LESSONS LEARNED

The Intervention Stage Rating (ISR) and Regulatory Remediation Process

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CREDIT UNION

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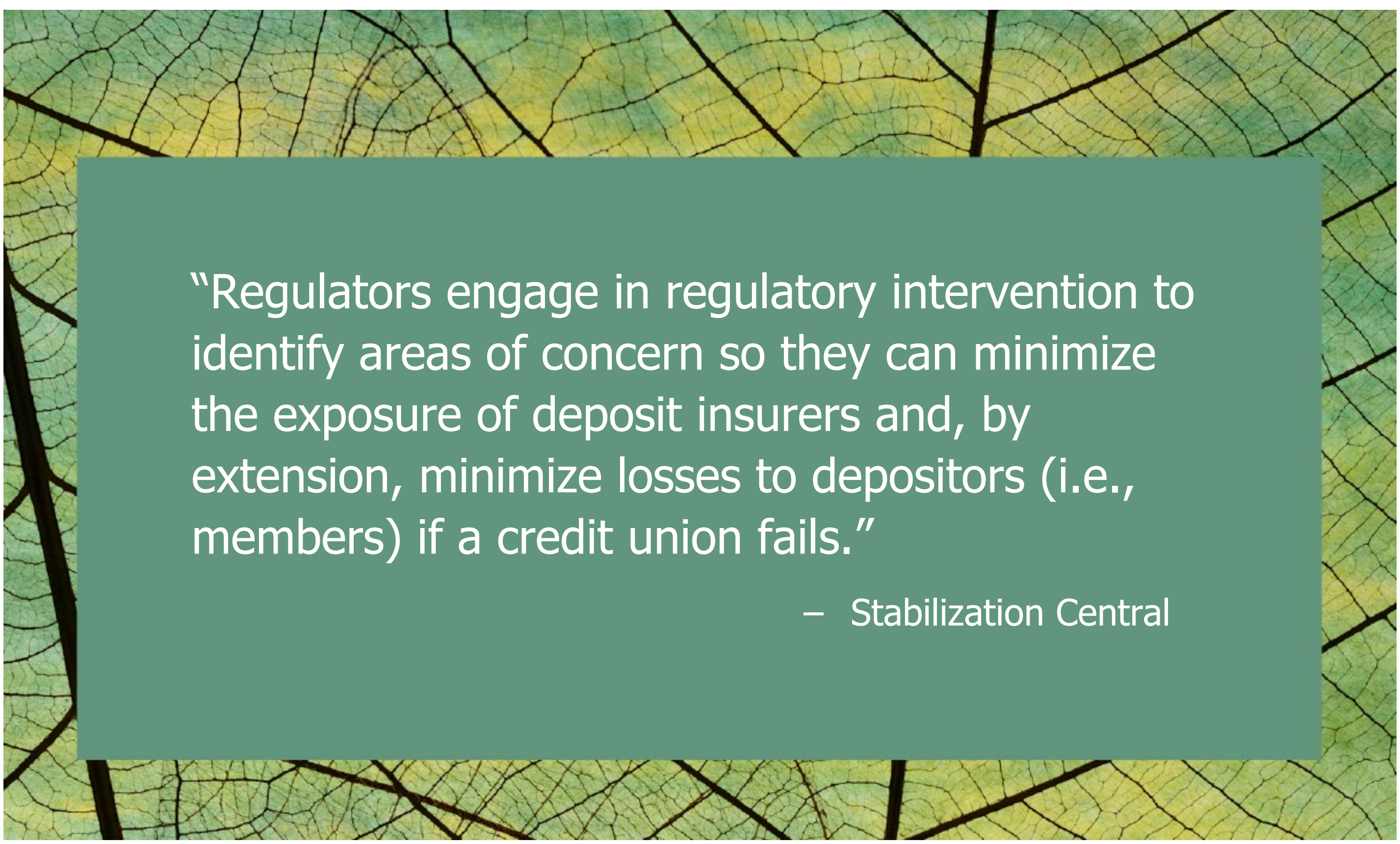

Background

Since its inception, Stabilization Central Credit Union ("Stabilization Central") has successfully guided credit unions through various regulatory interventions. One regulatory methodology used by Canadian financial services regulators ("regulators"), commonly referred to as the intervention stage rating ("ISR"), is not well understood by credit unions. This lack of understanding can often lead them to make unproductive decisions that impede their ability to reduce their intervention stage rating efficiently. However, board directors and senior management teams can leverage the regulatory intervention process to emerge as a stronger credit union.

