World Council of Credit Unions

January 9, 2015

Filed electronically
William Coen
Secretary General
Basel Committee on Banking Supervision
Bank for International Settlements
CH-4002
Basel, Switzerland

Re: Consultative Document: *Corporate governance principles for banks* (bcbs 294)

Dear Mr. Coen:

World Council of Credit Unions (World Council) appreciates the opportunity to comment on the Basel Committee's *Corporate governance principles for banks* consultative document (bcbs 294).[1] World Council is the leading trade association and development organization for the international credit union movement. Credit unions are cooperative depository institutions that operate to promote thrift and financial inclusion. Worldwide, there are 57,000 credit unions in 103 countries with US$ 1.7 trillion in total assets serving 208 million natural person members.[2] Credit union supervisors frequently apply the Basel Committee's international standards to credit unions even though credit unions are typically smaller than banks and are not systemically important financial institutions (SIFIs).

World Council supports the Committee's proposed *Corporate governance principles for banks* guidance in most respects. We are concerned, however, that some elements of the proposal could be read by supervisors as requiring unreasonably burdensome compliance requirements on smaller credit unions with limited staff resources, even though that does not appear to be the Committee's intent. Our detailed comments in response to the proposal are below.

In addition, the International Credit Union Regulators' Network (ICURN)—an independent international network of credit union regulators that promotes the guidance given by the leaders of the Group of 20 (G-20) nations for greater international coordination among financial services regulators[3]—in April 2013 promulgated a set of *Guiding Principles for Enhancing Governance of Cooperative Financial Institutions*.[4] ICURN developed its supervisory principles using the Basel Committee's 2010 corporate governance principles as a guide, but tailored its principles to the credit union and cooperative financial institution regulatory context.

[1] Basel Committee on Banking Supervision, *Corporate governance principles for banks -- consultative document* (2014), *available at* http://www.bis.org/publ/bcbs294.htm.
[2] World Council of Credit Unions, *2013 Statistical Report* (2014), *available at* http://www.woccu.org/publications/statreport.
[3] ICURN, About the Network, http://curegulators.org/curegulators_about.
[4] ICURN, *Guiding Principles for Enhancing Governance of Cooperative Financial Institutions* (Apr. 2013), *available at* http://curegulators.org/documents/ICURN_Guiding_Principles_Enhancing_Governance.

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World Council believes that the ICURN Guiding Principles are an appropriate, proportional approach to corporate governance of credit unions and other cooperative financial institutions, and that the ICURN Guiding Principles are generally consistent with the Basel Committee's proposed revisions to its guidelines on *Corporate governance principles for banks*.

World Council's Comments

- **Principle of Proportionality:** World Council strongly supports the principle of proportionality as expressed in the proposal, especially the statement in Paragraph 13 that "[t]he implementation of these principles should be commensurate with the size, complexity, structure, economic significance and risk profile of the bank and the group (if any) to which it belongs. This means making reasonable adjustments where appropriate for banks with lower risk profiles, and being alert to the higher risks that may accompany more complex and publicly listed institutions."

  Credit unions and other smaller financial institutions perform an important financial inclusion role in many countries—by serving populations which are unserved or underserved by large banks—and also help diversity the financial sector, making it more resilient and competitive. They primarily engage in low-risk business activities such as retail consumer lending and deposit-taking, and are typically much smaller and less complex than SIFIs and other internationally active banking groups both in terms of credit unions' corporate structures and in terms of their business activities. Credit unions also generally performed better than banks during the global financial crisis because of credit unions' lower risk business model and rulebooks that often include a high leverage ratio requirement, such as 6 percent capital-to-assets in order to be adequately capitalized.[5]

  Disproportionately burdensome regulatory requirements make it difficult for smaller financial institutions to continue operate sustainably and promote financial inclusion, financial stability, and competitive markets. Disproportionate regulatory burdens also effectively subsidize large financial institutions, which are better able to bear these costs, by creating artificial barriers to market entry.

  Increasing compliance costs are a driving force behind a long-term credit union merger trend in many developed credit union systems: Through mergers over the past 20 years the number of credit unions in the United States has declined from approximately 12,232 in 1995 to fewer than 6,543 today;[6] the number of credit unions in Canada has declined over that same period from approximately 952 in 1995 to around 724 today; and in Australia (where credit unions are subject to the same rulebook as Australia's SIFI banks) the number of credit unions and other mutuals has declined from

[5] *See, e.g.*, 12 U.S.C. § 1790d(c)(1)(B), *available at* http://www.law.cornell.edu/uscode/text/12/1790d ("An insured credit union is 'adequately capitalized' if—(i) it has a net worth ratio of not less than 6 percent; and (ii) it meets any applicable risk-based net worth requirement under subsection (d) of this section.").

[6] Credit Union National Association, *Monthly Credit Union Estimates—November 2014* (Jan. 2015), *available at* http://www.cuna.org/Research-And-Strategy/DownLoads/mcue/.

approximately 246 in 1995 to about 101 today.[7] Although small credit unions do an excellent job promoting financial inclusion in their communities, increasing regulatory burdens have made it increasingly difficult for these small institutions to remain competitive.

