Credit Union Governance

White Paper

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Introduction

As corporate governance continues to become an important issue affecting today’s marketplace, many theories, best practices and scorecards have been developed with the goal of creating efficient and effective governance principles. Although a plethora of good governance information has been developed, the World Council of Credit Unions, Inc. (WOCCU) believed it would be beneficial to its members and credit unions around the world for governance principles to address the particular nuances and unique characteristics of credit unions. As a result, WOCCU has developed the International Credit Union Governance Principles to create a governance model that more appropriately addresses the structure and mission of credit unions.

At their core, credit unions are fundamentally different from other financial institutions. For-profit financial institutions have one primary goal: to maximize the owners’ gain. As a result of this drive to increase profits, traditional corporate governance principles serve to ensure that profitability is achieved for the shareholders, not the actual users of the bank’s financial services. Like for-profit corporations, credit unions seek to generate profits in order to directly benefit the owners. However, unlike private commercial banks and other for-profit institutions, the members serve as both the owners of the credit union and the recipients of the credit union services. Therefore when credit unions maximize their profits, it results in the form of lower interest rates on loans, lower service fees and higher dividends for the members. In addition to this unique aspect, credit unions are democratic institutions, where a single member receives a single vote, regardless of financial stake in the organization.

The International Credit Union Governance Principles are ideals to be achieved and are intended to apply to credit unions, not second tier organizations. Credit unions are free to adapt these Principles as necessary to directly address local conditions.

Defining Governance

According to the Organization for Economic Co-operation and Development (OECD), “Corporate governance involves a set of relationships between a company’s management, its board, its shareholders and other stakeholders. Corporate governance also provides the structure through which the objectives of the company are set, and the means of attaining those objectives and monitoring performance are determined.”

To assist with relationship management and corporate structure, WOCCU has developed principles for the three-part system of governance. First, external governance addresses the issues that credit unions face as participants in the financial marketplace. All financial institutions, regardless of structure, are expected to operate in a transparent manner, comply with regulatory and prudential standards and be held accountable to the public.

Second, internal governance defines the responsibilities and accountability of the general assembly, the board of directors, management and the staff. These responsibilities include achieving an appropriate governing structure of the credit union, preserving the continuity of future credit union operations, creating balance within the organization and remaining accountable for their actions.

The third principle, individual governance, ensures that the credit union obtains directors and management who are able to fulfill the two previous obligations of external and internal governance through integrity, competence and commitment. By adhering to the principles of this three-part model of external, internal and individual governance, credit unions can better achieve their ultimate goal of bringing affordable, quality financial services to people around the world.

External Governance

External governance for credit unions consists of the credit unions’ responsibility to its members and to the general public. Since the ultimate mission of credit unions is to serve their members, credit unions must operate in a manner that produces member confidence. In order to generate public confidence, credit unions must exercise the governance standards of transparency, compliance and accountability.

Transparency

Transparency requires the actions of the board of directors to be visible to the credit union members, credit union regulators and the general public. This visibility ensures that credit unions operate in a manner consistent with the International Credit Union Operating Principles\(^2\) and avoid impropriety or the appearance of impropriety. To be transparent, credit unions should commit to regular honest communication of their activities to regulators and the general public in the spirit of full disclosure. Second, credit unions must complete financial statements that are compliant with generally accepted accounting practices and local regulatory standards and should make such statements available to members and to the general public.

The board and management of the credit union should engage in regular, honest communication to explain the actions of the organization to anyone who may be affected by them. This disclosure should include the objectives of the credit union, voting rights of credit union members, foreseeable risks, information about the board of directors including qualifications and any potential related party transactions. By ensuring that its decisions are made in the light of day, members have the ability to oversee the actions of the board that represents them. The credit union’s regulatory body should also be regularly informed of any actions that may be relevant. Additionally, World Council recommends the board inform the general public of any decisions that would affect it.

The board or management should then convey the disclosure through communication methods, including but not limited to member meetings, postings, online interaction or newsletters. The communication must occur at regular intervals to members and must provide honest, unvarnished facts.

