OSFI ISSUES NEW DRAFT CORPORATE GOVERNANCE GUIDELINE

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On August 7, 2012, the Office of the Superintendent of Financial Institutions (**OSFI**"), Canada's regulator of federal regulated financial institutions such as banks, insurers and loan and trust companies ("**FRFIs**"), issued for comment a draft guideline entitled *Corporate Governance of Federally Regulated Financial Institutions* (the "**2012 Guideline**"). [1] The 2012 Guideline is intended to supplement and modernize the existing OSFI *Corporate Governance Guideline* (the "**2003 Guideline**") [2] currently in force, purportedly bringing corporate governance of FRFIs into greater alignment with prevailing industry best practices and standards. In this paper, we review the 2012 Guideline and compare it to the 2003 Guideline, noting substantive changes in policy and direction.

While the 2012 Guideline remains consistent with the 2003 Guideline in its general direction and guidance, it intensifies focus and raises expectations for effective governance in a number of areas. This paper summarizes notable changes and trends under three broad categories: *Risk Management, Board of Directors, and Accounting Controls*. It is to be noted that the 2012 Guideline has been released for comment only, and is therefore subject to change.

1. risk management to risk governance

The most obvious change in the 2012 Guideline is the increased focus on risk. This is not surprising given the continuing increased global emphasis on enterprise risk management and risk-based supervision as tools for ensuring and regulating financial institution soundness and solvency.

In the 2003 Guideline, OSFI recognized the importance of managing risk and of implementing policies to deal with risk exposure, risk tolerance, and risk control. It was less clear in the 2003 Guideline who shouldered the responsibility for enterprise risk management. Boards of directors ("**Boards**") were expected to have a "general understanding" of risk exposure and of "techniques used to measure and manage those risks." Boards were also expected to define the overall philosophy and tolerance for risk, to set policies for risk management, and to receive regular reports from management. OSFI also expected the Audit Committee to ensure audit plans were "risked based," and to ensure that external auditors took into account the specific risk exposure of the FRFI.

risk governance

The 2012 Guideline represents somewhat of a major change from the 2003 Guideline in terms of risk. Risk management is now a mere subset of risk governance, which entails a more systematic, defined, and holistic approach to dealing with risk. FRFIs are now asked to develop a Risk Appetite Framework ("**RAF**") to guide risk exposure in pursuit of business objectives. Annex C to the new Guideline details OSFI's expectations as to the contents of a RAF. Essentially, a RAF is to contain statements of risk appetite (e.g. market risks, hedging strategies) and risk tolerance (e.g. credit limits, leverage ratios). It is to be approved by the Board and implemented by management across all business units as part of an integrated enterprise risk management strategy.

risk committee and the chief risk officer

Another new addition contained in the 2012 Guideline is the requirement to establish a Risk Committee. The Risk Committee is to be comprised of independent directors and its mandate is to oversee risk management on an enterprise-wide level. The Risk Committee is expected to supervise and review the performance of the Chief Risk Officer ("**CRO**"). The CRO is to be responsible for implementing processes and controls to assess, measure, monitor, and report on risk. The CRO is to be insulated from all business lines and revenue-generating activities. Access to the Board and the Risk Committee must be unimpeded, and the CRO is to have a "direct reporting line" to the Board.

In turn, the Risk Committee is to ensure that risk management activities remain independent from operations management, that risk management activities have adequate resources and visibility, and is to work with the CRO to review internal risk reports. OSFI emphasizes the importance of taking an enterprise-wide view of risk at the Board level, independent of senior management.

2. the board: more active, more independent

The 2012 Guideline amplifies the responsibility and accountability expected of directors through mandating a higher degree of involvement in management oversight, independence of Board processes, and an increased focus on Board committees and functions.

responsibilities

OSFI has clarified the essential responsibilities of the Board, distinguishing between activities under the purview of management that should be *reviewed* by the board, and primary Board duties that require board *approval*. This demarcation was less clear in the 2003 Guideline. Board *approval* applies to responsibilities such as setting business objectives, internal control frameworks, and external audit plans. Board *review*, on the other hand, is warranted for management-led responsibilities such as operational policies, financial performance, and the implementation of internal controls. While the scope of Board responsibilities has been clarified and made more comprehensive, OSFI's "hallmarks" of effective Board performance remain essentially unchanged.

OSFI also urges Boards to regularly commission third-party reviews to assess effectiveness of all "Oversight Functions".[3] While OSFI has expected FRFIs to establish independent and specific Oversight Functions for many years, the regulator now calls for a higher degree of Board scrutiny over their performance.

board chair

For many FRFIs, the role of Board Chair in 2012 and beyond will be more comprehensive than it was a decade prior. OSFI has increased the scope of the Chair's responsibility, and expects the Chair to devote significantly more time and energy to his or her role than fellow directors. A primary expectation is that the Chair will be actively involved in regular dialogue with fellow directors and senior management. The Chair is also expected to be a key interface between the FRFI and regulators. While OSFI has long supported director engagement with senior management, it now expects the Chair's reach to extend far deeper into the organization, having access to "all FRFI information and staff." Finally, after previously expressing no preference on the matter of non-executive Chair versus Lead Director, OSFI now indicates that it is "critical" that the role of Chair be separated from that of CEO.

skills and competence

A corollary to intensified Board responsibility is the increased expectation of skills and financial-sector expertise among directors. OSFI now considers it essential for individuals with relevant financial and risk management experience to be represented on the Board and across committees. Boards are urged to develop formal tools to evaluate skills, such as a "competency matrix", which would be reviewed annually with an eye to appropriate Board composition.

independence

In both versions of the Guideline, OSFI took the position that "demonstrable Board independence is at the core of effective FRFI governance." The degree of separation expected between Board and management, however, has intensified. As previously noted, OSFI now urges the role of Chair to be separated from that of CEO. OSFI also encourages regular in *camera meetings* of the Board and committees without any managers present. The Board is also encouraged to implement a director independence policy to ensure adequate independence, taking into account the needs and structure of the particular FRFI. The 2012 Guideline stresses that independence is to be construed much more broadly than the concept of "unaffiliated" which is contained in the relevant statutes. Director independence is to be determined in accordance with emerging international standards.

