**FINANCIAL SUPERVISORY COMMISSION
OF THE
COOK ISLANDS**

Banking Prudential Statement

BPS09

<u>Governance and Risk Management</u>

Objectives and key requirements of this Prudential Statement

This Prudential Statement sets out minimum foundations for the governance and risk management of banks. It aims to ensure that banks are managed in a sound and prudent manner by a competent Board of Directors, which make reasonable and impartial business judgements in the best interests of the institution and with due consideration to the impact of its decisions on depositors.

Contents

Authority

1. This Prudential Statement is issued by the Financial Supervisory Commission (FSC) in accordance with section 65 of the Banking Act 2011 (the Act).

Application

2. This Prudential Statement is applicable to all financial institutions licensed under the Banking Act 2011.

Definitions

3. The Prudential Statement has used the following terms, which unless otherwise indicated, have the meanings specified below:

   3.1. **Bank** – an entity licensed under the Banking Act 2011.

   3.2. **Executive Director** – a director who is a member of management of the bank.

   3.3. **Non-executive Director** - a director who is not a member of management of the bank.

   3.4. **Independent Director** - a non-executive director who is free from any business or other association – including those arising out of a substantial shareholding, involvement in past management or as a supplier, customer or adviser – that could materially interfere with the exercise of their independent judgement.

   3.5. **Risk Management Framework** - systems, structures, policies, processes and people within a Bank that identify, measure, monitor and control material risk.

   3.6. **Material Risks** - those that could have a material impact, both financial and nonfinancial, on the bank or on the interests of depositors.

   3.7. **Risk Appetite** – a statement of the aggregate amount and type of risk a financial institution is willing to accept in pursuit of its strategy and business objectives. A risk appetite is expressed in the form of both high-level qualitative statements and, where appropriate, quantitative measures.

   3.8. **Risk Culture** – are the values and behaviors within a financial institution that shape its risk decisions.

   3.9. **Risk Tolerances** - the maximum level of risk that the institution is willing to take regarding each type of risk, sometimes expressed as a risk limit.

Board and Senior Management Responsibilities

4. The Board of Directors of a bank (the Board) is ultimately responsible for the sound and prudent governance and risk management of the institution.

5. Where the bank is a branch operation of a foreign bank, the Commission will rely on the home regulator's governance framework in relation to the Board's responsibilities for that bank and oversight of Board's compliance with it, unless the Commission becomes aware of circumstances which require it to apply the standards set out in this Prudential Statement.

6. The Board must have a formal charter that sets out the roles and responsibilities of the Board. The charter should provide for the composition of the Board, including the range of skills and experience necessary for Board members. This is to ensure that each Director has appropriate skills and experience to make effective contributions to Board deliberations, and to understand the risks, and legal obligations of the Bank. The charter should also include periodic review of board composition and succession planning for the Board.

7. The Board, in fulfilling its functions, may delegate authority to management with respect to certain matters. This delegation of authority must be clearly documented. The Board must have mechanisms in place for monitoring the exercise of delegated authority. The Board is not abrogated of its responsibility for functions delegated to management.

8. The Board must ensure that senior management of the bank, collectively, have the full range of skills needed for the effective and prudent operation of the bank. This includes the requirement for management to have the necessary skills, knowledge and experience to understand the risks of the bank, including its legal and prudential obligations, and to ensure that the bank is managed in a way that takes into account these risks. This does not preclude the Board from supplementing its skills and knowledge through the use of external consultants and experts.

9. The Board and management must develop and implement an appropriate succession planning framework for key persons, positions and skills and experience within the bank.

10. Senior management of a bank is responsible for ensuring the bank's risk management framework operates effectively, and the risk profile of the institution is at all times in line with the Board set risk appetite.

11. Senior management of the bank with responsibilities relating to the business in the Cook Islands, must be ordinarily residing in the Cook Islands.

12. The bank must provide the external auditor of the bank with the opportunity to raise matters directly with the Board.