The credit union can also achieve transparency by implementing a policy to prevent conflicts of interest. The issue of conflicts of interest will be discussed further under the integrity principle of individual governance.

Second, credit unions should make available to members and the public financial statements that are compliant with accepted accounting practices. To safeguard the credit union, the board, management and the auditors owe a duty to the credit union members to accurately report the financial position of the credit union. The financial statements of the credit union should be expressed in a form that is compliant with its country’s accounting standards. These statements should accurately reflect the financial condition of the credit union, and should be provided in a timely manner to those who require them, especially credit union members. The year-end financial statements should also be reviewed by an independent and well-qualified auditor to provide the necessary assurance to the credit union members and general public that the financial statements are true and accurate assessments of the financial condition of the credit union.

Compliance

It is essential that credit unions comply with existing laws and regulatory standards. Through compliance, credit union members and the general public will have greater confidence in the ability of the credit union to weather difficulties and to remain a stable source of financial services. Credit unions

\(^2\)World Council of Credit Unions, Inc. developed the International Credit Union Operating Principles to relate the fundamental characteristics and commonalities of global credit unions. These Principles are founded in the philosophy of cooperation and its central values of equality, equity and self-help.
Compliance Continued

achieve this member and public confidence through compliance with the regulations and laws of its particular locality, the International Credit Union Safety & Soundness Principles and recommended external audit procedures.

First, the credit union is expected to comply with both the letter and spirit of regulation and to cooperate fully with its regulatory body and in compliance with the national and or state laws. Credit unions hold and administer substantial funds belonging to their members. This fiduciary responsibility requires credit unions to be supervised by an authorized, capable external agency responsible for the registration, regulation and supervision of financial institutions. If the implemented regulations and laws hinder the ability for the credit union to effectively operate, the credit union should then seek assistance from organizations such as the World Council of Credit Unions, Inc. to advocate for a change in the regulations and/or law.

Second, the board should ensure that the credit union meets or exceeds the International Credit Union Safety and Soundness Principles, as well as any other relevant standards for financial institutions implemented by the regulatory agency. The Safety and Soundness Principles reflect basic prudential standards intended to safeguard credit unions and their members from losses and to ensure credit unions function in a manner that preserves economic viability while serving members. As not-for-profit entities, credit unions must delicately balance the need to meet regulatory standards with their mission to bring quality services to members. In order to achieve this delicate balance, credit unions should adhere to these minimum prudential standards of safety and soundness to provide financial security to members.

The Safety and Soundness Principles consist of a set of performance indicators, each with a prudential norm that credit unions should meet. The target indicators have been developed based on WOCCU’s field experience to strengthen credit unions globally. To assist credit unions and their regulators in monitoring their financial performance relative to the Safety and Soundness Principles, WOCCU has developed and makes available the software monitoring system called PEARLS™.

It is essential that credit unions adhere to regulatory standards that are most advantageous to operating in a safe and sound manner. As a result if other regulatory standards are more rigorous than WOCCU’s PEARLS Safety & Soundness Principles, credit unions should adhere to the most stringent standards.

Third, it is vital for credit unions to follow the standard practice for external audit procedures. These procedures include annual external audits within 90 days of the end of each fiscal year. External audits help members catch potential oversights or fraud.

It is preferred for the audit relationship to be reexamined frequently and consideration be given to changing the auditor or the audit partner at least every 3-5 years in a competitive bidding process. Despite the importance of the external audit, the use of the same auditor over several years can result in an overly close relationship that leads to a “check the box” approach. By changing the auditor frequently, the board can help to maintain the auditor’s independence and ensure compliance with standard audit practices.

