



The Division of Credit Unions' Guide to Director Responsibilities

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This Guide to Director Responsibilities is intended to assist you as a director of the board of a credit union to establish and conduct prudent corporate governance practices for your credit union. This Guide is aspirational and is not intended to establish regulatory or examination requirements or provide legal advice.

The board’s basic responsibility is to set the strategic direction of the credit union and to monitor management’s implementation on a routine basis. This guidance offers key governance concepts to help directors understand the roles and responsibilities of the board and senior management. It also provides insights regarding how the Division of Credit Unions (DCU), Department of Financial Institutions, State of Washington, examiners evaluate governance of credit unions. A list of resources, with links to regulations, guidance and training materials, is included to help credit union directors with their responsibilities.

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Chapter I: Introduction

Credit unions play a vital role in the state's economy and local communities, and the governance processes of a credit union's board and senior management are perhaps the single most important element in the successful operation of a credit union. This white paper represents Division of Credit Unions' (DCU) guide for directors, which is a set of common-sense principles setting forth the basic responsibilities and duties of a credit union's board of directors. Broadly speaking, this guide describes a framework for corporate governance that applies to any institution. DCU believes that the core responsibilities of credit union directors should be presented in a clear and straightforward manner.

Credit union directors can benefit from staying current on the corporate governance lessons and experiences of other credit unions and credit union regulators as industry conditions and challenges evolve. This guide brings together principles from existing guidance regarding corporate governance as well as observations and practical tips from supervisory activities, ongoing communications, and outreach efforts that have helped credit unions and their boards manage the ups and downs of business cycles.

This guide is divided into chapters. Discussion includes:

- key governance concepts and the important roles and responsibilities of credit union directors and senior management;
- an expanded discussion of governance principles, particularly as they relate to credit union governance and planning activities; and
- an explanation of how DCU examiners evaluate the effectiveness of a credit union's board of directors.

An Appendix lists resources that are available to assist credit union directors in fulfilling their duties, including links to pertinent regulations, guidance, and DCU training materials.

The DCU would like to thank the Federal Deposit Insurance Corporation for allowing us to borrow from its 21st Century Reflections on the FDIC Pocket Guide for Directors. Our guide is intended to serve as a resource and an educational tool for directors of credit unions chartered by the state of Washington to promote prudent corporate governance practices. This guide is not to be construed as definitive regulatory, supervisory or legal guidance.

We also appreciate the advice given by representatives from the Washington State Credit Union Attorneys Committee who helped Linda Jekel, Director of Credit Unions, adapt this guidance for credit union directors.

Chapter II: Credit Union Corporate Governance

What is Corporate Governance?

Credit union boards and senior management are responsible for establishing and maintaining the credit union's corporate governance framework. Definitions of corporate governance vary, but they often focus on relationships, policies, and processes that provide strategic direction and controls in an organization. Strong corporate governance is the foundation for a credit union's safe-and-sound operations. An effective governance framework is necessary to remain profitable, competitive, and resilient through changing economic and market conditions. A corporate governance framework should be functionally sound and appropriate for the size, complexity, and risk profile of the credit union. The cornerstone of the credit union's effective corporate governance is well-drafted credit union bylaws that accurately reflect the credit union's policies and practices and comply with current state law. However, credit unions should generally not need to develop elaborate governance frameworks to be effective, or hire consultants to do so.

Responsibilities of the Board and Senior Management

The DCU expects boards of directors to provide a clear governance framework that incorporates sound objectives, policies, and risk limits. Equally important, the board should monitor the extent to which officers and employees comply with this framework and with applicable laws and regulations.

Primary Board Responsibilities. Directors have a primary responsibility to act in the best interests of the credit union. Directors fulfill this responsibility through two primary functions: decision-making and oversight. Board decision-making generally involves establishing credit union policy, setting strategic goals and taking key corporate actions such as hiring senior management executives, establishing a budget and delegating authority to management. The Board's oversight functions involve monitoring the credit union's business and affairs including financial performance, management performance, corporate and risk management policies and compliance with legal obligations and credit union policy. Both functions require that directors understand the credit union's business, their role and senior management's role to conduct the day-to-day operations and manage the risk of the credit union. Directors must oversee the credit union's operations effectively and make informed decisions without exercising the role of management.

The Washington Credit Union Act (Act) defines the relationship between the board and management of the credit union. In general, all corporate powers are exercised by and under the authority of the credit union's board of directors and its business and affairs managed by or under the direction of the board. The board has the overall responsibility for the credit union's direction, safety and soundness and legal compliance. To meet these responsibilities, the board must establish sound policies, retain qualified management and establish acceptable risk exposure levels. The board delegates operational management duties and functions to officers and senior management to conduct the day-to-day operations. Then, the board is responsible for overseeing the credit union's operations and management's performance.

Effective corporate governance requires a high level of collaboration between a credit union's board of directors and senior management, as well as a common understanding and awareness of the credit union's strategic objectives and risks. A well governed board will not be involved in day-to-day tactical, operational issues. Rather the board should exercise knowledgeable oversight over management's decisions. In carrying out a director's duty to manage the business and affairs, the director must exercise his or her own objective judgment independent of management. This entails engaging in robust discussions with senior management and perhaps challenging recommendations at times, rather than simply deferring to senior management decisions.

The DCU's expectations related to credit union director responsibilities and obligations are based on the Act and longstanding governance principles. The DCU has issued previous guidance concerning the responsibilities of credit union directors and officers reminding directors and senior management of their obligation to comply with federal and state statutes, rules, and regulations and address the fiduciary duties of loyalty and care they owe to the credit union (see Appendix for a listing).

Fiduciary Duties. The fundamental standard for directors' and officers' conduct is that each director and officer must perform his or her duties in good faith and in a manner he or she believes to be in the best interests of the credit union. The directors' and officers' fiduciary duties to the credit union are stated in the Act and are based upon corporate common law principles. This standard encompasses a "duty of care" and a "duty of loyalty".