13. Where a bank is part of a corporate group, whether that be a subsidiary or branch operation, and the bank utilises group policies or functions, the Board must ensure that these policies and functions give appropriate regard to the bank's business in the Cook Islands and its specific requirements.

Board composition for locally incorporated bank entities

14. The Board of a bank must have a minimum of three directors.

15. The Board must have a majority of independent directors and at least one director who is resident in the Cook Islands.

16. The chairperson of the Board must be an independent director of the bank.

17. A majority of directors' present and eligible to vote at all Board meetings must be non-executives.

18. The Board must be available to meet with the FSC on request, collectively and individually, at the discretion of the FSC.

19. For a bank that is a subsidiary of another FSC regulated institution or an overseas equivalent[1], the Board must have a majority of non-executive directors, but these non-executive directors need not all be independent. They can include Board members or senior management of the parent company or its subsidiaries, but not executives of the regulated institution or its subsidiaries. The Board must have at least two independent directors, in addition to an independent chairperson.

Senior Officer outside the Cooks Islands

20. Branches of foreign banks licensed and operating in the Cook Islands must nominate a senior officer of the corporate bank entity head office with delegated authority from the Board to be responsible for overseeing the Cook Islands branch operation. This "Senior Overseas Officer" may be a senior executive or non-executive director of the corporate bank entity.

Board performance assessment and renewal

21. The Board must have procedures for assessing, at least once every two years, its performance relative to its objectives. It must also have in place a procedure for assessing, at least once every two years, the performance of individual directors.

22. The Board must have in place a formal policy on Board renewal. This policy must provide details of how the Board intends to renew itself to ensure it remains open to new ideas and independent thinking, while retaining adequate expertise.

Persons not to be constrained from providing information to the FSC

23. The Board and senior management of a bank must establish and maintain policies and procedures to ensure that no current or former officer, employee or contractor (including professional service provider) of a bank is constrained or impeded, whether by

[1] An 'overseas equivalent' is one which is not licensed in the Cook Islands but is authorized and subject to prudential regulation in a foreign country

confidentiality clauses or other means, from disclosing information to the FSC, that may be relevant to the prudential supervision of the bank.

24. The Board and senior management of a bank must establish and maintain policies and procedures to ensure that such persons are not to be constrained or impeded from providing information to auditors, and others, who have statutory responsibilities in relation to the bank.

25. Banks must ensure that their internal policy and contractual arrangements do not explicitly or implicitly restrict or discourage auditors or other parties from communicating with the FSC.

Board Audit Committee

26. A bank must have a Board Audit Committee, which assists the Board by providing an objective non-executive review of the effectiveness of the bank's financial reporting and risk management framework unless, with respect to risk management, there is another Board Committee which carries out this function. The Board Audit Committee must have sufficient powers to enable it to obtain all information necessary for the performance of its functions.

27. The Board Audit Committee must have at least two members. All members of the Committee must be non-executive directors of the bank. A majority of the members of the Committee must be independent.

28. The chairperson of the Board Audit Committee must be an independent director of the bank.

29. The chairperson of the Board can sit on the Board Audit Committee, but cannot chair the Committee.

30. The Board Audit Committee must have a charter that includes a reference to the Committee's responsibility for the oversight of the FSC prudential reporting requirements, as well as other financial reporting requirements, professional accounting requirements, internal and external audit, and the appointment of the bank's external auditor.

31. The Board Audit Committee or Senior Overseas Officer must review the external auditor's engagement at least annually, including assessing whether the auditor meets the necessary Audit Independence standard.

32. The Board Audit Committee or Senior Overseas Officer must regularly review the internal and external audit plans, ensuring that they cover all material risks and financial reporting requirements of the bank.

33. The Board Audit Committee or Senior Overseas Officer must hold management to account for process and risk management deficiencies identified in the work of both the internal and external audits. As such, the Committee or Senior Overseas Officer must

have in place a system to track and respond to audit deficiencies and ensure timely corrective action is taken by management.