Public Accountability

Regardless of the political system a credit union operates under, it must be constantly aware of the responsibilities to governmental structures including regulators and legislative bodies, to the media and to the public as manifested through a high public opinion. As discussed under compliance, credit unions must adhere to all regulatory standards and laws implemented by governing bodies, and consequently, they will be held accountable to these governing bodies if they fail to follow the requisite proscribed measures. In addition, credit unions, like any financial institutions, rely on public confidence to remain operational. Credit unions must be aware that this confidence can erode very quickly if the institution is not well regarded by the entities outlined above, particularly the media. Therefore, the board of directors and management must be sensitive to how the credit union is portrayed to the media and within the community at large.
Internal Governance

In addition to a credit unions’ responsibility to its members and the general public, responsibility and accountability also arises to the general assembly of members, the board of directors, management and the staff of credit unions. This responsibility and accountability, known as internal governance, is essential for the credit union to operate in a cohesive and productive manner. In order to effectively govern internally, the general assembly and the board of directors have a duty to maintain an effective structure, to strive for the continuity of the credit union, to achieve balance within the organization and to remain accountable for their actions.

Structure

The following recommended structure of the board of directors ensures its democratic operation and its ability to provide unfettered service to the credit unions. First, World Council recommends the board be composed of an odd number of members, no less than five and no greater than nine. The purpose of this structure is to prevent tied votes. If the board has fewer than five members, it may be difficult for the board to adequately represent its diverse member body, while more than nine members may make consensus achieving difficult and may increase logistical problems.

Second, World Council recommends that consideration should be given to the rotation of directors. A rotation approach can encourage fresh viewpoints to enter the boardroom without the potential loss of organizational knowledge. The credit union may consider devising a formal training program to prevent the depletion of organization knowledge.

Third, interested credit union members, compliant with the individual governance standards of integrity, competence and commitment, should be allowed to stand for the nominating process. Although a nominating committee can be useful in identifying and nurturing potential board members, the democratic nature of credit unions requires that general members be allowed to represent the general assembly on the board. The opening of the process to general members helps regulate the power of the board and nominating committee.

The structure of the annual general meeting highlights the viability and importance of internal responsibility. The annual general meeting of the general assembly should be adequately promoted to ensure sufficient member participation. This meeting is the backbone of the internal governance system and is the highest decision making body in the credit union. By providing a forum for the general assembly of members to interact with the board, the annual general meeting of members serves as a check on the power of the board and management. However, the meeting cannot provide this check if members are not aware of it.

The annual general meeting should also be an opportunity for the directors to receive feedback and guidance from their fellow members. The board should encourage dialogue with general members at the annual general meeting, because it is the ultimate duty of the board to represent the wishes of the general assembly of members.
Continuity

In order for the credit union to serve its members it must remain in operation. As a result, the board of directors is responsible for the creation of continuity planning to address both the current competitive operational plan and contingency plans involving succession and disaster management. By having contingency plans already established during times of disaster, unexpected board/management departure or unforeseeable financial difficulties, it is much easier to assure the viability of the credit union.

First, the board must create strategies to maintain the competitiveness of the credit union. In order for the board to maintain a forward-looking strategy, it should undertake actions similar to the following:

1. review of the operational strategy of the credit union on a periodic basis
2. development of major plans of action
3. consideration of risk policy by specifying the types and degree of risk that the credit union is willing to accept
4. review of the annual budget
5. development of business plans for future operations
6. creation of performance objectives
7. approval of major capital expenditures and acquisitions
8. evaluation of credit union performance

It is imperative for the board to be monitoring the effectiveness of the above strategies and be able to adapt to the changing needs of the credit union. The board also must evaluate the effectiveness of the credit union operational strategies and revise them when necessary.

Second, the board should create succession plans for both directors and management that ensure the continued existence of the credit union. The loss of a board member or senior manager can be devastating to an organization. Often, considerable time is required for a new director or manager to become familiar with the credit union’s operations. This lag creates a serious competitive disadvantage for the institution, which may possibly affect the way the credit union serves its members. As part of an adequate succession plan, a nominating committee or similar organization should be constantly evaluating new potential candidates for the board.

Finally, the board should approve a disaster management plan and recovery plan. Disasters can be separated in three categories: natural disasters, human disasters and technological disasters. Natural disasters include the commonly known disasters of tsunamis, tornadoes, hurricanes, floods, fires and other storms. Human disasters include terrorist attacks, bomb threats, arson, robberies, hostage events and employment related strikes. Finally, technological disasters encompass computer viruses, power outages and computer system crashes.

