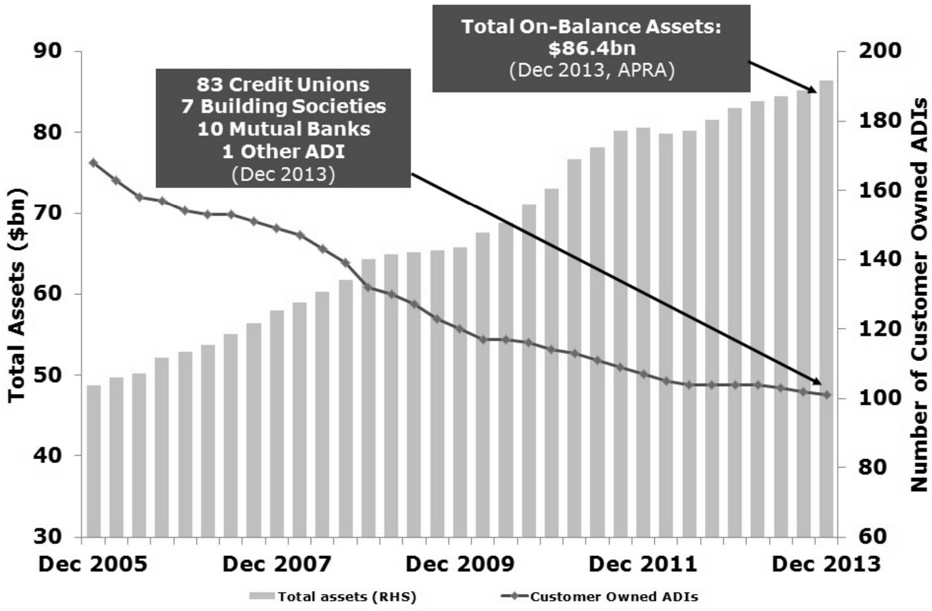
Asian Credit Union Forum
Bali, Indonesia
19th Sept 2014

The Requirement of being a 'Fit and Proper' Person for Director's Strategic Role

Mark Worthington
Select Credit Union Ltd
Australia

- First credit union in Australia – 1946
- 1956 100 CU's
- 1963 273 CU's
- 1973 833 CU's
- 1978 690 CU's
- 1993 357 CU's
- 2014 101 "Mutuals"
- Total assets A$86.4 billion
- More than 4.5 million members
- Collectively the fifth largest deposit holders
- High member/customer satisfaction



Credit Union "Australian Firsts"

- To offer payroll deduction for savings and loans
- To offer free life insurance on loans
- To introduce online computer operations
- To introduce ATMs
- To introduce point of sale machines
- To provide international ATM withdrawals
- First non-US financial institutions to join VISA

History of CU regulation

- To 1978 Registrar of Cooperatives
- 1978-92 Savings Reserve Board
- 1992-98 Financial Institutions Commission
- 1998- Australian Prudential Regulation Authority (APRA)

1978 to 1992

- Department of Cooperatives
- Credit Union Act 1969
- CU Savings Reserve Board
- Performance Indicators set to manage growth as well as profitability
- Reserves to assets ratio min 10%
- Reporting
- One small credit union failure in 1979 – depositors lost 30 cents in the dollar total $150,000

1978 to 1992

- Reserve Board powers
- Circumstances that a CU may be placed “under direction”
  - Trading at a loss, accumulated deficit, not liquid, not sufficient provision for doubtful debts, not complete monthly reporting.
- CU Savings Reserve Fund
- No deposit insurance scheme in Aust until 2009 (now $250,000 per account)

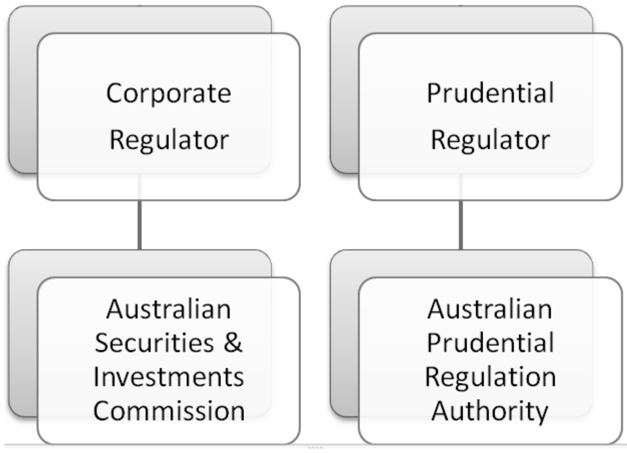
1992-1998

- Financial Institutions Commission formed to regulate Non-Bank Financial Institutions
- 1994 lost tax exempt status - company tax phased in – full company tax by 1997
- 1999 Financial Sector Reform Act facilitated the registration of credit unions as companies under the Corporations Act.
- Act conferred corporate functions and powers to ASIC and prudential functions and powers to APRA