This paper, within the Lessons Learned series, explores the ISR and regulatory remediation process in BC and Canada. We also describe what board directors and senior management can expect, as well as best practices and practical tips to navigate this challenging circumstance. The aim is to inform credit unions about the staging process based on Stabilization Central's extensive experience in this area, and to explain how we can support a credit union that finds itself under heightened regulatory scrutiny.

Intervention Stage Rating: A Primer

Regulators engage in regulatory intervention to identify areas of concern so they can minimize the exposure of deposit insurers and, by extension, minimize losses to depositors (i.e., members) if a credit union fails. The statutes for financial institutions across Canada provide a wide range of discretionary intervention powers that allow regulators to intervene and address concerns that may arise with deposit-taking institutions. Regulatory intervention also applies to other types of financial institutions, such as insurance and trust companies.

In BC and most other Canadian regulatory jurisdictions, regulators assign an ISR that reflects any issues and concerns arising from supervisory reviews, monitoring activities, or external market conditions. A stage rating is one form of intervention. ISRs are generally focused on prudential matters related to solvency concerns but can extend into business conduct issues, such as a significant breach of legislative compliance. This means that a regulatory decision to stage a credit union can occur for financial and non-financial reasons and will take into account the relative size, scope, and complexity of the institution.

Regulatory authorities across Canada have different numbers of levels associated with their ISRs. Some jurisdictions may have four levels of staging, while others, such as BC, will have five.[1] A credit union is "staged" once the regulator assigns it an ISR of level one or higher. Regulatory intensity increases as credit unions move up the intervention staging ladder, which may involve greater monitoring or the use of other regulatory tools. It is common for regulators to publish their supervisory framework, as well as intervention guides that outline their actions for each staging level.

Regulators communicate with the credit union regarding their ISR through a supervisory letter. This is a key document, as it communicates the regulator's assessed composite risk rating[2] ("CRR") for the credit union and confirms the credit union's ISR. A higher CRR will generally result in a higher ISR. The letter also provides a series of findings and remediation activities

[1] BC Financial Services Authority (BCFSA), "**Supervisory Framework 2021: For Provincially Regulated Financial Institutions**," Appendix E, p. 30.

[2] The CRR assesses a provincially regulated financial institution's risk profile—after considering assessments of its earnings and capital in relation to the overall net risk from its significant activities—and its liquidity. See BCFSA, "**Supervisory Framework 2021**," p. 17.

(often referenced as requirements or recommendations). These are items that need to be remediated by the credit union before the regulator lowers the rating or de-stages the credit union. In most cases, the completion deadlines provide an indicator of the importance of each requirement or recommendation. Regulators may choose to share the contents of the supervisory letter in advance of the ISR confirmation. The supervisory letter and ISR are confidential but can sometimes be shared with important third parties, such as auditors or Stabilization Central.

Why the Intervention Process Matters

Staged credit unions encounter increased regulatory attention and rigour. The level of regulatory intensity increases as credit unions move up the intervention staging ladder, and it is advisable to address issues before a stage level escalates. Regulators use the lower staging levels to intervene early and be proactive in addressing issues before they become more serious. Addressing issues through early staging allows regulators to avoid using more severe intervention tools later. The challenge for credit unions is to determine the best approach to achieve de-staging.

Staging decisions by the financial services regulator will not always be escalatory. This means that an ISR can be higher at the outset if the regulatory issue or concern is a serious one. If the regulator does not see progress toward remediation, it may increase the credit union's ISR, potentially resulting in sanctions such as severe business restrictions (e.g., the inability to offer commercial lending). In extreme scenarios, the credit union board and management team may be removed from control, or the institution may be forced into windup or amalgamated with another credit union.

A higher intervention stage rating will also have implications for a credit union's deposit insurance premium. Many Canadian deposit insurers incorporate the CRR and ISR in their annual premium calculations. The timing of a credit union's staging or de-staging can be important for deposit insurance premium calculations and budgeting purposes.