Because disasters vary widely in nature and scope, credit unions face a difficult challenge in devising a disaster management and recovery plan that is universal. It is essential for the plan to include provisions for recovery from the disaster and may include various scenarios for recovery depending on the type of disaster. It is also essential for the disaster management plan to include a business resumption plan that outlines the necessary steps for the credit union to return to operations. It is the responsibility of the board to update this disaster management and recovery plan on a regular basis in order to ensure its effectiveness.
Balance

Unlike for-profit institutions, credit unions should strive for a board that responds to the demands of the general membership. By creating a board in this manner, members are more likely to feel that they have a voice on the board and are more likely to feel a stronger connection with the credit union. As a result, a greater likelihood exists that members will continue their membership with the credit union.

The composition of the board should aim to reflect the demographic makeup of its members and the financial needs of members. By creating a board that reflects the age, gender and ethnic background of the credit union, the desires of the general assembly can more easily be developed by directors. An important note, however, is that while a majority of members may save more than they borrow, or vice-versa, the credit union must always strike a balance between policies that benefit savers and those that benefit borrowers. If policies are skewed in the direction that benefits borrowers, it may be difficult for the credit union to remain a strong institution.

Although diversity is an important component of the board’s makeup, financial or strategic experience should also play a part. Members with a strong financial background have a great deal to contribute to the development of the institution. In addition, all board members, regardless of background, must meet the standards of individual governance, including integrity, competence and commitment. The pursuit of diversity or experience on the board is not a valid reason to avoid these standards for directors. Moreover, the attempt to achieve a diverse board should also not weaken the provision of quality financial services. The ultimate responsibility of the board, no matter its composition, is to ensure the welfare of the credit union and the credit union members.

Accountability

Finally, credit union governance is incomplete without clearly specifying the internal accountability of the board of directors and management of the credit union. In order to meet the goals of internal governance, it is essential that the roles and responsibilities of the credit union’s various groups be clearly defined. Without a clear understanding of roles and responsibilities, the possibility for a breakdown in governance becomes much more likely. More detailed roles and responsibilities should be defined in writing and distributed to all members, directors and managers.

As the internal governing body of the credit union, the board of directors must be held accountable for the actions and consequences of the credit union. Consequently, the board, first and foremost, has a duty to the general assembly. As the ultimate owners of the credit union, the members of the general assembly delegate the board directors to function on their behalf. The general assembly then has the ability to question the actions of the board and to hold the board accountable.

The board also has a duty to management to establish policies and monitor the implementation of these policies. As servants of the general assembly, the board is ultimately responsible for steering the credit union and establishing its position within the market. However, once the board has established policies that meet these goals, professional managers then fulfill these policies. In order to ensure that these policies have been achieved, the board must then follow up with management regularly to chart its progress against predefined measures of success.

In addition to the board of directors, the management of a credit union should be held accountable for its actions and consequences. Specifically, management has the duty to prepare the strategic plan and budget, undertake operations, implement the policies approved by the board and achieve the targets specified in the strategic plan.

Since both the board of directors and credit union management are held accountable for the internal governance of the credit union, it is essential for the credit union to record this accountability through the bylaws and other policies. Establishing these duties in writing eliminates confusion and prevents groups from overreaching their bounds. As a result, the ultimate goal of serving the members becomes obtainable.
Individual Governance

No matter the strength of the governance system in place, a credit union’s board is only as strong as its individual members. Directors must possess the integrity, competence and commitment to work for the good of the credit union and to prevent this labor from being wasted. The success of the principles of external and internal governance depends fully upon a board where every member meets these standards of integrity, competence and commitment of individual governance.

Integrity

The general assembly grants a great deal of power to the board. Without a strong sense of integrity, board members have the potential to exploit this power for personal gain. As a result, the board of directors, as the internal governing body, must exhibit high ethical standards in all personal and professional interactions. In order to ensure that the ethical standards are met, the credit union should provide a standardized code of conduct clearly explaining proper and improper behavior. This written standardized code should provide strict boundaries for directors and managers, thereby preventing possible violations due to a lack of clarity.

