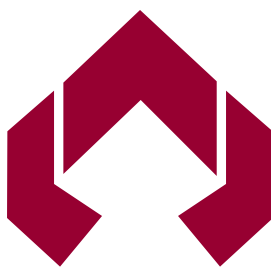




Office of the Superintendent of
Financial Institutions Canada

Bureau du surintendant des
institutions financières Canada



Corporate Governance Guideline

January 2003

**EFFECTIVE CORPORATE GOVERNANCE
IN
FEDERALLY REGULATED FINANCIAL INSTITUTIONS**

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I Introduction

Nature and Purpose of the Guideline

This guideline provides information to boards of directors and management of federally regulated financial institutions about the expectations of the Office of the Superintendent of Financial Institutions (OSFI) on corporate governance and the factors it takes into account in assessing the quality of governance of each institution.

This guideline applies to all federally regulated financial institutions other than branch operations of foreign banks and foreign insurance companies¹.

Individual institutions will adopt different approaches to corporate governance, taking into account the nature, scope, complexity, and risk profile of their institution. The supervisory process takes this into consideration in the evaluation of individual institutions.

Corporate governance refers to oversight mechanisms, including the processes, structures and information used for directing and overseeing the management of a company. It encompasses the means by which members of the board of directors and senior management are held accountable for their actions and for the establishment and implementation of oversight functions and processes. In this document, the term “board” refers to either the entire board or, where applicable for an individual institution, a committee of the board that has been delegated a particular element of board oversight.

OSFI will formulate its overall judgement on board effectiveness based on a variety of indicators, the most important of which are findings from monitoring and on-site examinations. OSFI will not look for strict adherence to, and extensive documentation of, the specific points covered in this guideline. As part of its supervisory process, OSFI will look for indications that, overall, processes or procedures are in place, that they are appropriate to the individual institution, and that they are operating effectively. OSFI will also look for indications that these processes or procedures allow the board to carry out its oversight responsibilities and that these responsibilities are being carried out.

¹ Branches do not have boards of directors and, accordingly, it would be inappropriate to apply the specific provisions of this guideline directly to branch operations. At the same time, consistent with the manner in which the OSFI ratings criteria are being applied, OSFI looks to the Principal Officer or Chief Agent of a branch to oversee the management of the branch, including matters of corporate governance. These individuals are recognized as having overall responsibility for their respective branches and therefore should be aware of this guidance.

The Role of Governance in the Supervisory Process

Effective corporate governance is an essential element in the safe and sound functioning of financial institutions. The board of directors and senior management are designated as key control functions in OSFI's Supervisory Framework. Effective oversight of the business and affairs of an institution by its board and senior management is also essential to the maintenance of an efficient and cost-effective supervisory system. It helps protect depositors and policyholders, and allows OSFI to rely on the institution's internal processes, thereby reducing the amount of supervisory resources needed for OSFI to meet its mandate. In addition, in situations where a financial institution is experiencing problems, or where significant corrective action is necessary, the important role of the board is heightened and OSFI requires significant board involvement in seeking solutions and overseeing the implementation of corrective actions.

OSFI supervises federally regulated financial institutions to assess their condition and monitor compliance with applicable laws and regulations. Supervision is carried out within a framework that is risk-focused². OSFI has developed a comprehensive set of ratings criteria, key among which is the quality of oversight and control provided by the board of directors and senior management of the institution. These criteria can be found on OSFI's Web site at www.osfi-bsif.gc.ca.

The Special Nature of Financial Institutions

This guideline draws attention to certain areas that are especially important for financial institutions, owing to the nature and circumstances of business conducted and risks assumed. A number of factors sets financial institutions apart from other business firms, and has led them to be subject to generally higher levels of regulation, including:

- the effectiveness of any economy depends significantly on how well its financial services sector functions. Relative to non-financial businesses, the failure of a financial institution can have a greater impact on members of the public who may have placed a substantial portion of their life savings with the institution and who may be relying on that institution for day-to-day financial needs. While not the case for all participants in the financial services industry, there is also potential in some circumstances for system-wide impacts from such failures or material impacts in selected markets, given the interconnectedness of the financial system. Safety and soundness concerns are, therefore, of particular importance for financial institutions;

² See Office of the Superintendent of Financial Institutions, *Supervisory Framework: 1999 and beyond*.