As a credit union moves up the stage rating level, the deposit insurer views the credit union as being at increased risk of insolvency and, by extension, a greater risk to the deposit insurance fund. The resulting higher deposit insurance premium incentivizes credit unions to avoid being staged or to take rapid remedial actions to be de-staged.

What to Do If You Are Staged

If the regulator stages your credit union, there are best practices to follow throughout the staging journey. Stabilization Central recognizes that a staging decision can be a stressful experience for board directors and the senior management team. However, your credit union can withstand the staging process by following these four best practices.

1. **Communicate in a measured way.** The staging process can be a frustrating experience for any credit union. However, in your interactions with the regulator, the use of emotionally charged language (written or verbal) can be counterproductive and prolong efforts to remediate issues. Credit unions communicating with the regulator should calmly and constructively seek to understand the regulatory requirements and the gaps in their performance.

2. **Seek immediate support.** Your credit union needs good advice on how to remediate issues and maintain constructive communication with the regulator. Credit unions undergoing the staging process will benefit from a dedicated team that can focus on remediation activities, with subject matter experts to help provide external feedback on your current situation. Stabilization Central can act as your key advisor throughout the staging journey.

3. **Be constructive.** The process of being staged and de-staged can be an incredible opportunity to improve how your credit union is managed and governed. Staging

can be the impetus for positive change, particularly if the credit union has outgrown its current practices. Many credit unions emerge from the staging process better positioned to manage and oversee risk. Stabilization Central provides elective services that will help your credit union advance its risk management and governance practices.

4. **Get clarity on expectations.** Some items in the supervisory letter may seem vague or unclear. It is important to have productive dialogue between the credit union and the regulator, to ensure you receive the clarity needed to action the remediation findings.

If the regulator refers a staged credit union to Stabilization Central, this referral may be noted in the supervisory letter, allowing Stabilization Central or your credit union to arrange an initial consultative meeting to discuss the engagement. Stabilization Central has been able to turn around credit unions in a way that uses regulatory-driven change to strengthen the organization, providing facilitation support and acting as a neutral sounding board throughout the process. Your credit union can benefit from Stabilization Central's expertise and extensive infrastructure during the staging process.

The Roles of the Board and Senior Management Team in the Staging Process

The board and senior management team perform integral roles when a credit union is staged. This is an opportunity for them to demonstrate leadership and accountability in response to regulatory concerns. Although boards and senior management team members may wish to assign fault, it is wiser to spend your credit union's limited time and resources addressing the immediate issues at hand. Regulators want to see boards and management be accountable for remediation efforts. They pay attention to collective actions and responses, and it is best to demonstrate your credit union's effectiveness in these and other areas. The credit union is best served by a board and senior management team who work together and speak as one organization when addressing the regulatory requirements and recommendations.

The staging process can be highly disruptive for an organization, and senior management should not view this period as business as usual. In particular, the chief executive officer (CEO) should assign a lead who will be accountable for the remediation efforts. The lead is typically an individual from the senior management team (e.g., chief risk officer, chief compliance officer, chief financial officer) who has the authority and capacity to focus on the remediation activities. The lead will keep the board and senior management team updated on remediation progress and communications with the regulator. All other senior management team members must be able to support the lead by responding to requests and providing information in a timely manner. The lead may or may not have support from a project manager who helps to coordinate the flow of information between the credit union team members, the regulator, and Stabilization Central.

As the staging process can involve significant change, leadership from the CEO is essential. The CEO should be visible throughout the staging process, not only in communicating with the regulator but also to their internal team members. In particular, the CEO can play a critical role in supporting the organization by prioritizing initiatives, including ongoing operations, and by working with senior management on the right change management approach to reassure credit union team members who may be affected by structural, or process changes implemented to meet regulatory requirements. The CEO needs to monitor the stress and workloads of credit union team members to achieve tight deadlines when meeting regulatory requirements. Being de-staged is the final objective, but how the credit union achieves this is of equal importance.

Board members have ultimate accountability over the credit union's remediation efforts. This accountability cannot be delegated to the CEO and senior management team, so board members must be committed to being fully engaged throughout the staging process. The board, through its chair, sets a clear tone for the credit union's response to the regulator. At a minimum, the board chair should be aware of pertinent communication between the CEO and the regulator during the staging process. It is not uncommon for a board and its chair to contribute a substantial amount of time towards remediation efforts.