1998 to present

- Australian Prudential Regulation Authority
  - APRA sets legally enforceable “Prudential Standards” for all regulated entities
  - Banks, Mutuals (credit unions, building societies, mutual banks), general and life insurance companies, as well as superannuation (pension) funds
  - APRA’s mission: to establish and enforce prudential standards and practices designed to ensure that, under all reasonable circumstances, financial promises made by institutions are met
  - Regulation is focused upon depositor protection

- From 1999 credit unions no longer considered to be cooperatives
- 2000 ASIC policy statement PS147, a cooperative is a “company with mutual structure”
- Definition of a mutual structure
  - Economic test - members have rights to receive an equal share of the surplus in a wind-up
  - Governance test - effectively one member one vote
- Hence, credit unions are “mutual companies” with both a corporate regulator and a prudential regulator
- Ten Australian credit unions have recently converted to become “Mutual Banks”



Corporate Responsibilities

- (s180) Directors must exercise their powers and discharge their duties with… care and diligence
- (s181) Duty to act in good faith and in the best interests of the company
- (s182-183) Not improperly use position (or information) to gain advantage or cause detriment
- (s184) Identifies intentional dishonesty as a criminal offence
- (s191-194) Duty to disclose and avoid conflict of interests

- (s180) Business judgement rule
  - Make judgement in good faith
  - Not have a material personal interest
  - Must inform themselves about the subject matter of the judgement to the extent they reasonably believe to be appropriate
  - Rationally believe the judgement is in the best interests of the business

Board Duties

- Must observe restrictions to powers described by Constitution (s125)

Dissenting from a Board decision

- If belief that decision is in breach of corporate duties (eg disclosures within annual financial report)
  - Record dissent in minutes may give prosecution relief (s1318)
  - If able under Constitution, convene a General Meeting
  - Consider no longer sitting on the Board - resign

Prudential Responsibilities

- Basle Committee on Banking Supervision
- "Principles for Enhancing Corporate Governance" Oct 2010
  - Board practices
    - Ultimate responsibility for the ADI, including risk strategy & appetite/tolerance, financial soundness, organisation structure & functioning, and governance
    - Corporate values and code of conduct
    - Oversight of senior management
    - **Board qualifications, training, composition**
    - Proper functioning of the Board
    - Role of the Chair
    - Board committees
    - Conflicts of interest

Basle II Capital Accord (01 Jan 2008)

- Pillar 1 Capital
  - Credit Risk (IRB, standardised approach)
  - Operational Risk (AMA, standardised approach)
  - Market Risk (trading activities only - not applicable)
- Pillar 2 Supervisory Review
  - ICAAP – credit concentration risk, interest rate risk, liquidity, strategic, contagion & reputation, regulatory, securitisation
- Pillar 3 Market Discipline
  - Consistency of reporting

Basle II Capital Accord (01 Jan 2008)

- Operational Risk defined as "the risk of loss resulting from inadequate or failed internal processes, people and systems…"
- The definition of Operational Risk allows prudential regulator to set prudential requirements for governance and fit & proper

Prudential Standards

- Capital adequacy (reserves)
- Liquidity
- Credit quality
- Risk Management
- Large exposures
- Outsourcing
- Business Continuity Management
- Audit
- Governance
- Fit & Proper

January 2015

Prudential Standard CPS 510
Governance

Objectives and key requirements of this Prudential Standard

This Prudential Standard sets out minimum foundations for good governance of an APRA-regulated institution in the deposit-taking, general insurance and life insurance industries or of a Head of a group. Its objective is to ensure that an institution is managed soundly and prudently by a competent Board (or equivalent), which can make reasonable and impartial business judgements in the best interests of the institution and which duly considers the impact of its decisions on depositors and/or policyholders.

The ultimate responsibility for the sound and prudent management of an APRA-regulated institution rests with its Board of directors (or equivalent).

It is essential that an APRA-regulated institution has a sound governance framework and conducts its affairs with a high degree of integrity. A culture that promotes good governance benefits all stakeholders of an institution and helps to maintain public confidence in the institution.