Duty of Care. A director's duty of care primarily relates to the responsibility to become and remain reasonably informed in making decisions and overseeing the credit union's business. The duty of care requires directors and senior management to make good faith informed decisions, which they may do by attending meetings, examining material information and preparing in advance of meetings, asking questions of management, being curious and skeptical when reviewing information, requesting and obtaining professional expert advice and actively participating in the decision making process.

Making informed decisions requires being informed and prepared for board meetings. To be informed and prepared, directors should ensure that management provides directors with sufficient information to consider and take actions, request additional information when appropriate and ask questions necessary to understand the information provided. It means relying on information, opinions, reports, or statements, including financial statements and other financial data of others, including management, legal counsel, accountants and other such experts, if the director reasonably believes the information is reliable and the person is competent in the matters presented.

Directors should establish clear expectations for management's provision of meeting materials and submission of those materials to directors with sufficient advance time so directors understand the information before decision-making. Also important, time-sensitive information that becomes available between meetings must be promptly distributed and reviewed by directors.

Delegation of matters to a credit union board committee (e.g. investments, governance, nominating, etc.) does not relieve a director of oversight responsibility. Directors should keep informed about board committee activities and information.

Directors are expected to attain financial literacy sufficient to perform their fiduciary duties and keep their knowledge up-to-date through continuous, appropriate training. Directors are expected to use and share their knowledge, experience and expertise so all directors are informed to make sound decisions.

A director may fail to act in good faith if the director fails to be informed or obtain necessary information to make a decision or has knowledge concerning the matter in question that makes reliance on such information unwarranted.

Duty of Loyalty. The duty of loyalty focuses on avoidance of improper conflicts of interests and requires fair dealing by directors involved in transactions where a personal or financial interest may arise. The duty of loyalty requires directors to act in good faith and in the best interests of the credit union and not in their own interests or the interests of persons or organizations with which they are associated.

Directors may not use their position for personal gain or advantage and should avoid conflicts of interest. Therefore, directors must be sensitive to any interest they may have that might conflict with the interests of the credit union. When a director has a potential conflict of interest (e.g. contract, transaction or relationship affecting or opposed to the credit union) the director must (i) fully disclose his or her interests to the designated board representative, and (ii) refrain or abstain from participating with the board during any presentation, deliberation or action on the issue.

A director may fail to act in good faith when the director fails to disclose a personal interest; intentionally acts with a purpose other than the credit union's best interests; or fails to act when they have a known duty to act.

Standards of Conduct. The board of directors and management must maintain very high standards of professional conduct including, but not limited to:

- Appropriateness of compensation policies. Management compensation policy should be commensurate with the size and complexity of the credit union. The board needs to ensure performance standards are in place for the chief executive officer and an effective formal evaluation process is used and documented.
- Avoidance of improper conflict of interest. Appropriate policies and procedures for avoidance of conflicts of interest and management of potential conflicts of interest should be in place.
- Promotion of professional ethics and behavior. The board of directors and management should not use the credit union for unauthorized or inappropriate personal gain. Credit union property should not be used for anything other than authorized activities. Management should act ethically and impartially in carrying out appropriate credit union policies and procedures.

Credit union directors sometimes express concern that they are being asked to perform "senior management functions." Although the recent financial crisis re-emphasized the importance of certain longstanding director responsibilities, the DCU has not shifted the expectation of senior management responsibilities to directors. In its broadest terms, the board's responsibility is to set policy and monitor its implementation. Management is delegated the responsibility to implement policy through the creation of procedures and practices.

The “CAMELS” rating system, which regulators use to evaluate a credit union’s management and its financial health, was adopted for Washington credit unions in 1988, and updated to add the letter “S” on January 20, 2015. It differentiates between director and senior management responsibilities:

...Generally, directors need not be actively involved in day-to-day operations; however, they provide clear guidance establishing acceptable risk exposure levels thru appropriate policies, procedures, and practices. Senior management is responsible for developing and implementing policies, procedures, and practices that translate the board’s goals, objectives, and risk limits into prudent operating standards...

While differentiating responsibilities, CAMELS also reflects that while boards and officers often work hand-in-hand, their formal roles within the credit union are distinct and should not be intermingled. Ultimately, the board is responsible for monitoring senior management and business operations.

The Tone from the Top – Maintaining a Strong Corporate Culture

The DCU has found that boards which diligently oversee the credit union’s operations are critical partners in supervisory efforts. Prudent oversight is rooted in the board sending a clear message to staff that they value a strong, responsible risk management culture that includes a strong ethical culture. A “risk management culture” can be described as the system of goals, objectives, policies, controls, values and behaviors present in an organization that influence risk decisions. An “ethical culture” can be described as the belief that the interests of members, the community, and other stakeholders take precedence over short-term profits. Credit unions rely on trust and public confidence to obtain and maintain members.

To maintain that confidence, credit unions should have a strong risk management culture that promotes strong ethical values and appropriate conduct. DCU expects that boards will establish policies on ethics and corporate conduct at all credit unions that the DCU supervises (see DCU Bulletin 05-05). The board should ensure the credit union has such policies that address at least the following areas:

- Safeguarding confidential information
- Ensuring the integrity of records
- Providing strong internal controls over assets
- Providing candor in dealing with auditors and examiners
- Avoiding improper self-dealings and inappropriate acceptance of gifts or favors
- Observing applicable laws
- Involving internal auditor(s) in monitoring the corporate code of conduct or ethics policy
- Providing a mechanism to report questionable activity
- Providing periodic training and acknowledgement of policy requirements
- Periodically updating policies to reflect new business activities

The Board’s Relationship with Members

The Board has the duty to act in the best interest of the credit union. In carrying out the Board’s responsibilities to act for the best interest of the credit union, the board should understand and appreciate that the members, as a group or individually, have a very limited role and voice in credit

union corporate governance. The role of members is generally confined to the election or removal of directors and supervisory¹ committee members and voting upon extraordinary corporate changes (e.g. mergers, charter conversions). In connection with these functions, members have a limited, but distinct number of member rights under the Act.

