OSFI releases final revised corporate governance guideline

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Yesterday, Canada's federal financial institutions regulator, the **Office of the Superintendent of Financial Institutions** (OSFI), released the final version of its revised **Corporate Governance Guideline** (the Revised Guideline). The Revised Guideline sets forth OSFI's expectations for the corporate governance of federally-regulated financial institutions (FRFIs). Like the previous Guideline issued in 2003, it applies to all FRFIs except foreign bank branches and foreign insurance company branches.

Last August OSFI released an initial draft of the Revised Guideline, which was open for comment until September 14, 2012. We reviewed that initial draft in our August 2012 **Financial Services Update**. OSFI received detailed and critical feedback on the initial draft from the relevant industry associations and a large number of FRFIs, and a consultation process on the initial draft continued through the fall. In December, OSFI released a significantly revised draft only to the industry associations and sought only very material comments on the December draft. OSFI ultimately accepted some, but not all, of the key comments received (the materials released with the Revised Guideline include an Annex summarizing the key comments received and OSFI's response). As a result, despite the industry's efforts, the Revised Guideline will impose a number of significant new burdens on many FRFIs. This Financial Services Update reviews the key changes to the Revised Guideline from the initial August draft and considers the key consequences of the Revised Guideline for FRFIs and some of the practical implementation considerations for FRFIs.

Overview of the Revised Guideline

As noted in our August Financial Services Update, the Revised Guideline is intended to:

- ensure that FRFIs have prudent corporate governance practices and procedures that contribute to their safety and soundness;
- promote industry best practices in corporate governance;
- be consistent with and complement:
    - the respective FRFI statutes and related regulations; and
    - OSFI's Supervisory Framework (**most recently revised in 2011**) and Assessment Criteria; and

- address international standards as articulated by a number of international organizations.

To best meet those goals, the Revised Guideline focuses on (i) enhancing the effectiveness of Boards by providing clarity on board responsibilities and competencies; (ii) strengthening FRFIs' risk governance by requiring the development of a "Risk Appetite Framework" (RAF) to guide risk-taking activities; and (iii) improving the overall internal control framework of FRFIs by clarifying the roles of the Chief Risk Officer and audit committee.

The key sections of the Revised Guideline, namely Section III, IV and V, focus, respectively, on three fundamental components of corporate governance for FRFIs:

- the role of the Board;
- risk governance; and
- the role of the audit committee.

As noted above, the Revised Guideline applies to all FRFIs other than foreign bank branches and foreign insurance company branches. Branches do not have boards of directors and, accordingly, the specific provisions of the Revised Guideline do not apply directly to branch operations. Instead, OSFI looks to the Chief Agent or Principal Officer of a branch to oversee the management of the branch, including corporate governance matters. Those individuals are recognized as having overall responsibility for their respective branches and, therefore, should be aware of the contents of the Revised Guideline. The Chief Agent or Principal Officer of branches should refer to OSFI Guidelines E-4A or E-4B, as appropriate.

Key Changes from the Initial Draft Revised Guideline

Overall

- OSFI has more strongly and prominently emphasized that FRFIs should apply the guidance having regard to their own circumstances and that the Revised Guideline is not a "one-size-fits-all" set of expectations. OSFI recognizes that FRFIs may have different corporate governance practices depending on their size; ownership structure; nature, scope and complexity of operations; corporate strategy; and risk profile.
- OSFI has softened certain of the more prescriptive wording and added qualifications acknowledging the need for flexibility in adopting the Revised Guideline. For example, various expectations in the initial draft that Boards or institutions would undertake certain actions have been softened and qualified as being applicable "where appropriate". Similarly, the phrasing of a number of very prescriptive expectations, such that the Board shall *ensure* that certain actions happen, or *verify* certain assurances, have been eliminated or toned down.
- The description throughout of "independent oversight functions" (finance, compliance, internal audit, actuarial and risk management) has been changed to merely "oversight functions".

The Role of the Board

- The expectation that a Board approve, among other things, the appointment, performance review, compensation and succession plans with respect to the CEO and other members of senior management (including the heads of oversight functions) has been softened in respect of senior management and the heads of the oversight functions to only requiring approval *where appropriate*.
- However, the Board is now expected to approve the mandate, resources *(amount and type) and budgets* for the oversight functions. This very granular and operational level requirement for approval of budgets for oversight functions was strongly objected to by industry associations as not being within the appropriate role of the Board, but has nonetheless survived to the final version of the Revised Guideline.