Governance Standard (CPS-510)

- The Board is ultimately responsible for prudent management
- Board must have a charter setting out its roles and responsibilities
- Board must document delegations
- Directors must have necessary skills, knowledge, experience
- Must meet with regulator upon request
- Independence criteria

Governance Standard (CPS-510)

- Board composition
  - Minimum 5 directors
  - Majority assessed as independent
  - Chair must be independent
- Annual Board and director performance assessments
- Renewal policy
- Remuneration policy
- Remuneration Committee

January 2013

AUSTRALIA

Prudential Standard CPS 520

Fit and Proper

Objective and key requirements of this Prudential Standard

This Prudential Standard sets out minimum requirements for regulated institutions in determining the fitness and propriety of individuals to hold positions of responsibility. Its objective is to ensure that a regulated institution prudently manages the risks posed to its business operations and financial standing by having persons acting in responsible positions who are not fit and proper.

The ultimate responsibility for ensuring the fitness and propriety of the responsible persons of an APRA-regulated institution rests with its Board of directors (or equivalent).

Persons who are responsible for the management and oversight of a regulated institution need to have appropriate skills, experience and knowledge, and act with honesty and integrity. These skills and qualities strengthen the protection afforded to depositors, policyholders and other stakeholders. To this end, regulated institutions need to prudently manage the risk that persons in positions of responsibility might not be fit and proper.

Fit & Proper Standard (CPS-520)

Purpose

- The objective of the prudential standard is to protect the interests of depositors and other members, by ensuring that persons who are responsible for the management and oversight of the credit union have the appropriate skills, experience and knowledge and that they will act with honesty and integrity.

Fit & Proper Standard (CPS-520)

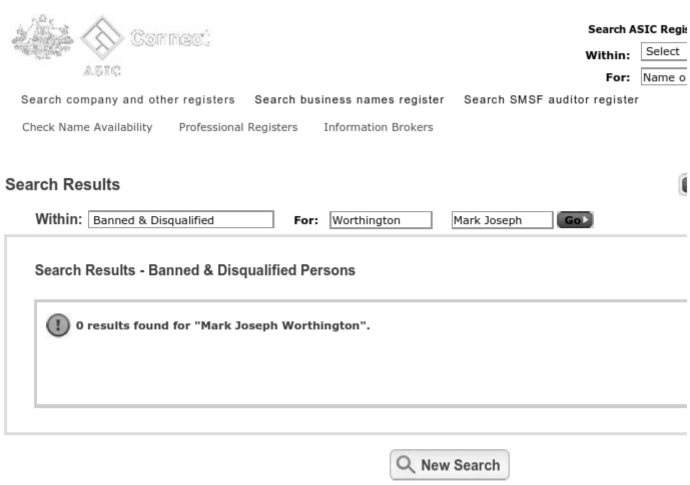
- Fitness – qualifications, skills, experience, knowledge
- Propriety – character, honesty, integrity

- Fitness and propriety must be assessed upon appointment and then annually
- If not fit and proper cannot be a director
- Applies to “responsible persons” – directors, senior managers, external auditor

Fit & Proper Standard (CPS-520)

- Objective tests
  - Not disqualified by prudential or corporate regulator
  - No criminal history (police checks obtained)
  - Not a current or former bankrupt
  - Material qualifications verified
  - Not have conflict of interest

- Not disqualified



- No criminal history

AFP Ref: 89C8B198C
Client Ref:

17 July 2014

Australian Federal Police
Criminal Records
Locked Bag 8550
CANBERRA CITY ACT 2601
Ph: 02 6140 6502
ABN 17 864 931 143

SELECT CREDIT UNION LTD
PO BOX 313
CONCORD WEST NSW 2138

Standard Disclosure
All recorded unspent offences released
Name Check Only

This is to certify that there are **no disclosable court outcomes** recorded against the name of:

WORTHINGTON, Mark Joseph born on 16 March 1961

in the records of the Australian Federal Police and the police in all Australian States and Territories as at 09 July 2014.

This document is not issued as a form of identification.