- financial institutions may have high ratios of debt to equity, making them more vulnerable to unexpected adverse events;
- financial institutions can experience severe liquidity problems if their customers or counterparties lose confidence in their safety and soundness;
- financial institutions accept funds from the public and often deal in long-term financial commitments, which are predicated on a high degree of confidence in the long-term stability and soundness of the institutions making these commitments; and
- the values of many of financial institutions' assets and liabilities can be volatile and may be difficult to price accurately, since they are not traded in financial markets. Similarly, financial institutions may issue and trade in complex financial instruments, which can be difficult to evaluate properly and can materially and rapidly affect the risk profile of an institution.

These characteristics create unique challenges for the governance of financial institutions and underscore the importance of effective risk management systems and rigorous internal controls. They point to the need for knowledgeable, independent oversight exercised by or on behalf of the board of directors, along with the additional assurance of regulatory oversight, to provide assurance to markets on the reliability of reporting and disclosure. Also, as a consequence of being a regulated industry, the governance processes of financial institutions are subject to review and may be influenced by the views of OSFI and other regulatory bodies.

Finally, many financial institutions have complex organizational structures with a large number of entities (some of which may not be regulated) used to deliver different financial products. For these organizations, the relationship between the parent company and its subsidiaries merits special consideration and the effective governance of subsidiaries should be a high priority for directors and senior management.

II OSFI's Approach to Assessing the Effectiveness of Governance

General Approach

OSFI's framework for assessing the effectiveness of governance is based on a twofold approach: 1) an assessment of the governance process against a range of characteristics, and 2) an assessment of the institution's performance or effectiveness in carrying out its governance responsibilities.

Characteristics may contribute to, but do not guarantee, effective governance. OSFI expects directors of federally regulated financial institutions to be aware of OSFI's expectations as expressed in this document and in the OSFI ratings criteria.

As reflected in the ratings criteria, board characteristics are assessed on the following elements:

- composition of the board;
- the board's role and responsibilities;
- the nature and operations of board committees;
- board practices; and
- board self-assessment programs.

Effective board performance means the board actively embracing its responsibilities and bringing its collective skills and experiences to bear in providing independent, objective and thoughtful oversight and guidance to the institution.

The degree of applicability and weighting of individual criteria within these elements will depend on the nature, scope, complexity and risk profile of each institution.

The basic oversight responsibilities of boards include:

- reviewing and approving organizational structure and controls;
- reviewing and approving organizational and procedural controls, and satisfying themselves that these controls are operating effectively;
- ensuring that the CEO and other members of senior management are qualified, competent and compensated in a manner that is consistent with appropriate prudential incentives;
- taking an active role in the choice, review and approval of broad strategies, business objectives and plans;
- reviewing and approving policies for major initiatives and activities;
- monitoring of performance against business objectives, strategies and plans;
- obtaining reasonable assurance on a regular basis that the institution is operating within an appropriate control framework; and
- undertaking succession planning for the position of CEO and other critical management positions.

The Ongoing Evolution of Governance Practices

The quality of corporate governance practices is becoming an increasingly important factor in maintaining market confidence. Considerable guidance is available on the responsibilities of boards of directors and on corporate governance more generally. Guidance and related practices are evolving rapidly in several areas, including board and audit committee independence, responsibilities with respect to risk management and strategic planning, and assessment of board performance.

Securities commissions, stock exchanges, governmental and international bodies, and others have issued guidance on corporate governance. OSFI expects federal financial institutions to be aware of emerging best practices that are applicable to their institution (which may depend, for example, on whether the institution is a publicly-traded entity), and will look for indications that these have been considered and, where appropriate, incorporated into the institution's governance practices.

III Effective Board Performance

Appropriate organizational structures, policies and controls help promote, but do not ensure, good corporate governance. Effective corporate governance is mainly the result of dedicated directors and senior managers performing faithfully their duty of care to the institution. What makes structures and policies work in practice are knowledgeable and competent individuals, with a clear understanding of their role and strong commitment to, and initiative in, carrying it out.