One of the most important responsibilities of the board in its relationship with members is to conduct a fair and transparent election process. The election of credit union directors is frequently uncontested. While, the board nominating committee is responsible for nominating at least one candidate for each vacant board position, often incumbent directors select and nominate just fellow incumbent directors. The board and nominating committee should actively solicit and consider all qualified board candidates to permit the members to choose the credit union's directors.

The Board's Relationship with the Audit/Supervisory Committee

The credit union's audit or supervisory committee safeguards credit union assets through their audit responsibilities. The audit committee's existence and functions are mandated by the Act and a credit union's bylaws. The audit committee has distinct oversight responsibility for the credit union's internal controls and financial reporting. The audit committee has exclusive responsibility for conducting an annual audit of the credit union, including retaining and overseeing the engagement and performance of an independent audit of the credit union's financial statements and internal controls. The audit committee evaluates the audit process, oversees financial reporting, evaluates risk management, examines compliance with applicable laws, and establishes practices to safeguard credit union assets.

The board should work closely with and support the audit committee's functions. Also, the board needs to keep the audit committee informed of its actions. In particular, the board should allow at least one audit committee member to attend regular meetings. One area of overlap and occasional tension between the board and audit committee is the authority over the credit union's internal auditor or audit department. To ensure impartiality and coordination, the internal auditor should report to the audit committee and keep the board and management informed on internal control issues and deficiencies. Accordingly, the board and audit committee should develop a mutually agreed policy or charter to balance management's authority over internal audit staff and preserve the autonomy of the internal audit functions.

¹ Also known as an audit committee

Chapter III: The DCU Guide for Directors

Maintain Independence

First and foremost, the board and individual directors should establish and maintain the board's independence. One of a director's key duties is to provide independent judgment, which requires appropriately challenging senior management's opinions, recommendations and assessments. To effectively provide independent judgment, credit union directors should make every effort to attend and be prepared for board meetings and assigned board-level committee meetings. Directors should strive to understand reports and summaries and ask questions if they do not.

Critical evaluation of issues before the board is essential. Boards should not be a "rubber stamp." Boards who routinely approve senior management decisions without exercising their own informed judgment are not adequately serving their credit union or their members.

Select and Retain Competent Management – Talent Development and Succession Planning

In hiring and retaining a qualified chief executive officer (or manager), the board of directors is ensuring that the right people are in place to carry out the board's vision, policies and strategic plan. Credit union directors, especially those in small towns and rural areas, often indicate that hiring and retaining key officers, and those who may step into those roles in the future, can be challenging. Boards should ensure that senior management officials possess the experience and knowledge necessary to fulfill the obligations of each key position, and monitor and evaluate senior management's performance in effectively carrying out their assigned responsibilities.

Boards should provide for an effective pre-employment screening program to appropriately vet candidates and ensure that the senior management team possesses a high level of integrity. Every employee has to be bondable which generally prohibits any person who has been convicted of certain criminal offenses from participating in the affairs of the credit union. Additionally, Section 741.205 and 701.14(c) of the National Credit Union Administration (NCUA) Rules and Regulations requires federally insured credit unions that are not in compliance with minimum capital requirements or are otherwise in a troubled condition must seek the NCUA's approval before hiring directors or senior executive officers.

Basic features of effective personnel administration include a clear organizational structure, detailed position descriptions, training and development opportunities, sound compensation policies, and effective communications. Regular evaluation of the management and staffing structure helps to ensure that necessary positions and reporting lines are established and appropriate for the credit union's size, activities, complexity, and risk profile. This evaluation should be updated when new initiatives and product lines are being considered or new risks emerge. Having these systems in place ensures there is accountability for key decisions and strategies.

A management succession and talent development plan is a valuable tool to build bench strength and maintain continuity in the chief executive and other key senior management positions. The succession

and talent development plan should start with an assessment of potential successors who may be groomed from within, along with the training, mentoring, and developmental resources needed to do so. Sound planning also addresses the process of identifying potential successors from outside the organization, when necessary. A management succession and talent development plan should generally cover at least a three- to five-year horizon.

Credit unions face strong competition for skilled, experienced staff who know and understand the credit union model. The rewards and opportunities for credit union employees, especially in small or rural communities, may be very different compared to their large credit union counterparts. Thus, growth and retention of staff throughout the organization is an important component of the talent development process.

Even the smallest credit unions can find ways to motivate employees and expand and diversify their skills through cross-training, service on committees or special projects, attending conferences, and coaching and mentoring relationships. Some credit unions have worked with local universities and colleges by supporting credit union courses and offering student internships. There is no single approach to employee retention and development, but taking a proactive and innovative approach may be a good first step.

From Northwest Credit Union Association's "Credit Union Philosophy Certification Manual":

Credit union board members are elected by the members of the credit union. The credit union's board members are responsible for articulating the credit union's mission, setting policies and strategic direction, and ensuring that the credit union is operating legally. The board is also responsible for approving the credit union's operating budget and hiring the credit union Manager/CEO.

Establish, With Management, the Institution's Long- and Short-Term Business Objectives

A key responsibility for a credit union's board is to work with senior management to set the future direction of the credit union by establishing the credit union's long- and short-term business objectives.

Understand the Credit Union's Risk Profile

To set appropriate business objectives for the credit union, properly monitor the credit union's operations, supervise the CEO, and monitor senior management, credit union boards should have a solid understanding of the credit union's risk profile. Evaluating a credit union's risk profile involves more than looking at its financial condition today. It includes assessing the riskiness of the business model, meaning the types of products and services the credit union offers and how they are delivered; evaluating how the credit union manages the risks associated with its business model and growth plans; and looking outside the credit union to consider potential external threats from the credit union's operating environment.