34. The members of the Board Audit Committee and the Senior Overseas Officer must, at all times, have free and unfettered access to senior management, the internal auditor, the heads of all risk management functions and the bank's external auditor, and vice versa.

35. The Board Audit Committee must establish and maintain policies and procedures for employees of the bank to submit, confidentially, information about accounting, internal control, compliance, audit, and other matters about which the employee has concerns. The Committee should also have a process for ensuring employees are aware of these policies and for dealing with matters raised by employees under these policies.

36. Members of the Board Audit Committee and the Senior Overseas Officer must be available to meet with the FSC on request.

37. The internal auditor must have a direct reporting line and unfettered access to the Board Audit Committee or Senior Overseas Officer.

Remuneration Policy

38. A bank must establish and maintain a documented Remuneration Policy, approved by the Board.

39. At a minimum, the Board must be responsible for:

    39.1. conducting regular reviews of the Remuneration Policy;

    39.2. overseeing bank wide compliance with the Remuneration Policy;

    39.3. considering on an annual basis compensation for the Chief Executive Officer (CEO), direct reports of the CEO, other persons whose activities may in the Board's opinion affect the financial soundness of the bank; and

    39.4. ensuring that the performance-based remuneration encourage behaviour that supports both the bank's long-term financial soundness and its risk management framework.

40. The Remuneration Policy must set out who is covered by the Policy and at a minimum:

    40.1. detail the remuneration objectives and the structure of the remuneration arrangements, including but not limited to any performance-based remuneration components;

    40.2. align remuneration with the objectives of the bank; and

    40.3. encourage behaviour that takes into consideration the bank's long-term financial soundness and risk management.

41. The Remuneration Policy must ensure that the structure of the remuneration of risk and financial control personnel, does not compromise the independence of these personnel in carrying out their functions.

Strategic and Business Planning

42. The Board and senior management must develop a strategic plan for the bank, with appropriate measurable benchmarks. The strategic planning process should include the establishment of corporate objectives and the effective oversight of the implementation of these objectives.

43. The Board or Senior Overseas Officer must ensure that the strategic plan is current, feasible and based on sound economic and financial assumptions and is consistent with applicable laws, regulations, guidelines and internal policies.

44. A bank must maintain a written Business Plan that sets out its approach for the implementation of its strategic objectives. The business plan must be a rolling plan of at least three years' duration that is reviewed at least annually, with the results of the review reported to the Board or Senior Overseas Officer.

45. A bank must identify and consider the material risks associated with its strategic objectives and business plan, and must explicitly manage these risks through the risk management framework, including how changing these plans affects its risk profile.

Risk Management Framework

46. A bank must maintain a risk management framework that enables it to appropriately develop and implement strategies, policies, procedures and controls to effectively manage its risks.

47. A bank must have policies and procedures that provide the Board or Senior Overseas Officer with a comprehensive institution-wide view of its material risks.

48. A bank's risk management framework must provide a structure for identifying and managing each material risk to ensure the institution is being prudently managed, having regard to the size and complexity of its operations.

49. A bank must ensure that compliance with, and effectiveness of, the risk management framework is subject to review by internal or external audit at least annually. The results of this review must be reported to the Board or Senior Overseas Officer.

50. A bank's risk management framework must, at a minimum, include:

    50.1. risk appetite statement;

    50.2. risk management strategy;

50.3. policies and procedures supporting clearly defined and documented roles, responsibilities and formal reporting structures for the management of material risks throughout the institution;

50.4. a management information system that adequately measures and reports on all material risks;

50.5. risk management function; and

50.6. a review process to ensure that the risk management framework is effective in identifying, measuring, monitoring and controlling material risks.

51. A bank's management information system must provide the Board and senior management with regular, accurate and timely information in relation to the institution's risk profile, and how the risk profile compares to the risk appetite.

