved director job descriptions and expectations specifying each director's role and responsibilities. Providing clear expectations for individual directors helps to keep everyone aligned.

In addition to the above areas, the Board Governance Manual was overhauled to align with new legislation and best governance practices. Amendments were proposed to our rules, and a new director appointment policy was developed as part of our commitment to ensuring a strong, diverse, and qualified board.

Key Lessons

1) **Seek support:** Leverage external resources to help with capacity and/or knowledge gaps. Consider switching external support providers every couple of years to provide a fresh perspective. Stabilization Central can leverage its network of top-notch expertise to provide support that is tailored to your credit union's specific needs. Additionally, the Governance Toolkit has five modules that provide digestible and actionable resources and templates.

2) **Implementing effective board administration practices takes time and effort:** Be sure to consciously make governance top of mind and an area of focus year-over-year. The absence of a strong governance framework puts your credit union at risk, as the operations cascade from the strategic direction and risk appetite set by the board. Some organizations may not have a dedicated Governance Officer; however, it is imperative to have an individual in your credit union who is responsible for supporting the board and its governance. Additionally, these individuals need the capacity to carry out their duties effectively, including the appropriate training and development for this essential role.

3) **Pace yourself:** Governance is not a sprint; it is a journey of continuous improvement. Tackle governance projects using a phased approach with achievable deadlines. Establish a systematic process that allows for the completion of "bite-sized" pieces of work over time. It will make the process feel less daunting. Stabilization Central focused on one or two projects per quarter, recognizing that some would span multiple quarters, and doing so made it easier to track and see progress.

4) **Make it your own:** Focus on what is critically important to your credit union, and prioritize these pieces.

Additional Tips

- ➢ Regularly review the criteria that the regulator uses when assessing your credit union's overall effectiveness in a particular area of its business, to better understand where gaps may exist. Leverage continuous monitoring calls with your Relationship Manager to get feedback.

- ➢ Consider including your Board Chair in periodic conversations with your regulatory Relationship Manager to discuss the board's governance journey and demonstrate the board's continued engagement and commitment to its role of overseeing the credit union.

- ➢ Peer-to-peer sharing and collaboration are big parts of the credit union sector. Often, these conversations occur only at the management level. However, conversations between board chairs or directors of peer credit unions may provide insights into areas of focus or learnings from a board governance perspective.

For more information on how Stabilization Central can assist your credit union with its governance practices, please contact info@stabilizationcentral.com.

Endnotes:

---

[1] Basel Committee on Banking Supervision (BCBS), Bank for International Settlements, *Report on the 2023 Banking Turmoil* (October 2023). https://www.bis.org/bcbs/publ/d555.htm

[2] Ibid., p. 8.

[3] Starling Insights, Peter Routledge, Clare Bolingford, Stephen Scott, Ted MacDonald, Stuart Mackintosh, and Mirea Raaijmakers, *Deeper Dive — UK Parliamentary Commission on Banking Standards: A Global 10-Year Look-Back* (July 2023). https://insights.starlingtrust.com/content/thoughts/deeper-dive-pcbs-a-global-10-year-look-back

[4] BC Financial Services Authority, *Governance Guideline* (September 2013). https://www.bcfsa.ca/media/91/download

[5] Ibid., p. 4.

[6] Office of the Superintendent of Financial Institutions, *Acts and Regulations* (January 2024). https://www.osfi-bsif.gc.ca/en/guidance/acts-regulations

[7] Richard LeBlanc, *The Handbook of Board Governance* (2016), John Wiley & Sons, p. 213.

[8] Ibid., p. 288.

[9] BC Financial Services Authority, "Overall Board of Directors Assessment Criteria," https://www.bcfsa.ca/about-us/what-we-do/mandate-and-values/regulation-and-initiatives/supervisory-framework-and-guidance/overall-board-directors-assessment-criteria

[10] Ibid., p. 575.

Other References:

Basel Committee on Banking Supervision, Bank for International Settlements, *Corporate Governance Principles For Banks*, (July 2015). https://www.bis.org/bcbs/publ/d328.pdf

UK Parliamentary Commission on Banking Standards, *Changing Banking for Good: Report of the Parliamentary Commission on Banking Standards* (June 2013). https://www.parliament.uk/globalassets/documents/banking-commission/Banking-final-report-vol-ii.pdf