When the phrase “complexity, nature, scope, and risk” of a credit union’s activities is used to describe how rules or guidance should be applied, it refers to this type of assessment of a credit union’s risk profile. Credit unions are not all the same. Even those that seem similar at first can have vastly different risk profiles, and the DCU would expect credit unions with a higher risk profile to have stronger risk management practices and a higher degree of board oversight (see illustration on page 12). This does not mean that all credit union boards are expected to have an elaborate “enterprise risk management” process or software or formal risk committees, and all credit unions are not expected to hire consultants in the risk assessment and monitoring process. However, credit union boards and senior management are expected to understand and monitor the credit union’s risk profile.

This expectation is discussed in DCU Bulletin 15-02 on the CAMELS system as follows:

The capabilities of the board of directors and management, in their respective roles, to identify, measure, monitor, and control the risks of a credit union’s activities and to ensure a credit union’s safe, sound, and efficient operation in compliance with applicable laws and regulations is reflected in this rating. Generally, directors need not be actively involved in day-to-day operations; however, they provide clear guidance establishing acceptable risk exposure levels thru appropriate policies, procedures, and practices. Senior management is responsible for developing and implementing policies, procedures, and practices that translate the board’s goals, objectives, and risk limits into prudent operating standards.

Management practices need to address the seven risk categories and other risks commensurate with the nature and scope of a credit union’s activities. Sound management practices are demonstrated by active oversight by the board of directors and management; competent personnel; adequate policies, processes, and controls taking into consideration the size and sophistication of the credit union; maintenance of an appropriate audit program and internal control environment; and effective risk monitoring and management information systems. This rating should reflect the board’s and management’s ability as it applies to all aspects of the credit union’s operations as well as other financial service activities in which the credit union is involved.

The ability of management to respond to changing business conditions, or the initiation of new activities or products, is an important factor in evaluating a credit union’s overall risk profile and the level of supervisory attention warranted.

An Illustration of Two Credit Unions with a Similar Financial Position, but with Very Different Risk Profiles

Two credit unions each have about \$500 million in total assets and a Return on Assets (ROA) of approximately one percent. The credit unions operate in suburban areas of the same mid-sized U.S. city, and have similar capital levels and a similar mix of asset types and funding sources.

Credit Union A's ROA had been hovering at about 0.8 percent for several years, but increased to one percent very recently due to income from a new program of high-yield but high-risk lending the credit union launched about a year ago. The new lending program has grown rapidly. The credit union's loan loss reserve has been decreasing due to increasing loan losses related to the program, and the capital ratio has declined due to the growth. Also, the senior loan officer position has turned over twice in the past year, and senior management has not forecast how large the new portfolio will become. The credit union's board receives regular reports regarding the new portfolio, but has not set objectives for the desired rate of return on the activity or parameters around its growth.

Credit union B has not changed its lending product line for a number of years and has grown steadily, maintaining a one percent ROA during that time, including through several business cycles. Senior management and the board have recently decided to launch a new product line and have forecasted the effects on earnings, the loan loss reserve, and capital over the next three years. The board ensured that sound policies and appropriately skilled staff were in place prior to implementing the new program. The board also placed limits on the size of the new product line and risk tolerance "circuit breakers," so new lending will stop if the income it produces is not sufficient to build the additional loan loss reserves and capital needed to support the new activity.

Although this is just a high-level summary without all the facts, these credit unions appear to be similar on the surface, but have very different risk profiles. Credit Union A appears to have a higher risk profile than Credit Union B. The board and senior management of Credit Union A entered into a new area of lending without establishing risk and return objectives and growth limits for the program, and there is a lack of management stability in the oversight of the program. Credit Union B appears to have a lower risk profile. The board and senior management have done an effective job of managing credit risk and maintaining earnings, even through the ups and downs of several business cycles. Moreover, they performed due diligence when planning for a new product launch, and developed a contingency plan if the product does not succeed.

Set Risk Objectives and Parameters

Once a credit union board has a sense of a credit union's risk profile, it should set an appropriate "risk appetite" for the institution. Risk appetite means a set of objectives and risk parameters within which senior management should operate. The DCU expects credit union boards to establish prudent limits around risk areas that could affect the condition of the credit union, which should not in most cases require the extra expense of vendor-provided modeling software.

There is no single list of areas for which boards should set risk objectives and parameters. At a minimum, however, the DCU would expect objectives and parameters for overall credit risk; for asset concentrations, by business line and by borrower, as appropriate; for the credit union's funding mix; and for interest rate risk. A credit union's board should also monitor senior management's adherence to objectives and parameters, ask probing questions, and take early action if the situation changes or if risk management practices are not sufficient to support the risk objectives and parameters.

Strategic Planning

Credit union boards and senior management face everyday challenges and opportunities related to constantly evolving economic and market conditions, competition, and innovation, along with emerging or unforeseen risks, such as cyber threats or natural disasters. Sound strategic planning is crucial in dealing with uncertainty and change. To be effective, strategic planning decisions must be dynamic and updated as circumstances change.

The DCU expects its supervised credit unions to have a strategic planning process to guide the direction and decisions of senior management and the board. This process is unique to each institution, driven by its culture, mission, business model, risk appetite, resources available (including management talent), risk profile, size, geographic location, members served, and other considerations. As a result, the formality of the strategic planning process will vary from credit union to credit union, but a strategic plan should be more than just a piece of paper. For most credit unions, strategic planning should be a dynamic process designed to answer a few basic questions: Where are we now, where do we want to be, how do we get there, and how will we know we are successful?

Where are we now? The success of any strategic plan begins with a solid understanding of the credit union's mission, vision, business model, risk profile, risk appetite, and positive influences (strengths, opportunities) and adverse influences (weaknesses, threats). This analysis helps prioritize which opportunities should be pursued, and which gaps need to be filled. As an example, if a credit union with a business model that focuses largely on vehicle lending has material credit administration issues to resolve, devoting significant resources to launching a new commercial real estate department before resolving the issues would likely have negative consequences.