- Portions of Annex B in the previous Guideline and the initial draft relating to the corporate governance responsibilities of the Boards of subsidiary financial institutions have been relocated into the body of the Revised Guideline. However, helpful flexibility that was previously contained in Annex B has been deleted. In particular, the acknowledgement that "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" has been deleted.
- The expectation in the original draft that the Board should periodically commission independent third party reviews of Board effectiveness and practices has been toned down in response to vigorous criticism from industry associations and other commentators that such reviews would result in expensive and unnecessary duplication of existing controls and present a number of issues related to the availability of reviewers, the purposes of the review, process considerations and privilege issues. The expectation now more flexibly provides that Boards should *occasionally* conduct a self-assessment with the assistance of independent external advisors and that *the scope and frequency of such external input should be established by the Board*. Consequently, although the scope and timing of the obtaining of such input is left to the Board's discretion, the expectation remains that external reviews should occasionally be conducted.
- The suggestion that directors should seek internal or external education opportunities in order to fully understand the risks undertaken by the FRFI has been supplemented to also include understanding developments in corporate and risk governance practices.
- The initial draft focused in part on Board "independence", which in this context OSFI described as being much broader than the notion of "non-affiliated" as defined in the various FRFI statutes. OSFI referred instead to the concept of independence as having been described and elaborated upon in various international reports and documents (which in turn had stressed the ability and inclination to provide objective, impartial challenge to management). This led to a concern that affiliated directors could not qualify as "independent" under this broader test, as they could not be independent enough to provide objective, impartial challenge to management on behalf of all stakeholders. Conversely, certain non-affiliated directors might not have qualified as sufficiently "independent" in the broad sense. This could have posed major challenges for FRFIs that are subsidiaries of foreign groups and/or are controlled by an individual sole shareholder or related group of individual shareholders, and was consequently strongly objected to during the consultation process. The guidance in the Revised Guideline has now been softened to clarify that the Board should merely be independent from senior management and that the Board's behavior and decision-making process be *objective and* effective, taking into account the particular circumstances of the FRFI. The Revised Guideline also carries forward from the initial draft the expectation that the Board have a director independence policy that takes into consideration the specific shareholder/ownership structure of the FRFI and, where appropriate, director tenure. OSFI's broader notion of "independence" also now reflects "legal" documents including "securities law".
- The expectation that individual Board members should be able to meet regularly with management of business units and oversight functions with or without other members of senior management present has been strengthened to provide that such individual Board members *should* meet regularly with such management *with and without* other members of senior management present.
- The expectation that *senior management* should ensure that oversight functions have the resources and support to fulfill their duties, are sufficiently independent of operational management and have the capacity to offer objective opinions and advice to the Board and senior management has now become a responsibility of the *CEO*.
- The expectation that the heads of oversight functions should have, for functional purposes, a direct reporting line to the Board or the relevant Board committee (although still technically reporting to the CEO) has been rephrased/clarified and relocated from a footnote to an emphasized text box.
- As with the expectation that Boards engage independent third party reviews of governance processes, the similar expectation that Boards engage independent third party reviews of oversight functions and processes has similarly been softened to a requirement that the Board should *occasionally* conduct a benchmarking analysis of those functions and

processes with the assistance of independent external advisors, *with the scope and frequency of such external input being established by the Board*.

Risk Governance

- The Board-approved RAF is now described as intended to be well understood throughout the organization and supported by all operational, financial and corporate policies and practices and procedures. On its face these are very broad expectations that could technically apply to *every* employee of the organization and to *all* corporate policies and procedures, rather than, for example, only the *relevant* employees and/or the *material* policies and procedures.
- In response to industry feedback, the RAF has been re-characterized as being intended to consider only the *material* risks to the FRFI, and not, generically, *all* types of risk.
- In Annex B, the recommended contents of the RAF have been significantly expanded and clarified.
- The previously proposed expectation that the Board should also periodically commission independent third party reviews to assess the effectiveness of the FRFI's risk management systems and practices has been deleted altogether.

Risk Committee

- In response to critical industry feedback, the proposal in the initial draft that the newly-required risk committee be comprised of directors who are all "independent" in OSFI's proposed broader sense has been softened to only being that the members be "non-executives" of the FRFI. The notion of "non-executives" is explained in a footnote to mean a member of the Board "who does not have management responsibilities within the firm". In another footnote, OSFI, in a further concession, indicates that for small, less complex FRFIs, in place of establishing a separate risk committee, the Board should merely ensure that it has the collective skills, time and information to provide effective oversight of risk management on an enterprise-wide basis.
- The expectation in the initial draft that the risk committee should be responsible for approving, at least annually, the mandate, competencies and resources of the CRO, approving the CRO's performance reviews and overseeing succession planning for the CRO position and other key position within the risk management functions, has been deleted in the Revised Guideline, as this is now within the purview of the entire Board.