OSFI looks not only for evidence that institutions have appropriate policies and processes in place but also for indicators that these policies and processes are understood, are being followed and that, as a result, they are effective.

OSFI recognizes that to be effective, boards of directors must operate as an organic whole. While OSFI expects all directors to play an effective role, it is recognized that the contribution of individual directors will vary based on their particular qualifications and experience.

In OSFI's view, the hallmarks of effective corporate governance by the board and its members include:

Judgement:

- decisions that strike a reasonable balance between business objectives and risk management and control functions.

Initiative:

- proactive exercise of responsibilities by members, while respecting the responsibility of the CEO and senior management to manage the institution;
- readiness to both advise and challenge management;
- an adequate commitment of time by members for board responsibilities;
- involvement in the determination and review of the institution's business objectives and strategies.

Responsiveness:

- responsiveness to issues or deficiencies identified by management, the independent oversight functions and regulators;
- involvement in management's response to regulatory recommendations and requirements;
- responsiveness to issues identified in board evaluations of itself or management.

Operational Excellence:

- processes and ways of operating that permit discussion and advance consideration of important matters and transactions, based on appropriate and timely information and analysis;
- periodic review of the adequacy and frequency of information the board needs to fulfill its responsibilities.

IV Risk Management

Risk Management Processes

Risk taking is a necessary part of any business and financial institutions are certainly no exception. Financial institutions' choices of business objectives and strategies are intimately tied to decisions about the particular risks the institution is prepared to take and what means it will use to manage and mitigate these risks.

The types of risks assumed and the relative importance of particular types of risks in the institution's risk management process will differ based on the institution's business mix and risk tolerance. Risk management means, in part, understanding the quality of assets and the nature of associated liabilities.

Risk management systems and practices will differ, depending on the scope and size of the institution and the nature of its risk exposures. But whatever the particular approach, every institution should have integrated policies that, taken together, apply to the organization's significant activities regarding the corporate philosophy on risk management, the institution's permissible exposure to risk, objectives of risk management, delegation of authorities and

responsibilities, and processes for identifying, monitoring and controlling/managing risk. This process should be tailored to the particular nature of the institution and can, for example, have different degrees of centralization or decentralization and be organized in various ways. It should enable the board and senior management to meet their organization-wide responsibilities. Comprehensiveness is a key attribute of effective risk management.

Risks may arise from direct exposure or through exposures taken by subsidiaries or affiliates. In either case, institutions should be in a position to identify all the significant risks they face, assess their potential impact and have policies in place to manage them effectively. Institutions should review their policies and practices regularly to ensure that they remain appropriate in light of changing circumstances and in light of how policies and practices have performed. Along with management, the board of directors is responsible for overseeing the performance of such reviews.

The Role of the Board in Risk Management

The board has a number of oversight responsibilities with respect to risk management. Effective board practices include that the board:

- have a general understanding of the types of risks to which the financial institution may be exposed and of the techniques used to measure and manage those risks;
- review and approve the overall risk philosophy and risk tolerance of the institution. OSFI expects the board to be aware of material changes to the institution's business strategies or risk tolerance and the limits within which individuals are authorized to act;
- review and approve significant policies or changes in policies for accepting, monitoring, managing and reporting on the significant risks to which the institution is exposed;
- require that management have a process for determining the institution's desired level of capital, taking into account risks assumed, and for ensuring that capital management strategies are in place;
- require from management timely and accurate reporting on significant risks faced by the institution, the procedures and controls in place to manage these risks, and the overall effectiveness of risk management processes. The board should be aware of, and satisfied with, the manner in which material exceptions to policies and controls within the institution are identified and monitored, the nature of reporting to the board, and the consequences within the institution, when exceptions are identified;

- assure itself that the risk management activities of the institution, however organized, have sufficient independence, status and visibility and are subject to periodic reviews; and
- include in its reviews of changes in strategies or new business initiatives, a review of requisite/related changes in risk management and controls.