Where do we want to be? This step considers both short- and long-range goals and objectives. These objectives should align with the core mission and values of the credit union, as well as the board's established risk appetite and the credit union's policies. The planning time horizon will not be identical for every credit union, but, a three- to five-year planning horizon is generally satisfactory for most credit unions.

Boards and senior management should have a solid grasp of the current and future operating environment.

The NCUA provides a wealth of industry and economic information that credit unions may use to inform their strategic decisions. For example:

- Industry at a glance is a quarterly updated quick-look at the key facts and figures at the credit union industry (found at <https://www.ncua.gov/analysis/Pages/industry/at-a-glance.aspx>)
- Financial Trends in Federally Insured Credit Unions (found at <https://www.ncua.gov/analysis/Pages/industry/fact-sheets.aspx>)
- State and City Economic Data (found at <https://www.ncua.gov/analysis/Pages/industry.aspx>)
- FOCUS e-Newsletter (can subscribe or review past issues at <https://www.ncua.gov/services/Pages/small-credit-union-learning-center/services/focus-e-newsletter.aspx>)

This does not necessarily require an elaborate economic forecast or a multitude of charts and graphs, and in most cases can probably be done in-house given the abundance of data and resources available online.

Information gathering should focus on the current operating environment and determine what is needed to support the credit union's goals and objectives. The emphasis should be on quality, not quantity. The boards should consider different scenarios and what would be necessary to operate successfully under varied economic, market, and interest rate conditions. While DCU does not expect credit unions with less than \$10 billion in total assets to have complicated stress test processes and programs that may be provided by vendors, it does expect that credit union boards and senior management understand how external changes can affect their credit union.

How do we get there? The ability to translate these goals and objectives into an achievable plan will depend on the tactics chosen and whether the credit union has (or can reasonably acquire) the necessary personnel, financial, and other resources and information systems. For credit unions that plan significant growth, new products or locations, or other initiatives, this step is particularly important. It also is important that planning addresses the need to maintain adequate capital and liquidity as the operating environment evolves in potentially unpredictable ways. Internal communication of the strategic plan and accountability by officers and staff for each area are essential for effective implementation. Finally, backup plans will help minimize disruption and reactive decision making if things do not go as expected.

How will we know we are successful? A well-designed plan may still fail if its implementation is inadequate. This is why the primary focus should be on the ongoing process of strategic planning as opposed to the production of a static, written document. Well-supported goals and performance measures should be built in and reviewed periodically to ensure senior management's execution meets

the board's expectations. Regular review also allows the board and senior management to adjust tactics as needed to accommodate changing market and economic factors. Board reports should provide sufficient information to accurately assess whether the credit union is on track.

Supervise Management

Supervision of the chief executive officer (or manager) and monitoring senior management is the broadest of the board's duties, and the scope of appropriate supervision will vary from credit union to credit union. The board must ensure that senior management has established, and the board has adopted, policies for the most important areas of the credit union. The board must also monitor implementation of the policies and provide for independent review and testing of compliance with its policies and applicable laws and regulations. Finally, directors are expected to personally review any reports of examination or other official supervisory communications, heed the recommendations and comments therein, and most importantly, monitor management's corrective actions.

Adopt Operating Policies

The board should ensure that all major operational areas and activities are covered by clearly communicated policies that can be readily understood by all employees and that are appropriate for the credit union's size. Often times the board will delegate to subcommittees of the board the task of periodically reviewing and approving certain board policies, especially when the subject matter is complicated. Specific policies should address, at a minimum:

- Governance
 - Hiring process and succession planning for CEO
 - Compensation, fees, and benefits for CEO
 - Committee structure and responsibilities
 - Strategic planning, profit planning and budget
 - Conflicts of interest
 - Code of ethics
- Loans
 - Loan policy and procedures
 - Loan documentation
 - Credit underwriting
 - Credit administration
 - Internal loan review
- Liquidity and Sensitivity
 - Asset-liability/funds management
 - Interest rate exposure
 - Investments
 - Asset growth and capital allocation
- Risk management and compliance
 - External audit program

- Internal audit system
- Internal controls and information systems
- Compliance activities
- Operational risk strategies.

Additional expectations for these areas and expectations related to other specific risk areas are embedded in topical guidance and within published examination manuals. In addition to covering areas outlined, credit union boards should ensure that senior management has established appropriate risk management policies and procedures in Bank Secrecy Act (BSA)/Anti-Money Laundering (AML) compliance, information technology and cyber risk, and compliance with consumer protection laws and regulations.

Of course, depending on the credit union's business model, risk profile, location, and other factors, a credit union's board of directors may adopt policies, and management may implement procedures, for additional areas of the credit union.

Monitor Operations and Oversee Business Performance

Although credit union directors are often not experts in banking or finance, they need to remain current with changes in the credit union's financial condition and risk profile. To do this, credit union boards should make sure the credit union's senior management provides periodic reports and summaries of the credit union's financial position and conformance with its policies and procedures. The frequency and content of reports and summaries will vary among credit unions, and some credit union boards may choose to assign more detailed monitoring and oversight of particular risk areas to board-level committees.

Additionally, credit union directors should review the credit union's periodic reports of examination. These reports provide the regulator's assessment of the credit union's operations, financial condition, and risk profile through the assigned CAMELS individual component ratings and the overall composite rating of the credit union as well as through the comments and analysis contained within the report. The DCU also encourages directors to participate in the examination process by meeting with examiners and asking questions. At the start of examinations, credit union directors will be invited to participate in regularly scheduled meetings between DCU examiners and directors. The CAMELS ratings definitions provide the roadmap for how examiners assess a credit union's risk profile. Examination reports and related information, including CAMELS ratings, are protected confidential information under law. Some boards have found it useful to use the definitions in a "self-rating" exercise, where they act as if they were examiners and rate the credit union between examinations as part of the risk profile monitoring process.