Board committees can be assigned primary responsibility to coordinate and work with the senior management team on specific aspects of the staging process, but the entire board retains oversight responsibility. It is very common for a risk or audit committee to be assigned primary responsibility to work with senior management on remediation efforts. This may involve the committee discussing and professionally challenging the options and approach proposed by the management team to remediate issues. It may also involve making decisions on governance changes or organizational policies. More specifically, the committee members will be actively communicating with management to understand the credit union's gaps and the regulator's expectations.

Credit union boards and senior management are advised to engage with Stabilization Central early and often during the staging process, to receive advice on regulatory compliance, risk management, and governance.

How Stabilization Central Supports the Remediation Process

As a stabilization authority, Stabilization Central is notified by the regulator when a credit union's ISR goes above zero. Stabilization Central meets with a credit union immediately after being notified. A meeting is also scheduled with the regulator to understand their concerns, their expectations of support for the credit union, and the logistics. The regulator drafts an engagement letter to outline its expectations of Stabilization Central, including specific areas to provide support. Often, Stabilization Central is requested to review and validate the credit union's work before it is finalized for submission to the regulator. This allows Stabilization Central to provide an independent assessment of the quality of the credit union's work.

Stabilization Central drafts a letter of stabilization services for the credit union, based on the prioritized topics in the regulator's engagement letter, to lay out the terms of the engagement and how Stabilization Central will provide support. This includes identifying subject matter specialists with decades of experience who will offer independent assessments, feedback, and recommendations to get the credit union moving in the right direction. It also includes having access to the credit union's board to provide advice and offer feedback, as required.

Stabilization Central will schedule regular meetings (often biweekly) with the credit union's management team to review progress, discuss roadblocks, and determine what to prioritize next. This ensures management is following through on sustaining improvements over time. On a monthly basis, Stabilization Central will prepare a report to the regulator, assessing the credit union's progress. As a credit union gets close to completing its remediation work, Stabilization Central will issue a report and opinion to the regulator on whether the credit union should be reviewed for de-staging.

Practical Tips If Your Credit Union Is Staged:

- **Do not panic.** Credit unions have been through this process and emerged as stronger, more resilient financial institutions. Credit unions that succeed in being de-staged do so through careful planning and deliberate steps.

- **Reach out to Stabilization Central.** Remediation support is what we do best. We have the knowledge, experience, and infrastructure to help your credit union from the time it is staged through to de-staging.

- **Apply a project management discipline** when managing and coordinating the staging process. This will involve the use of project management tools and technology. If you do not have a dedicated project manager, please ask Stabilization Central how we can support you.

- **Allocate a budget for remediation work.** An investment of additional internal resources may be required, as well as external support from third-party contractors to provide independent expertise and recommendations.

- **Pace yourself.** The staging process is a marathon rather than a sprint. Regulators want to see well-considered responses to remediation requirements, and time may be required to see evidence of sustained changes at the credit union. It also takes time for the regulator to review these before the requirements and recommendations will be considered closed.

Proactive Tips to Avoid a Higher ISR

Other papers in the Lessons Learned series focus on various specific topic areas, but below are a few ways your credit union can continually evolve:

- **Ensure your risk appetite framework is aligned with new strategies.** If your credit union is pursuing new ventures or new ways of doing business, be sure it has the capability and capacity to manage and oversee the associated risks. At minimum, this should involve aligning the credit union's risk framework with policies and reviewing how it will monitor risks as it moves forward with new strategies.

- **Encourage your board to increase its education and training.** The financial services industry is constantly changing to meet new regulatory expectations. Identify the areas where your board needs more training, and build a development plan. Consider obtaining coaching for the board so they understand the questions they should be asking to provide effective oversight of the credit union. Stabilization Central offers tailored training and coaching for your board to stay ahead in this changing landscape.

- **Improve your documentation.** This may involve enhancing reporting to show the level of risk analysis, as well properly recording board discussions and questions in the minutes of meetings. The regulator will be reviewing your documents to understand whether the board is undertaking its oversight responsibilities appropriately.

- **Conduct spot checks.** Choose a few files (e.g., retail and commercial loan files) to ensure the credit union is collecting all the necessary information from members and providing the depth of analysis required to evidence risk management practices.

For more information on how Stabilization Central can assist your credit union through the intervention staging process, please contact **info@stabilizationcentral.com**.

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