52. A bank's data quality must be adequate for timely and accurate measurement, assessment and reporting on all material risks across the institution and must provide a sound basis for making decisions.

Risk appetite statement

53. A bank must have and maintain a clear and concise risk appetite statement that addresses its key risks. The Board is responsible for setting the risk appetite of the institution and must approve the risk appetite statement.

54. A bank's risk appetite statement must, at a minimum, convey:

54.1. level of aggregate risk that the Board is willing to assume and manage in the pursuit of the institution's business objectives;

54.2. for each key risk, the maximum level of risk that the Board is willing to operate within, expressed as a risk limit;

54.3. the process for monitoring compliance with each risk limit and for taking appropriate action in the event that it is breached; and

54.4. the timing and process for review of the risk appetite.

Risk management strategy

55. A bank must maintain a risk management strategy (RMS) that addresses its key risks. The RMS must be approved by the Board.

56. At a minimum, an RMS must:

56.1. describe each of the bank's key risks and its approach to managing these risks;

56.2. list the policies and procedures dealing with risk management matters;

56.3. summarise the role and responsibilities of the risk management function;

56.4. describe the risk governance relationship between the Board, board committees and senior management with respect to the risk management framework; and

56.5. outline the approach to ensuring all persons within the institution have awareness of the risk management framework and for instilling an appropriate risk culture across the bank.

Risk management function

57. A bank must have a designated risk management function that, at a minimum:

57.1. is responsible for assisting the Board, board committees and senior management to develop and maintain the risk management framework;

57.2. is appropriate to the size, business mix and complexity of the bank;

57.3. has the necessary operational independence and independent reporting lines to the Board, board committees and senior management to conduct its risk management activities in an effective and independent manner;

57.4. is resourced with staff who have clearly defined roles and responsibilities and who possess appropriate experience and qualifications to exercise those responsibilities;

57.5. has access to all aspects of the institution that have the potential to generate material risk, including information technology systems and systems development resources; and

57.6. is required to notify the Board of any significant breach of, or material deviation from, the risk management framework.

58. A bank may engage the services of an external service provider to perform part of the risk management function where the institution can demonstrate to the FSC that the risk management function meets the requirements in paragraph 57.

59. Outsourcing any part of the risk management function by a bank must also meet the requirements of the *Banking Prudential Statement on Outsourcing*.

Compliance function

60. A bank must have a designated compliance function that assists senior management in effectively managing compliance risks.

61. The compliance function must be adequately staffed by appropriately trained and competent persons who have sufficient authority to perform their role effectively, and have a reporting line independent from business lines.

Risk management declaration

62. The Board or Senior Overseas Officer must make an annual risk management framework declaration to the FSC within 120 days of the institution's balance date, stating that, to the best of its knowledge and having made appropriate enquiries:

    62.1. the bank has in place systems for ensuring compliance with all prudential requirements;

    62.2. the risk management framework is appropriate for the size and complexity of the bank; and

    62.3. the internal control systems in place are operating effectively.

63. The declaration must be signed by the chairperson of the Board and the chairperson of the board risk committee or audit committee; or the Senior Overseas Officer.

64. The Board or Senior Overseas Officer must qualify the risk management declaration if there has been any significant breach of the risk management framework. Any qualification must include a description of the cause and circumstances of the breach and steps taken to remedy the problem.

65. A bank must notify the FSC immediately after it becomes aware:

    65.1. of a significant breach of the risk management framework; or

    65.2. that the risk management framework did not adequately address a key risk.

Internal Audit

66. A bank must have an independent and adequately resourced internal audit function, that is reflective of the size and nature of the bank's business.

67. The objectives of the internal audit function must include evaluation of the adequacy and effectiveness of the financial and risk management framework of the bank.

68. To fulfil its functions, the internal auditor must, at all times, have unfettered access to all the bank's business lines and support functions.

69. A bank must ensure that the scope of internal audit includes a review of the policies, processes and controls put in place by management to ensure compliance with the FSC's prudential requirements.

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