Provide for Independent Reviews

Credit unions operate within a regulatory framework based on state and federal laws and regulations that are designed to protect the credit union's stakeholders (members, creditors, employees, and others). Examples include legal lending limits, rules limiting insider and affiliate transactions, capital

requirements and consumer protection laws. This framework is supplemented by interagency, NCUA (for federal deposit requirements), and DCU policy statements and regulatory guidance and examination guidance. Examples of interagency and DCU policy statements include the previously discussed CAMELS ratings, the Interagency Policy Statement on the Allowance for Loan and Lease Losses, and Interagency Guidelines Establishing Information Security Standards.

What Is the Difference Between Rules, Policy Statements, and Guidance?

Examiners cite apparent violations of laws and rules in the examination report. Violations may be technical in nature, indicating the need to simply correct the noted issue or indicating a problematic practice or flaw in the credit union's processes or controls. Depending on the facts, violations of laws and rules are usually deemed to be an unsafe and unsound practice and usually form the basis for a formal enforcement action or imposition of civil money penalties. Contraventions of policy statements or nonconformance with regulatory guidance are also cited in examination reports.

Policy statements and regulatory guidance are DCU-approved statements of the principles and expectations by which the DCU exercises its general supervisory authority. These are referred to as Bulletins or Interpretative Letters at DCU or Letters to Credit Unions, Regulatory Alerts and Accounting Bulletins, among others from NCUA. As such, it usually takes repeated or egregious contraventions of policy statements or nonconformance with guidelines before an examiner would determine the practice to be an unsafe or unsound practice that could form the basis for an enforcement action. Examiner concerns about a credit union's implementation of examination guidance are usually referenced in applicable sections of the examination report, depending on the topic. These concerns may result in recommended action on the part of management to mitigate the identified risks. It is important for a credit union to avoid repeat criticisms of any nature in an examination report.

Credit union directors are not expected to have detailed knowledge of applicable law, rules, and regulatory expectations. However, they are expected to monitor operations to ensure that they are controlled adequately and are in compliance with laws and regulations. In general, the board should establish a mechanism for independent review and testing of compliance with board policies and procedures, applicable laws and rules, policy statements and guidance, and accuracy of information provided to senior management. These reviews might be accomplished by an internal auditor reporting directly to the board, or by a committee of the board. In DCU's experience, some managers will seek examiners' views about how their credit union compares with its peers in a variety of specific respects, or how other credit unions have handled issues similar to those faced by their credit union. These discussions can help inform the board and management about sound risk management practices observed at other credit unions. Such informal discussions, however, are not the channel by which the DCU conveys supervisory recommendations. Agency recommendations and findings are conveyed through the report of examination and other written correspondence from DCU.

Credit union boards should also ensure that the credit union has a strong system of internal controls. An important element in ensuring the effectiveness of the internal control system is establishing an internal audit function as described in DCU Bulletin 06-07. All credit unions should have an internal audit

function that is appropriate for its size and the nature and scope of its activities. A small credit union with few employees and noncomplex operations can ensure that it maintains an effective and objective internal audit function by implementing a set of independent reviews of key internal controls by the Supervisory Committee. Boards should also make sure that the credit union has appropriate policies, procedures, and training programs to ensure that directors, Supervisory Committee members, officers, and employees are familiar with applicable laws, rules, and regulatory expectations.

From DCU Bulletin 15-02:

The following aspects of internal controls deserve special attention:

- 1. Information Systems. It is crucial that effective controls are in place to ensure the integrity, security, and privacy of information contained on the credit union's computer systems.*
- 2. Segregation of Duties. The credit union should have adequate segregation of duties in every area of operation. Segregation of duties may be limited by the number of employees in smaller credit unions.*
- 3. Audit Program. Audit functions and processes should be commensurate with the credit union's size, sophistication, and risk. The program should be independent, reporting to the supervisory committee without conflict or interference from management. An annual audit plan is necessary to ensure risk areas are examined, and the areas of greatest risk receive priority. Reports should be issued to management for comment and action and forwarded to the board of directors with management's response. Follow-up of any unresolved issues is essential and should be covered in subsequent reports.*
- 4. Record Keeping. The books of every credit union should be kept in accordance with well-established accounting principles. A credit union's records and accounts should reflect its actual financial condition and accurate results of operations. Records should be current and provide an audit trail. The audit trail should include sufficient documentation to follow a transaction from its inception through to its completion. Subsidiary records should be kept in balance with general ledger control figures.*
- 5. Protection of Physical Assets. A principal method of safeguarding assets is to limit access to authorized personnel. Protection of assets can be accomplished by developing operating policies and procedures for cash control, joint custody (dual control), teller operations, and physical security of the computer.*
- 6. Education of Staff. Credit union staff and volunteers should be thoroughly trained in specific daily operations. A training program tailored to meet management needs should be in place and cross-training programs for office staff should be present. Risk is controlled when the credit union is able to maintain continuity of operations and service to members.*

Some DCU and interagency policies and guidance require independent reviews. For example, an independent review is a critical component of the control processes for BSA/AML, interest rate risk, the allowance for loan and lease losses methodology, and compliance with consumer protection laws, regulations, and internal compliance policies and procedures. The DCU does not expect all credit unions to hire consultants to conduct independent reviews. Rather, DCU and interagency policies and guidance state that independent reviews will vary substantially in form and scope for credit unions, depending on the business model and complexity of operations and generally may be conducted by one of the following: a credit union's staff or Supervisory Committee, provided the individual is qualified and independent of the function under review; the credit union's internal audit function; or the credit union's external auditor or some other qualified third party.

Heed Examination Reports

The recent crisis showed that for “turn-around credit unions” – those that were troubled, but returned to satisfactory condition – the board and senior management's responsiveness to supervisory concerns was a key differentiating factor between those credit unions that survived, and similarly situated credit unions that ultimately failed or had to be merged. Directors should personally review reports of examination or other supervisory activity and other correspondence from the credit union's supervisors. Findings and recommendations should be reviewed carefully. Progress in addressing problems should be tracked, and directors should discuss issues of concern with the examiners.