Included in this standardized code, both directors and managers must not have criminal backgrounds or bankruptcies, because directors and managers should inspire the highest level of trust in members. A revelation that one of the top leaders of the credit union has a criminal history could severely impact member confidence.

In addition, credit unions must take all necessary measures to avoid conflicts of interest. In particular, the board of directors should not use their positions on the board to benefit personally. To accomplish this ethical consideration, board members must excuse themselves from discussions and voting on matters in which they or their relations have an economic interest.

Furthermore, immediate family members or those with close relationships to any of the board of directors or staff should not serve on the board or in management concurrently. A familial or close preexisting bond provides numerous opportunities for wrongdoing, such as collusion on votes, and opens the credit union to charges of nepotism. No matter how qualified or impartial the directors may be, the reputation of the credit union cannot be risked.

Finally, the standardized code of conduct reflecting integrity should include provisions discussing loans. Although the lending policy should comply with local regulatory requirements, World Council recommends the board of directors approve any loans made to any director or members of management. These loans to management or directors should be scrutinized even more closely than those given to general members, since the possibility for wrongdoing is much higher. Any director who may benefit from the granting of the loan must be excused from the voting process. If the loan is approved, the board should review the status of the director’s outstanding loan on a quarterly basis to ensure regular, on-time payments have been made. If any loans of the directors become delinquent by more than three months, the director must be removed from their position or must resign.

Competence

In order to meet the needs of both external and internal governance, it is important that all members of the board possess basic financial skills. Credit unions, as financial institutions, require a board that fully understands the environment in which they operate or have the skills and experience to understand financial operations.
**Competence Continued**

To fully understand and complete their responsibilities, individual members should have financial or business skills and a member-focused viewpoint. A strong board helps maintain a strong credit union, and individual directors have the opportunity to contribute to this strength in two ways: through the contribution of specialized knowledge and member representation. Members with a background in finance or business come to the board with skills that help the credit union succeed in a competitive environment. In addition, those directors who provide diversity to the board reinforce ownership for members, and may provide a new and unique point of view.

In addition to specialized financial or business skills, all members of the board should possess the ability to interpret financial statements and standards or commit to acquiring the necessary skills through education or training within one year of their appointment. Serving as the representatives of the general assembly requires that board members understand all the information about the credit union that is presented to them. Without these basic skills, directors will be unable to participate fully in the decision-making process. If members are voted to the board, it should be their responsibility to acquire the requisite skills if they do not initially have them. If necessary, the credit union may adopt a formal educational program for new directors.

**Commitment**

It is both an honor and a serious commitment to represent the general assembly on the board. Directors should be prepared to devote the time necessary to fulfilling their duties, should work with other members of the board to create a single, well-functioning entity and should assist in fulfilling all obligations.

Directors should be willing and able to commit the necessary time to the credit union, especially through participation and attendance at regular board meetings and the annual general meeting. Board responsibilities and activities have the potential to take much of the directors’ time. Despite this, directors must devote themselves fully to the success of the credit union. If the directors are unable to attend meetings, the members at the annual general meeting may consider dismissing and replacing the director depending on the frequency of the absences.

Directors must be committed to respect the decisions of the board, adhering to all policies that have been adopted regardless of personal opinion and to speak with one voice. Consequently, the principle of one voice should define all actions of the board. When making decisions, the board may disagree during this consensus-building process; however once a decision is made, each individual member of the board of directors must adopt and promote the decision in a unified manner to the management of the credit union.
Conclusion

WOCCU believes its three-part model of external, internal and individual governance addresses the broad spectrum of duties and responsibilities needed to efficiently and effectively operate a credit union. Although each credit union is inherently different due to geographic location, size, services and member needs, this code of governance is meant to serve as a general guide, ideals to achieve rather than mandatory requirements. Each credit union must adapt its code of governance to address individual concerns. Ultimately, however, it is imperative for every code of governance to reflect the fundamental responsibility and goal of credit unions to operate in a manner that provides quality yet affordable financial services to everyone.