CROs

- The expectation that each FRFI have a designated CRO has been softened to "a senior officer who has responsibility for the oversight of all relevant risks across the firm (CRO or equivalent)". As well, the expectation that, for functional purposes, the CRO should have a direct reporting line to the Board or risk committee has been clarified in the same fashion as described above, and relocated from a footnote to an emphasized text box. OSFI confirms in a footnote that in small, less complex FRFIs, the CRO role can be held by another executive (i.e. the executive has dual roles).
- The Revised Guideline newly states that the CRO's compensation should not be linked to the performance (e.g. revenue generation) of specific business lines of the FRFI.
- In a number of places, the expectation that the CRO and the risk management function be *independent* of risk taking activities and provide an *independent* view to the risk committee has been softened/clarified to being *objective* and providing an *objective* view.
- The expectation that the CRO should meet with the Board/risk committee on a regular basis *without* the CEO or other members of senior management present has been changed to *with and without*.

Role of the Audit Committee

- The previously proposed expectation that all audit committee members be independent (which would have overruled the requirements in the applicable FRFI statutes) has been deleted. This had been a significant point of contention for industry commentators.
- The proposal in the initial draft that the chief internal auditor, the chief financial officer and the appointed actuary should have direct reporting lines to the audit committee has been deleted and the expectation in the initial draft that the audit committee should be responsible for approving external audit fees and the scope of the audit engagement has been softened to the expectation that the audit committee recommend to the shareholders the appointment, reappointment, removal and remuneration of the external auditors. The Revised Guideline also clarifies that the audit committee should agree to the scope and terms of the audit engagement and approve the audit engagement letter.
- An expectation has been added that the audit committee should annually report to the Board on the effectiveness of the external auditor.
- A proposed expectation that the audit committee should *ensure* that the financial statements fairly present the financial position, results of operations and the cash flows of the FRFI has been softened to requiring that the audit committee should probe, question and seek assurances from the external auditor that such financial statements fairly present such items.

Supervision of FRFIs

- FRFIs are newly expected to notify OSFI of any potential changes to the membership of the FRFI's Board and senior management, and any circumstances that may adversely affect the suitability of Board members and senior management. While an addition from the initial draft, this was significantly toned down from the December version.

Commentary

Key Consequences

As noted in our earlier Financial Services Update, the Revised Guideline introduces a number of significant new expectations and will raise the corporate governance bar for many financial institutions in Canada. Even with the additional flexibility incorporated into the final version, there remains significant concern for smaller institutions that the Revised Guideline too heavily reflects the large bank/large insurer context and will prove significantly burdensome. Despite industry pushback, the final version of the Revised Guideline includes a number of provisions that supplement the relevant express requirements under the applicable FRFI statutes, including the expectation for a new risk committee and a CRO function. The expectation for occasional independent third party reviews will also prove onerous and expensive.

The challenge for all institutions will be determining how to implement "appropriately" the expectations in their own circumstances, whether they are a Canadian parent FRFI, a subsidiary FRFI of a Canadian parent, a subsidiary FRFI of a foreign parent, etc. While the additional flexibility is welcomed, institutions are in some respects left with a double-edged sword that ultimately offers little guidance on OSFI's expectations. For some subsidiaries of foreign parents, often with limited Canadian operations and a minimum number of non-affiliated directors, the challenge will be how to best comply with the expectations while making the best use of significant resources or expertise available at the parent level.

Taking together, the additional expectations in the Revised Guidelines may well incline new entrants to Canada to proceed by way of a branch operation, rather than a subsidiary subject to the much more onerous requirements of the Revised Guideline.

Practical Implementation Considerations

Commenters pleaded for a staged implementation of the Revised Guideline, and OSFI eventually acquiesced. OSFI expects FRFIs to conduct a self-assessment of compliance with the Revised Guideline and to establish a plan to address any deficiencies. FRFIs should advise their Relationship Manager in writing of the results of their self-assessment and the related action plans by May 1, 2013. The selfassessments are to be retained by the FRFI and made available to OSFI upon request. Full implementation of the Revised Guideline by FRFIs is expected by no later than January 31, 2014. For directors of small and medium-sized FRFIs, OSFI will be offering seminars on the Revised Guideline commencing in the spring. FRFI Boards will be contacted directly with further details.

Despite the breathing room, FRFIs will still consequently need to promptly review and update all of their corporate governance structures and processes to ensure "appropriate" compliance with the Revised Guideline. In particular, they will need to establish a risk committee and implement a CRO function, if appropriate to their circumstances and not already implemented. They will also need to consider their preferred approach on timing and terms of engagement of third party advisors to provide benchmarking assistance. Practically, the large Canadian banks and life insurers and the larger property and casualty insurers are far advanced in their compliance with the Revised Guideline. However, for smaller life and P&C insurers, the impacts may be much more significant.