In particular, when reviewing the report of examination, directors should pay heightened attention to any Issues cited by examiners. Examination Issues are intended to highlight and prioritize for the board the most important or immediate examiner concerns and criticisms. Examples of Issues include, but are not limited to:

- Emerging issues or new strategies with which the board needs to be more proactive in establishing policy and risk management parameters;
- Policy weaknesses that, if left unaddressed, could increase the risk profile or adversely impact the condition of the credit union, or impair senior management effectiveness;
- Repeat examination recommendations or regulatory issues that have continued to escalate in importance; and
- Significant noncompliance with laws and regulations or nonconformance with regulatory guidance.

As part of the supervisory process, DCU examiners consider how a credit union operates in relation to a wide range of applicable rules, policies and guidelines. Rules issued by the DCU and NCUA pursuant to statutory authority have the force and effect of law, while statements of policy and guidelines generally do not. When recommendations to address nonconformance with a specific policy and guidelines are provided in the report of examination, this is to assist directors and senior management to improve risk management practices or conditions that are important to the credit union's safety and soundness. These recommendations should be thoughtfully considered and implemented, as appropriate.

Boards are expected to ensure that senior management develops and implements timely corrective measures to address all Issues. The DCU caseload examiner may follow up shortly after the examination to check in on the board's and senior management's progress in addressing issues.

Keep Informed

Again to maintain independence, directors must keep themselves informed of the activities and condition of their credit union and of the environment in which it operates. They should attend board and assigned committee meetings regularly, and should be careful to review closely all meeting materials, auditor's findings and recommendations, and supervisory communications. Directors also should stay abreast of general industry trends and any statutory and regulatory developments pertinent to their credit union. Boards should work with senior management to develop a program to keep directors informed.

The pace of change in credit unions today makes it particularly important that directors commit adequate time to be informed participants in the affairs of their credit union. The DCU participates with or has developed many resources and programs to help directors and senior management stay up-to-date on changes to credit union laws, regulations, and supervisory expectations. In particular, the DCU encourages all credit union directors to explore webinars and resources available from NCUA, the Northwest Credit Union Association, Consumer Financial Protection Bureau, and DCU.

The Appendix to this guide provides resources that can assist credit union directors with staying informed.

Chapter IV: Assessing Credit Union Board Effectiveness

The quality of the board and senior management and the manner in which they govern a credit union's affairs are perhaps the most important factors in the successful operation of a credit union. Studies of failed and troubled credit unions indicate that ineffective leadership and oversight by boards and senior management are often the root cause of a credit union's problems. Because the consequences of governance failures may be serious, DCU examiners carefully assess a credit union's corporate governance framework at each onsite examination.

Rating Management

This governance assessment takes place as part of the review of credit union management, including the performance of the board of directors and senior management in conducting a credit union's activities in a safe-and-sound manner, effectiveness of risk management processes, and compliance with applicable laws and regulations. The findings of this assessment are incorporated into the "Management" rating component of the CAMELS rating.

Examiners assess the Management component relative to the credit union's size, complexity, and risk profile. This assessment focuses on the effectiveness of the board and senior management in identifying, measuring, monitoring, and controlling the risks of a credit union's activities. These elements are addressed in the definition of the "Management" component rating, as well as in the safety and soundness. Elements that factor into the Management component review include, but are not limited to:

- Adequacy of the policies and procedures covering each area of the credit union's operations (written, board approved, followed);
- Budget performance compared against actual performance;
- Effectiveness of systems that measure and monitor risk;
- Risk-taking practices and methods of control to mitigate concerns;
- Integration of risk management with planning and decision-making;
- Responsiveness to examination and audit suggestions, recommendations, or requirements;
- Compliance with laws and regulations;
- Appropriateness of the products and services offered in relation to the credit union's size and management experience;
- Market penetration;
- Rate structure;
- Appropriateness of disaster preparedness planning for continuity of operations; and
- Succession planning for key management positions.

Strategic Planning Considerations

The quality of the credit union's planning process is a key consideration in the appraisal of credit union management, earnings, and capital. Examiners evaluate the adequacy of a credit union's planning process.

Strategic planning involves a systematic process to develop a long-term vision for the credit union. The strategic plan incorporates all areas of a credit union's operations and sets broad goals enabling credit union management to make sound decisions. The strategic plan should identify risks and threats to the organization and outline methods to address them.

As part of the strategic planning process, credit unions should develop a business plan for the next one or two years. The board of directors should review and approve the business plan, including a budget, in the context of its consistency with the credit union's strategic plan. The business plan needs to be consistent with the strategic plan. Examiners also assess how the plan is put into effect. The plans should be unique to and reflective of the individual credit union.

Information systems and technology (IS&T) should be included as an integral part of the credit union's strategic plan. Examiners assess the credit union's risk analysis, policies, and oversight of this area based on the size and complexity of the credit union and the type and volume of ecommerce systems and services offered. Examiners consider the criticality of e-commerce systems and services in their assessment of the overall IS&T plan.

When to Adjust the Level of Board Oversight

The appropriate level of board oversight will vary from credit union to credit union and must evolve along with changes in the nature and complexity of the credit union's operations as well as in response to external factors. The following non-exhaustive list provides a few examples of conditions evident at credit unions where the DCU would expect a higher level of board oversight:

- A CAMELS composite or component rating of 3, 4 or 5, the existence of an enforcement action, or both
- Elevated asset or funding concentrations
- Complex or highly specialized products or activities
- High levels of historical or planned growth
- Rapidly shifting balance sheet structure
- Low or shrinking levels of liquid assets
- Plans to change the business model or enter into significant new lines of business
- Deviations from credit union policy or prudent credit union practice, violations of laws and regulations, or heightened examiner or auditor criticism
- Poor operating results
- Low capital levels
- Operational problems in BSA/ AML, information technology, and cybersecurity
- Deterioration in local economies or in business line fundamentals
- Low consumer compliance ratings, or high levels of consumer complaints

The DCU strongly encourages credit union directors to be involved in the examination and supervision process. In addition to reviewing reports of examination, this includes attending board meetings where results are being discussed, and following up with the examiner-in-charge, financial examiner supervisor, or program manager with any questions or concerns about DCU expectations on any aspect of the supervisory process.