Authorised by:

Co-ordinator
Criminal Records

- Not a current or former bankrupt

National Personal Insolvency Index

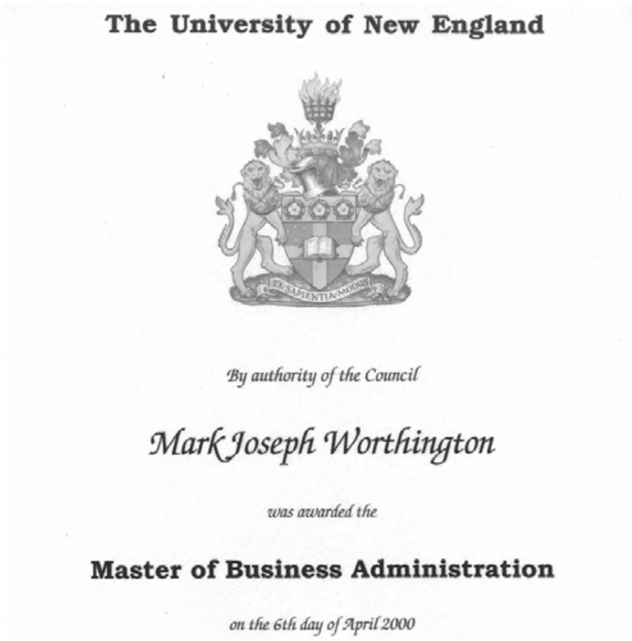
Browse

Provided On	16-May-2013 13:19:21
Provider Searched With	WORTHINGTON% MARK JOSEPH% Male
Matches	0

NO RECORD could be found of any individual on the National Personal Insolvency Index using the specified criteria.

ITSA Disclaimer: The information in this extract comes from the Insolvency and Trustee Service Australia's (ITSA) National Personal Insolvency Index (NPII) at the time and date indicated in this document. If you consider that the information contains errors, please promptly advise ITSA on 1300 364 785.

- Material qualifications verified


The University of New England

By authority of the Council

Mark Joseph Worthington

was awarded the

Master of Business Administration

on the 6th day of April 2000

Fit & Proper Standard

- Subjective tests – “Required Competencies”
  - Understand the role of a director
  - Capacity to make an effective contribution to the Board
  - Knowledge of CU, financial services industry, regulatory environment
  - Ability to read and understand financial statements
  - Capacity to undertake continuous professional development
  - Ability to evaluate, form conclusions and make good judgements (and ask questions)

CPS-520 Fit & Proper

- Must have process to prevent a not Fit & Proper person becoming a director or other responsible person (senior manager and auditor)
- Must be able to remove a not Fit & Proper person
- Select CU
  - Amended Constitution
  - Director Nominations Committee
  - DNC reports to Board
  - Board resolves to allow nominee to become a candidate

Example DNC Interview Questions

- All candidates
  - If you were presented with the financial statements for another credit union, what key information would you look for and why?
  - (Asset size, profitability, CAR & trend, capital components (ie pref shares or sub debt), credit quality/write offs)
- Re-standing candidates
  - What is Select Credit Union's Capital Adequacy Ratio and why is this ratio important?
  - (APRA min 8%. Select's PCR (APRA prescribed capital ratio) is 12.5%. CU actual 23%. Capital adequacy is a buffer against the risks associated with banking activities – mainly credit risk)

- Constitution s9.2 Eligibility to be a Director
- An individual is eligible to be a director:
  - (d) if the board has established a Director Nominations Committee, the board has considered a report by the Director Nominations Committee and has resolved that the person appears to have the skills that would allow him or her to make an effective contribution to board deliberations and processes.
- Constitution s9.8 Director Nominations Committee
  - (1) The Director Nominations Committee must include at least 2 independent persons who are not directors or employees of the Credit Union.
  - (2) The Director Nominations Committee must assess whether a candidate (including an elected director standing for re-election) or any person otherwise being considered for appointment as a director (including an appointed director) has skills that allow him or her to make an effective contribution to board deliberations and processes.

- Annual Board Assessment

BOARD ASSESSMENT

Director:		Date:	

COMPETENCY RATING KEY:	
0 = Not achieved	3 = Largely achieved (very few shortcomings)
1 = Limited achievement (extensive shortcomings)	4 = Fully achieved (no shortcomings)
2 = Partially achieved (virtues/shortcomings balanced)	

	STRATEGIC PLANNING	0	1	2	3	4
1.	A regular strategic planning process is conducted					
2.	There is active director input in the planning process					
3.	There is active management input in the planning process					
4.	Strategic Plan progress is reviewed at Board meetings					
5.	Strategic Plan progress is used for senior management performance reviews					

Comments:

- 50 questions assessing Board performance

- Annual Director Assessment

DIRECTOR PEER ASSESSMENT

Director being assessed:		**Date:**	
Assessing director name:			

COMPETENCY RATING KEY:
0 = Not achieved
1 = Limited achievement (extensive shortcomings)
2 = Partially achieved (virtues/shortcomings balanced)
3 = Largely achieved (very few shortcomings)
4 = Fully achieved (no shortcomings)