Boards should not treat this as a checklist of criteria requiring extensive, documented policies and procedures. However, OSFI is of the view that these general attributes of board performance are important for board effectiveness. OSFI recognizes that individual institutions will adopt different approaches to board oversight of risk management, taking into account the nature, scope, complexity, and risk profile of their institution.

V Internal Controls

Internal Control Mechanisms

Internal controls encompass the policies, processes, culture, tasks and other aspects of an institution that support the achievement of the institution's objectives. They facilitate the efficiency of operations, contribute to effective risk management, assist compliance with applicable laws and regulations, and strengthen capacity to respond appropriately to business opportunities.

The Role of the Board in regard to Internal Control Mechanisms

Development and implementation of an adequate and sound system of internal controls is normally the responsibility of senior management. The board of directors, however, is ultimately responsible for ensuring that such a system is established and maintained. As part of this responsibility, the board should regularly, at a high level, review the system of internal controls to determine that it works as expected and that it remains appropriate.

Useful inputs into these reviews include:

- management reports on the operations and financial condition of the institution, the performance of risk management and other control systems during the period under review, and any significant non-compliance with controls, the institution's code of conduct, or with laws and regulations;
- internal and external audit opinions on the adequacy of controls for the institution as a whole and for individual business activities, and recommendations for improvements;
- for insurance companies, the Dynamic Capital Adequacy Test (DCAT) along with reports of the appointed actuary on the value of policy

liabilities, on the current and prospective position of the institution, and on matters that might have a material adverse impact on its financial condition;

- the audit report on the audited financial statements and all other reports of the external auditor, including the auditor’s management letter;
- views, solicited by the board, of the institution’s external and internal auditors and legal counsel; and
- the views and observations of the regulators of the financial institution.

The board should ensure that management takes prompt action to correct any material control problems that emerge from these reviews and that there is a board process in place to follow up on progress made to correct deficiencies. The board, along with senior management, should also proactively consider whether deficiencies identified in one area may also be present in other areas.

VI Independent Oversight Functions

The Role of Independent Oversight Functions

In some of its oversight responsibilities, the board relies on the advice and opinions of internal oversight functions (internal audit and compliance; the appointed actuary for insurance companies; and risk management where such a function exists separately) as well as of the external auditor. These functions are most effective when they are able to provide independent and objective assessments of the matters they examine. It is important that the board, through the examination of work done by these parties, establish a basis for this reliance. The board should support these functions and ensure they are independent, have the authority to carry out their responsibilities, and have direct access to the board.

These functions help the board validate whether internal controls are working and whether the institution’s operations and results are reliably reported. OSFI expects boards a) to satisfy themselves that these functions are in a position to operate effectively, and b) to take advantage of the assistance these functions can provide, by familiarizing themselves with the work of these functions, reviewing and understanding their reports to the board, and following up on concerns raised by their findings.

The Role of the Board in regard to Independent Oversight Functions

To assure itself that these functions are in a position to support the board as expected, the board in general terms should:

- actively exercise its responsibility for recommending to shareholders a suitable nominee for appointment as external auditor;
- take an active interest in the selection of heads of internal oversight functions;
- review the mandates and organizational structures of the internal control functions, and approve any major changes thereto, and regularly review the scope of the proposed activities of these internal functions and of the external auditors;
- require that those who are responsible for fulfilling these functions are independent from the operations under review and free of influences that may affect their ability to perform their responsibilities objectively;
- require that the internal oversight providers and the external auditor have unrestricted access to the board, including through periodic meetings without senior management present;
- satisfy itself that those who are responsible for fulfilling these functions have the resources and authority required to perform their duties appropriately and receive support from senior management, and should generally seek assurances that work plans provide adequate coverage in light of the risks faced by the institution;
- satisfy itself that the remuneration provided to key individuals in these functions adequately reflects the importance of the function and that the incentives contained in these remuneration packages for the function are not inconsistent with its role and responsibilities;
- discuss key findings of the reports produced by these functions, understand how material disagreements are dealt with, and follow-up on any concerns raised by these functions; and
- regularly review the nature of the function being carried out as well as the effectiveness and independence of those fulfilling these functions.