3. accounting controls

While the 2003 Guideline established a broad mandate for the Audit Committee to become involved with external audits, its authority was limited to *discussing, reviewing* and *meeting* with auditors. In contrast, the 2012 Guideline states that the Audit Committee, rather than management, "should be responsible for approving external auditor fees and the scope of the audit engagement." The new Guideline also codifies a new role within the FRFI: Chief Internal Auditor.

The Chief Internal Auditor, along with the CFO and the Appointed Actuary, "should have direct reporting lines to the Audit Committee," rather than exclusively to management. These changes can be viewed as part of the broader trend of increasing the responsibility of independent Board members and intensifying oversight on decisions formerly under the sole purview of senior managers.

OSFI also expects the Audit Committee to assess the appropriateness of accounting and actuarial practices. It should be noted that this responsibility implies a relatively advanced and specialized skill set for Audit Committee members.

4. commentary

In the draft 2012 Guideline, OSFI has chosen to further raise the bar with respect to its regulatory requirements for corporate governance. Although there are references within the 2012 Guideline acknowledging that implementation of some of the requirements may vary among organizations (for example, "depending on the nature, size, complexity and risk profile of the FRFI"), it still largely remains a broad-brushed, one-size-fits-all approach with the emphasis on independent directors as the gatekeepers.

In a speech to the Toronto Board of Trade that pre-dated the draft 2012 Guideline, [4]OSFI's Superintendent acknowledged the arguments that increased Board involvement in corporate governance could eventually result in Board responsibility overload and a blurring of the lines of responsibility between the Board and management. She indicated at that time that OSFI was currently "assessing all the things we ask boards to do." Appendix A to this paper sets out a chart that summarizes existing OSFI guidance (applicable to insurers only) which specifically contain duties and responsibilities for Boards. The regulatory onus on such Boards is not insignificant.

In addition, aspects of the 2012 Guideline could be seen as blurring the line between the Board and management, and possibly even between the Board and external advisors. Examples include the statement that FRFI Boards as well as management "need to have a full understanding of the risks attendant to the FRFI's business model including each business line and product". It is difficult to imagine how independent directors of banks, for example, can realistically be informed of the risks involved with *each product* offered by the bank.

Further, an "adequate number of" members of the Risk Committee (all independent directors) are to have "sufficient knowledge in the risk management of financial institutions", and, "where appropriate, the Committee should include individuals with technical knowledge in risk disciplines that are significant to the FRFI." As well, members of the Audit Committee (all independent directors) are required to have skills and expertise sufficient to enable them to assess whether the FRFI's accounting and actuarial practices are appropriate and within acceptable bounds. Also, the 2012 Guideline indicates that the Audit Committee is responsible for *ensuring* that the financial statements present fairly the financial position, results of operations and cash flows of the FRFI.

The 2012 Guideline expects independent directors to fulfill their duties with a high degree of scepticism. Boards are directed to take measures to independently verify management assurances and this appears to be in addition to the requirement to commission formal periodic third party reviews of Oversight Functions. Not that healthy scepticism in an outside director is ever a bad thing, but taking all of these observations together, the 2012 Guideline could be seen as creating a new quasi-managerial role for independent directors of FRFIs. For certain FRFIs, such as wholly-owned subsidiaries where the shareholder controls the appointment and removal of directors as well as management and sets the strategic direction for its subsidiary, many aspects of this kind of role do not fit. Where there is a sole or dominant shareholder, one of the most important functions of the independent directors, from a theoretical point of view, is to protect against shareholder abuse of the FRFI by policing the self-dealing provisions in the legislation, rather than spending most of their time second-guessing senior management.

Assuming few changes are introduced to clarify the applicability of portions of the 2012 Guideline to different FRFIs, it appears that the challenge for many FRFIs, such as non-banks, will be to sift through the requirements in order to identify the ones that apply to the particular FRFI and from there determine the aspects and levels of implementation that are best-suited to their organization. The determination, of course, should be based on a demonstrably defensible rationale. Perhaps this kind of compliance determination exercise may evolve (vis à vis OSFI) into an approach that is similar to the "comply or disclose" approach adopted by securities regulators.
Click here for Appendix A - summary of directors' duties under OSFI guidance

[1] Office of the Superintendent of Financial Institutions, *Draft Guideline, Corporate Governance of Federally-Regulated Financial Institutions* (OSFI, 7 August 2012).[ps2id id='1' target=''/]

[2] Office of the Superintendent of Financial Institutions, *Corporate Governance Guideline* (OSFI, January 2003).[ps2id id='2' target=''/]

[3] OSFI conducts regular reviews of each of six "Oversight Functions". These are Risk Management, Internal Audit, Compliance, Financial Analysis, Senior Management, and the Board of Directors. Office of the

Superintendent of Financial Institutions, *Introduction to the Supervisory Framework Ratings Assessment Criteria* (OSFI, July 2002).[ps2id id='3' target=''/]

[4] *Remarks by Superintendent Julie Dickson, Office of the Superintendent of Financial Institutions to the Toronto Board of Trade*, Toronto Ontario, April 5, 2012.[ps2id id='4' target=''/]