World Council urges the Committee to finalize Paragraph 13 and other references to the principle of proportionality as proposed. Without the proportionality concept smaller credit unions and other small- and medium-sized financial institutions could be required by national and provincial supervisors to implement unnecessary and impractical corporate governance rules designed for banks with hundreds of billions of dollars in assets.

- **Governance Structure:** World Council supports the statement in Paragraph 16 that "this document does not advocate any specific board or governance structure" and urges the Committee to finalize this statement as proposed. As cooperatives, credit unions often use different terminology and committee structures than joint-stock companies; for example, credit unions' shareholders are typically called "members" and credit unions often have both a board of directors and a "Supervisory Committee" which is responsible only for compliance supervision and audit.

- **Board of Directors Responsibilities:** World Council supports the board of directors' overall responsibilities as expressed in Principle 1, and strongly supports the statement in Paragraph 20 that "[t]he board has ultimate responsibility for the bank's business strategy and financial soundness, key personnel decisions, internal organisation and governance structure and practices, and risk management and compliance obligations."

- **Board Qualifications and Composition:** World Council supports Paragraph 46 of Principle 2 ("Board qualifications and composition"), which says "[t]he board should be comprised of individuals with a balance of skills, diversity and expertise who collectively possess the necessary qualifications commensurate with the size, complexity and risk profile of the bank."

  World Council also strongly supports Paragraph 53's statement that "[i]n order to help board members acquire, maintain and enhance their knowledge and skills, and fulfil their responsibilities, the board should ensure that members participate in induction programmes and have access to ongoing training on relevant issues. The board should dedicate sufficient time, budget and other resources for this purpose, and draw on external expertise as needed. More extensive efforts should be made to train and keep updated those members with more limited financial, regulatory or risk-related experience."

  Credit unions are much smaller, less complex, and lower risk than most banks, and credit union directors are typically unpaid volunteers who may not have previous

[7] World Council of Credit Unions, *2013 Statistical Report* (2014), *available at* http://www.woccu.org/publications/statreport; World Council of Credit Unions, *Historical Credit Union Data: 1995-2011* (2012), *available at* http://www.woccu.org/publications/statreport.

financial institution experience; a credit union serving air transport workers, for example, may have board members who are more likely to have air transport experience than banking experience. Board members from these membership groups play an important role in keeping the institution responsive to the service demands of the members, who are the credit union's customers and owners. We believe that training for credit union board members without previous financial institution experience as outlined in Paragraph 53 is a reasonable way to help these directors better understand the workings of their institution.

Credit unions also face legal limitations on board compensation that restrict their ability to attract and retain directors with extensive banking experience. Many credit union systems do compensate the board's Treasurer in order to ensure appropriate financial expertise on the board, but these credit unions may not be allowed to compensate other board members because of limitations on board compensation in the applicable credit union act. For example, Sections 111 and 112 of the United States' Federal Credit Union Act operate so that only one officer of the board can be compensated (usually the Treasurer) and does not allow for other director compensation except for reasonable health and accident insurance and reasonable expenses related to their board service.[8]

It is essential that the fitness and propriety criteria for credit union directors not be equivalent to the fitness and propriety criteria for directors of SIFIs and other complex banking institutions. It would be very difficult for many credit unions to attract and retain many board members with significant banking experience when the credit unions are prohibited by law from paying most of their board members. In addition, credit unions' smaller size, less complex operations, and lower risk business activities make it unnecessary for all or most of a credit union's directors to have prior financial institution experience.

We believe that Paragraph 46's guidance regarding board expertise being judged collectively in the context of a specific institution's complexity, as well as Paragraph 53's guidance regarding remedial and ongoing training for directors, are essential to credit unions' ability to find directors who are willing to serve on an unpaid basis. We urge the Committee to finalize Paragraphs 46 and 53 as proposed.

- **Audit Committee:** World Council supports most aspects of Principle 3 ("Board's own structure and practices"), however, at many credit unions the audit committee's role as described in Paragraphs 67-69 is performed by the Supervisory Committee which is not part of the board of directors even though the Supervisory Committee is elected by the member-shareholders in the same manner as the board of directors.[9] This credit union Supervisory Committee governance structure is similar to the "supervisory board" in

[8] 12 U.S.C. §§ 1761(c), 1761a, *available at* http://www.law.cornell.edu/uscode/text/12/chapter-14/subchapter-I.
[9] *See, e.g.*, 12 U.S.C. § 1761d, *available at* http://www.law.cornell.edu/uscode/text/12/1761d ("The supervisory committee shall make or cause to be made an annual audit and shall submit a report of that audit to the board of directors and a summary of the report to the members at the next annual meeting of the credit union . . . .").

the "two-tier" board structure referenced in Paragraph 15 although the credit union Supervisory Committee is not usually considered a "board."

We believe that the traditional credit union Supervisory Committee approach is consistent with the spirit of the audit committee guidance in Paragraphs 67-69 and the "two-tier board" and governance model referenced in Paragraphs 15-16 even if the Supervisory Committee is not technically a "board" committee under some jurisdictions' credit union legislation.