A board of directors will often oversee these independent oversight functions through an appropriate committee, such as the audit committee or the risk management committee.

Boards should not treat this as a checklist of criteria requiring extensive, documented policies and procedures. However, OSFI is of the view that these general attributes of board performance are important for board effectiveness. OSFI recognizes that individual institutions will adopt different approaches to board oversight of independent oversight functions, taking into account the nature, scope, complexity, and risk profile of their institution.

The Role of the Audit Committee

Legislation requires that each financial institution establish an audit committee comprised of non-employee directors, a majority of whom are not “affiliated” with the institution (as defined in the financial institutions legislation and the Affiliated Persons Regulations associated with each financial institution’s governing statute). Current best practices suggest or require that all audit committee members be “independent” board members, as defined in associated guidance.

The statutory duties of the audit committee include reviewing the annual statements of the institution, evaluating and approving internal control procedures for the institution, and meeting with the independent oversight providers to review their functions and discuss the effectiveness of the institution’s internal controls and reporting practices.

OSFI expects the audit committee to satisfy itself that the institution’s audit plan is risk based and covers all relevant activities over a measurable cycle, and that the work of internal and external auditors is co-ordinated. Where part or all of the internal audit function is outsourced, the board still has a responsibility to oversee the performance of internal audit as a whole.

With respect to the external audit, the audit committee should:

- assure itself that the scope of the audit plan is appropriate, risk based, and addresses major areas of concern, and that the audit plan is reviewed with appropriate frequency;
- assess the skills and resources of the auditor, taking into account the risks and complexity of the financial institution, and be satisfied with the content of the auditor’s engagement letter prior to it being signed;
- obtain assurances regarding the independence of the auditor, and the audit firm’s internal policies and practices for quality control;
- establish criteria for the types of any non-audit services that the external auditor may provide, including rules stipulating when advance approval by the audit committee is required for new contracts;
- assess whether the institution’s accounting practices are conservative and appropriate. OSFI would expect institutions to adopt accounting and actuarial practices that are clearly within the bounds of acceptable practice;
- ensure that the committee receives all material correspondence between the external auditor and management related to audit findings;
- hold regular meetings with the external auditor, without management present, to understand all issues that may have arisen between the auditor and management in the course of the audit and how those issues have

been resolved, and the extent to which accounting practices being used by the institution are appropriate relative to the materiality of the item. In addition, these meetings should address any other matters that the external auditor believes that the audit committee should be aware of in order to exercise its responsibilities. In the case of insurance companies, similar activities should take place with respect to the work of the appointed actuary;

- discuss with senior management and the external auditor the results of the audit, the annual and quarterly financial statements and related documents, the audit report, and any related concerns that the external auditor may have;
- discuss with the external auditor the quality of the financial statements and satisfy itself that the financial statements present fairly the financial position, the results of operations and the cash flows of the financial institution;
- regularly review the external auditor's performance; and
- make a recommendation concerning the appointment of the external auditor.

VII Governance of Subsidiaries and Holding Companies

Parent boards must be aware of all material risks and other issues that may ultimately affect the organization. As some of these risks may originate in subsidiaries, it is necessary that the parent board be able to exercise adequate oversight over the activities of the subsidiary.

The corporate governance responsibilities of boards of subsidiary financial institutions are the same as those of regulated parent financial institution boards. The corporate governance responsibilities of regulated holding company boards are the same as those of regulated financial institutions, with a few exceptions (e.g., a regulated holding company is not required to have a conduct review committee or to establish procedures to deal with complaints).

Boards of parent companies should determine what board structures for its subsidiaries would best contribute to an effective chain of oversight. It is recognized that in the case of a regulated subsidiary, the board structure of the subsidiary may be affected by legislative requirements. Regardless of the composition of the board of the subsidiary, parent boards should exercise adequate oversight of the activities of subsidiaries to ensure that the parent board can meet its responsibilities. At the same time, this does not suggest that boards of subsidiary institutions should replicate all corporate

governance activities of parent boards or that parent boards should assume responsibility for the performance of specific duties of subsidiary boards.