		RATING				
	BOARD CONTRIBUTION	**0**	**1**	**2**	**3**	**4**
1.	The director displays thorough preparation for all meetings					
2.	The director communicates relevant views on matters before the Board/committee					
3.	The director regularly contributes informed opinion on matters before the Board/committee					
4.	The director actively participates in Board policy reviews					
5.	The director actively participates in the annual budget process					
6.	The director actively participates in the strategic planning process					
7.	The director demonstrates capacity to act as a committee chair					

Comments:

- 26 questions assessing individual director performance

Eligibility

- Propriety - Objective tests
- Fitness - Subjective tests (required competencies)

Annual assessment

- Propriety - Objective tests
- Fitness - Director assessment by peers

Constitution

- Used to prevent a not fit and proper person being appointed

Case Studies
(where directors appear to not be fit and/or proper)

- National Safety Council
- Centro Properties Group
- HIH Insurance

National Safety Council of Aust

- CEO John Friedrich committed $290m fraud
- Investigation outcomes
  - Real name Johann Friedrich Hohenberger
  - not an Australian citizen
  - did not possess any valid birth certificate
  - did not appear on any electoral roll

  - The trial judge found that the company had been insolvent for nearly five years and that this could have been 'fairly easily appreciated by an adult person of normal intelligence who had a general knowledge of the company's activities and an inclination to consider the accounts and auditor's report for half an hour.‘
  - The Chairman was found liable for $97m

Centro Properties Group

- The Australian company Centro has $30bn assets and is the second largest retail property owner/manager in Australia and the fifth largest in the US
- ASIC brought a case against the CFO and directors of Centro group under s180 (care and diligence) and s344 (all reasonable steps to ensure accuracy financial reporting)
- Finding – 2007 Annual Report inaccuracies:
  - $1.5bn of short term liabilities incorrectly classified as non current (>12 months), and
  - Failure to disclose material post balance date event ($2bn loan guarantees)

Centro Properties Group

- Debt classification
- directors knew that the borrowings were maturing in the short term, and a basic understanding of the meaning of current liability should have led them to ask why the borrowings had not been classified as current liabilities
- Post balance date event
- Proper diligence would have caused directors to turn their mind to the absence of any disclosure about the $2bn loan guarantees provided to associated companies

Centro Properties Group

- The Judge's Reasoning
- "A reading of the financial statements by the directors is not merely undertaken for the purposes of correcting typographical or grammatical errors or even immaterial errors of arithmetic. The reading of financial statements by a director is for a higher and more important purpose: to ensure, as far as possible and reasonable, that the information included therein is accurate. The scrutiny by the directors of the financial statements involves understanding their content"

Centro Properties Group

- The Judge's Reasoning
- "…the objective duty of competence requires that the directors have the ability to read and understand the financial statements"
- In performing these obligations, directors are entitled to rely upon others (i.e. management and auditors PWC). They may not, however, substitute reliance upon the advice of others for their own attention and examination of an important matter that falls specifically within the board's responsibilities

Case Study

- What not to do….
- The Owen Royal Commission Report into the failure of HIH Insurance 2003
  - Australia’s largest corporate failure
  - $5.3 billion loss was as a result of mismanagement, not fraud

HIH corporate governance lessons

- Beware the dominant Chief Executive
  - Appointed friends and associates to the Board
  - No clearly defined limits of authority
  - Board highly inclined to waive rules and guidelines
  - Management was not held accountable or subject to questioning
- Ineffective Chairman
  - Board papers not an effective tool for consideration and review
  - Chair had no involvement in determining information provided to the Board
  - Directors “had no idea what the strategy of the company was”
  - Chair did not take responsibility to ensure full disclosures of conflicts
  - Chair ignored concerns raised by two non executive directors

HIH corporate governance lessons

- Board did not ask questions
  - Board did not understand, test or endorse strategy
  - Long term strategic plan never formally developed
  - Failure to understand strategy led to failure to understand risks
  - Directors did not understand financial statements
- Failure to grasp concept of conflict of interests
  - Board members remained present when their private interests were at issue
  - Unsecured and undocumented loans made to some directors
- Unusual accounting transactions
  - Budgetary control ineffective
  - One off EOFY transactions used to disguise performance
  - Board did not consider appropriateness of practices

HIH corporate governance lessons

- Ineffective Audit Committee
  - No concern for risk management or internal controls
  - Committee rarely met with auditors in absence of management
  - Could not and did not ask the right questions
- Compromised auditor independence
  - Board had 3 former partners of the audit company Andersons
  - Chairman was former Andersons partner and continued to receive fees
  - Audit team member removed after meeting with Board without management