- **Chief Risk Officer:** World Council is concerned that the requirement in Principle 6 ("Risk management") for institutions to employ a "Chief Risk Officer" (CRO) could be read by regulators as a mandate to require small credit unions with limited staff resources and/or less-than-high-risk profiles to employ a CRO based on "local governance requirements," even though that does not appear to be the Committee's intent.

  Many smaller credit unions are operated entirely by volunteers and, while we agree that all financial institutions should engage in effective risk management, it would simply not be practical for many small credit unions to employ a CRO even if that were the "local governance requirement" for commercial banks in that jurisdiction. Further, if having a CRO is indeed a local governance requirement in a jurisdiction, that requirement will be in effect for local institutions whether or not this Basel Committee guidance addresses "local governance requirements" in the CRO context.

  World Council therefore urges the Committee to clarify the first sentence of Paragraph 106 as follows to focus the CRO requirement on banks engaged in higher risk activities:

  > "Large, complex and internationally active banks, and other banks~~, based on their~~ with a higher risk profile ~~and local governance requirements,~~ should have a senior manager (CRO or equivalent) with overall responsibility for the bank's risk management function."

- **Risk-Management Infrastructure and Stress Testing:** World Council is concerned that Paragraphs 115, 116, 117, and 118 in Principle 7 ("Risk identification, monitoring and controlling") may be read to require small credit unions to invest in expensive stress tests that are not necessary for community financial institutions.

  While we agree with Paragraph 115's statement that "[t]he sophistication of the bank's risk management . . . should keep pace with developments such as balance sheet and revenue growth," we do not support the statements in Paragraph 118 that all institutions should perform internal stress tests.

  We agree that stress tests are critical for SIFIs and other highly complex international banks, since the very complexity of such institutions makes it difficult to conceptualize how the bank could fail.

For relatively simple credit unions, however, stress tests can impose large compliance burdens without providing useful supervisory information. Stress tests take up a significant amount of staff time and compliance resources at smaller credit unions, which is not justified at an institution that is not systemically important or highly complex.

The goal of the stress test requirement for less complex and smaller credit unions is also unclear. With a systemically important bank, the purpose of the stress test is to determine how failure could occur in a very complex financial institution. This is not necessary for most credit unions because they do not have this level of complexity, meaning that the stress test—if it uses unreasonably pessimistic assumptions—could become an avenue for regulatory imposition of remedial requirements based on hypothetical situations; this approach would impose real life compliance expenses in order to fight imaginary problems.

We believe that smaller credit unions' limited compliance resources would be best spent addressing likely-to-occur risks, such as credit quality, rather than to address the unlikely worst-case scenarios presented by stress tests.

- **Internal Audit:** Many smaller credit unions cannot afford to employ a full-time internal auditor and for that reason the internal audit function at credit unions has traditionally been performed by the Supervisory Committee discussed above under "Audit Committee." The Supervisory Committee has also traditionally had the role of engaging the credit union's external auditor, and is typically composed of unpaid volunteers with backgrounds in accounting or law.

  The Supervisory Committee is fully independent from the credit union's board of directors and senior management because the Supervisory Committee members are elected by the credit union's member-shareholders and are accountable to those member-shareholders. As volunteers who are also member-shareholders of the credit union, the Supervisory Committee members have every incentive to perform the internal audit function effectively and in the interests of the credit union's owners, i.e. its member-shareholders.

  We urge the Committee to clarify that an internal audit function performed by a Supervisory Committee or similar internal audit committee is consistent with the "independent and qualified internal audit function" discussed in Paragraphs 139-143 of Principle 10 ("Internal audit").

- **Compensation:** As cooperatives, credit unions issue their shares at par and the members fully pay in these shares to par value without creating any additional paid-in capital or capital surplus. Credit union shares are typically traded and redeemed at their par value with the main return to the investor coming in the form of dividends,[10] as was

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[10] *See, e.g.,* 12 U.S.C. § 1763, *available at* http://www.law.cornell.edu/uscode/text/12/1763 ("At such intervals as the board of directors may authorize, and after provision for required reserves, the board of directors may declare a

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the case with most joint-stock company shares prior to the creation of income and capital gains taxes. (Of course, if losses exceed the institution's retained earnings and impair the credit union's paid-in capital, the class of credit union shares absorbing this loss would be written down *pari passu*.)

We urge the Committee to clarify that the "compensation structure" promoting "long term performance" does not require stock-based compensation because credit unions cannot issue common stock or stock options. To the extent that a particular credit union is complex enough to need to have a long-term compensation structure, this policy goal can be achieved through bonuses and other forms of restricted cash and retirement compensation.

World Council appreciates the opportunity to comment on the Basel Committee's proposed *Corporate governance principles for banks* guidance. If you have questions about our comments, please feel free to contact me at medwards@woccu.org or +1-202-508-6755.

Sincerely,

Michael S. Edwards
VP and Chief Counsel
World Council of Credit Unions

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dividend to be paid at different rates on different types of shares, at different rates and maturity dates in the case of share certificates, and at different rates on different types of share draft accounts.").