Financial institutions should pay special attention to the performance, composition and activities of subsidiary boards, especially where:

- the activities of a subsidiary are significantly different or independent from the core business of the parent;
- special expertise is required to provide oversight of the subsidiary's activities;
- there is the potential for conflicts of interest between the various stakeholders of the parent and the subsidiary;
- there is a need for close oversight of some activities of the subsidiary that, although perhaps not material by some measures, might give rise to material reputational, legal or regulatory risks for the financial institution as a whole; or
- the subsidiary operates in a jurisdiction that has substantially different expectations of governance.

VIII Board Independence

Demonstrable board independence is at the core of effective governance. The importance of board independence is addressed in guidance from various sources, in legislation and in the OSFI ratings criteria. While certain structures, including those described in this guideline and OSFI's rating criteria, can encourage independence, OSFI does not view any one structure as guaranteeing independence. What matters is that a particular structure and the board's behaviour are effective, taking into account the particular circumstances of the financial institution. Independence is normally a matter of the board demonstrating its ability to act independently of management when appropriate and includes such practices as having regular meetings without management present. In selecting board members, the recruitment process and the development of a director profile should emphasize the independence of board members. Where appropriate for the financial institution, depending on its ownership structure, this might be aided by the creation of a separate nominating committee composed entirely of non-management directors. OSFI will consider the structure and performance of individual boards in assessing independence.

Concerning the issue of having a non-executive chair versus a lead director to act as board leader, OSFI believes that either option can achieve the desired result of enhanced board independence, provided that the non-executive chair or lead director has a clear and comprehensive mandate to act as board leader and is operating in that manner, that the position is remunerated

commensurate with these responsibilities, and that a regular evaluation is performed for that board position. OSFI also believes that institutions should elect to have one or the other model.

The role and responsibilities of a non-executive chair/lead director are elaborated upon in various documents, including *Beyond Compliance: Building a Governance Culture*, Final Report, Joint Committee on Corporate Governance, November 2001 (Appendix B). OSFI will take into account this or similar guidance in its assessment of an individual institution’s approach to board independence.

IX The Relationship between the Board and Regulators of the Financial Institution

As a supervisor, OSFI conducts on-site examinations and monitors the performance of regulated institutions to assess safety and soundness, the quality of control and governance processes, and regulatory compliance. OSFI’s reports and findings can provide useful input to the board’s own oversight of the institution. Open communication between the board and regulators helps promote the mutual trust and confidence essential to the reliance-based system of supervision that OSFI follows.

A board that carries out its responsibilities effectively will:

- understand the regulatory environment within which it and its subsidiaries operate;
- be informed of the results of examinations by OSFI and other regulators;
- require appropriate follow-up on recommendations and any deficiencies identified by the regulators, including following up with senior management to determine if weaknesses found are indicators that similar problems may exist elsewhere in the organization;
- consider regulatory findings in its on-going evaluation of senior management, recognizing that primary responsibility for identifying weaknesses rests with the board and senior management; and
- be open to sharing with regulators information pertaining to the regulators’ oversight of the institution.

X The Relationship between the Board and Senior Management

The board’s primary interface with management is through the CEO. The board also has important relationships with other critical management positions.

The CEO and senior officers are responsible for managing the institution on a day-to-day basis, within the authority delegated to them by the board and in compliance with applicable laws and regulations. In this regard, their skills, competence, integrity and experience are critical factors in the safety and soundness of the institution.

Senior management promotes the effectiveness of the board of directors by providing the board with sound advice on the organizational structure, objectives, strategies, plans and major policies of the financial institution. It sets out and analyzes options for the board, makes and supports recommendations, and provides relevant data and context to enable the board to reach informed decisions. It facilitates the board's oversight role by providing relevant, accurate and timely information to the board, enabling it to oversee the management and operations of the institution, assess policies, and determine whether the institution is operating in an appropriate control environment. Senior management also facilitates effective oversight through fostering candid and robust board discussions.

It is also senior management's responsibility to ensure that the independent oversight functions, such as internal audit, the appointed actuary, and compliance and risk management, have the resources and support to do their work and the capacity to offer objective opinions and advice to the board and to senior management.