Conclusion

This guidance provides a framework of basic corporate governance principles and concepts. When the board uses an effective corporate governance framework, it will provide the relationships, policies, and processes that will drive the credit union to be profitable, competitive, and resilient during changing economic and market conditions. Corporate governance concepts help credit union directors understand their roles and responsibilities. Their primary responsibility is to act in the best interest of the credit union when they decide on the strategic direction and exercise knowledgeable oversight of management's implementation. Oversight requires high level collaboration and robust discussions between the board and senior management, including challenging management's recommendations at times. The Washington Credit Union Act requires directors to act in a fiduciary role and examiners expect directors to maintain very high standards of conduct. A strong corporate culture for risk management and ethics will ensure the trust and public confidence of current and future members.

Appendix

DCU Bulletin 04-05 “Board of Directors Examination Questionnaire”

<http://www.dfi.wa.gov/sites/default/files/credit-unions/bulletins/B-04-05.pdf>

DCU Bulletin 06-03 “Corporate Governance Task Force Summary”

<http://www.dfi.wa.gov/sites/default/files/credit-unions/bulletins/B-06-03.pdf>

DCU Bulletin 05-05 “Corporate Governance Models” <http://www.dfi.wa.gov/sites/default/files/credit-unions/bulletins/B-05-05.pdf>

DCU Bulletin 03-05 “Directors are the Key” <http://www.dfi.wa.gov/sites/default/files/credit-unions/bulletins/B-03-05.pdf>

DCU Bulletin 06-07 “Internal Audit” <http://www.dfi.wa.gov/sites/default/files/credit-unions/bulletins/B-06-07.pdf>

DCU Bulletin 15-06 “Implementing the CAMEL Component “S” Rating in Washington State”

<http://www.dfi.wa.gov/sites/default/files/credit-unions/bulletins/B-15-06.pdf>

DCU Bulletin 15-02 “Changes to the CAMEL Rating in Washington State”

<http://www.dfi.wa.gov/sites/default/files/credit-unions/bulletins/B-15-02.pdf>

RCW 31.12.255 “Board of directors—Powers and duties”

<http://app.leg.wa.gov/RCW/default.aspx?cite=31.12.255>

RCW 31.12.267 “Directors and officers—Fiduciary duty—Information relied on”

<http://app.leg.wa.gov/RCW/default.aspx?cite=31.12.267>

RCW 31.12.269 “Directors and committee members—Limitations on personal liability—Exceptions”

<http://app.leg.wa.gov/RCW/default.aspx?cite=31.12.269>

RCW 31.12.285 “Suspension of members of board or supervisory committee by board—For cause”

<http://app.leg.wa.gov/RCW/default.aspx?cite=31.12.285>

RCW 31.12.335 “Supervisory committee—Duties”

<http://app.leg.wa.gov/RCW/default.aspx?cite=31.12.335>

RCW 31.12.345 “Suspension of members of a committee or members of the board by supervisory committee—For cause” <http://app.leg.wa.gov/RCW/default.aspx?cite=31.12.345>

RCW 31.12.404 “Additional powers—Powers conferred on federal credit union—Authority of director”

<http://app.leg.wa.gov/RCW/default.aspx?cite=31.12.404>

RCW 31.12.426(2) “Loans—Secured or unsecured loans” “...(2) Loans to directors, supervisory committee members, and credit committee members may not be made under more favorable terms and conditions than those made to members generally...”

<http://app.leg.wa.gov/RCW/default.aspx?cite=31.12.426>

Interpretative Letter 97-12 “Disqualification of Director for Absence”

<http://www.dfi.wa.gov/sites/default/files/credit-unions/interpretive-letters/O-97-12.pdf>

Interpretative Letter 05-05 “Conflict of interest by candidates for board of directors or supervisory committee positions” <http://www.dfi.wa.gov/sites/default/files/credit-unions/interpretive-letters/I-05-05.pdf>

Federal Financial Institutions Examination Council (FFIEC) Guidance FFIEC Policy Statement on Uniform Financial Institutions Rating System. <https://www.fdic.gov/regulations/laws/rules/5000-900.html>

Business Continuity Planning Handbook <http://ithandbook.ffiec.gov/it-booklets/business-continuity-planning.aspx>

Cybersecurity Assessment Tool <https://www.ffiec.gov/cybersecurity.htm>

FFIEC Bank Secrecy Act/Anti-Money Laundering Infobase
http://www.ffiec.gov/bsa_aml_infobase/default.htm.

FFIEC Information Technology Infobase <http://ithandbook.ffiec.gov/it-booklets.aspx>

Lessons Learned from Hurricane Katrina https://www.ffiec.gov/katrina_lessons.htm

Northwest Credit Union Association (NWCUA) has created an online credit union philosophy training manual, available to credit unions at no cost - See more at: http://cuphilosophyquiz.com/wp-content/uploads/2016/01/2_2016-NWCUA-CU-Philosophy-Manual_1-29-16.pdf

NWCUA Professional Development Calendar <https://www.nwcua.org/professional-development>

NCUA Webinars and Videos <https://www.ncua.gov/newsroom/Pages/videos.aspx>

CFPB guides, bulletins, videos, tools and other support materials to help credit unions understand, implement, and comply with their rules <http://www.consumerfinance.gov/policy-compliance/guidance/implementation-guidance/>

Northwest Credit Union Association Model Bylaws [annotated version](#)