Response to *Financial Institutions Act* & *Credit Union Incorporation Act* Review:

Initial Public Consultation Paper

GVC credit union
GREATER VANCOUVER COMMUNITY
For Real People

September 02, 2015

Introduction

This paper sets out Greater Vancouver Community Credit Union's (GVC's) response *to Financial Institutions Act* & *Credit Union Incorporation Act* Review: Initial Public Consultation Paper, released by the Ministry of Finance in June 2015.

GVC is one of the oldest credit unions in British Columbia. It celebrated the 75th anniversary of one of its antecedent credit unions, Rosary Credit Union in 2015. Its 43 FTE staff serve its more than 6000 members through four branches in Greater Vancouver: Burnaby, Vancouver, Surrey and New Westminster. At mid-year 2015, it had $214.9 million in assets, loans of $194.8 million, deposits of $198.4 million and a capital base of $14.7 million (16.0% of risk weighted assets). By asset size, it is the 25th largest of 42 B.C. credit unions.

This response strives to address the objectives of the legislative and regulatory framework established by the *Financial Institutions Act* ("FIA") and the *Credit Union Incorporation Act* ("CUIA"), especially as those Acts relate to credit unions. Those objectives include "(maintaining) stability and confidence … by reducing the risk of failures and providing consumer protection", "(creating) an environment where the financial services sector and the entities within it can continue to grow and prosper, (promoting) sound risk management and appropriate/responsible risk-taking; (enabling) early detection and timely intervention and resolution of issues, (reflecting) international standards, while reflecting the particular needs of B.C.'s financial sector, taking into account the nature, structure, size, scope and complexity of (those) institutions, and (fostering) member engagement".

Overall/Framework Issues

1. Financial Consumer Protection

The Ministry's Public Consultation Paper ("the Paper") seeks input on whether or not B.C. should adopt a market conduct code for the fair treatment of consumers, which code would apply to financial institutions. As will be repeated throughout this response, any such action by government needs to be based upon actual need, not perceived need. As noted in the Paper, the FIA contains prohibitions on prohibitive tied selling and disclose requirements relative to conflicts of interest. Further, the *Business Practices and Consumer Protection Act* applies to credit unions. To our knowledge, these statutory provisions, taken together, have sufficed to ensure the protection of credit union members. Where a credit union may have abused the trust of members, the appropriate course of action lies to the civil or criminal justice system. Unless evidence exists to the contrary, no further protection is warranted.

The Paper questions whether credit unions should be required to have an internal complaint handing process and to offer member access to an independent ombuds service, even though the Paper notes that "(government) has rarely received complaints about credit union conduct". It is unlikely that credit unions, today, do not have an internal complaint process, by which complaints can be elevated through management, to the board of directors, if the member so desires. Requiring, by law, such a process to be developed may not be unwarranted. However, before serious consideration is given to requiring credit unions' participation in an independent ombuds service, the actual need for such a service needs to be demonstrated. As member-owned and controlled institutions, credit unions are highly responsive to their members. In our opinion, the cost of belonging to the federal Ombudsman for Banking Services and Investments is simply not warranted.

In line with foregoing comments concerning the provision of ombuds services, one would have to question the need to regulate the way (not the financial appropriateness) in which a credit union might close a branch office. As the Paper notes, credit unions have far more often opened branches when a bank has withdrawn from a community. Branch closures have been and remain rare. Credit unions have more often than not been the last financial institution to close a branch, in a community. While several branch closures on Vancouver Island in the recent past are understood to have concerned some members, a credit union cannot be expected to maintain a branch that is a drain on its resources, a financial cost to both the institution and its members, through uncompetitive rates and higher service charges. Again, as member-centric institutions, directed by those members, credit unions take pains to communicate regularly with their members. Regulating the how, not the what, of infrequent occurrences would seem to be unnecessary.

2. Market Discipline/Public Disclosure of Key Financial Information

The Paper questions whether B.C. financial institutions should be required to disclose financial and risk information, beyond what they do.

Most, if not all, credit unions publish their annual reports on their websites, which may or not require membership in that credit union to access. Every member is entitled to a copy of her credit union's most recent annual report and audited financial statements.

However, the issue of consumers and investors imposing "market discipline" on credit unions is not relevant, as there is no market for credit union equity. Credit union shares do not trade on stock exchanges. Credit unions are controlled by their members, through boards of directors elected on the basis of one member, one vote. As has been evidenced time and again, if a credit union's management or its board of directors drifts away from the goals and objectives of the membership, directors are replaced, democratically, and senior management can be refocussed or repurposed. Credit unions do not have controlling shareholders who can support a board or management team at odds with its shareholders; it is simply not possible.

As to the disclosure of consolidated financial information on the B.C. credit union system to other governmental authorities, regulatory or otherwise, whether within the province or outside of B.C., the regulator should have the capacity to do so, if that capacity does not currently exist.

FICOM should not have the capacity to publish disaggregated financial information of individual credit unions. Again, such information is available to members. Credit unions do not have investors who would require such information before purchasing a joint stock corporation's equity or debt.

3. Financial Literacy

The Paper questions whether financial institutions need additional tools to fight financial abuse. The *Adult Guardianship Act* permits persons, including financial institutions, to report suspected abuse to a designated agency but not next of kin. Either or both that act and the FIA should be amended to permit financial institutions to notify next of kin or guardians of cases of suspected financial abuse of members/customers.

4. Technological Change

The FIA and the CUIA are seriously out-dated with respect to the limits they impose on the ways in which financial institutions may communicate with members/customers. Today, even if member of a credit union request that a credit union provide information about their financial affairs to them, only electronically, credit unions cannot distribute notices and statements, only electronically. The FIA should be amended to permit members to consent to receiving records and notices electronically, such as is permitted corporations under the province's *Business Corporations Act*. Further, the *Business Practices and Consumer Protection Act* should be amended to provide that members/customers may consent to receiving notices respecting disclosure of the cost of credit, electronically.

6. Regulatory Powers and Guidelines

The Paper questions whether FICOM has adequate tools to address current and emerging risks in a timely and effective manner. While only FICOM can make the argument that it does or does not, it must be noted that FICOM, today, has very broad powers to regulate financial institutions. This includes its capacity to disqualify directors and officers and to address any shortfall that it may determine in the affairs of an individual institution, including requiring a board of directors to review its I&L policies, requiring that a credit union acquire liquid assets in excess of the regulatory minimum if it considers a credit union's liquid assets are or will be, within a year, inadequate in relation to its business, and requiring that a credit union hold more capital than required pursuant to the Capital Requirements Regulation. It can place a credit union under supervision and/or administration and order the wind-up of a credit union if its capital base falls below a prescribed level.

The array of powers it has, today, should obviate the need for FICOM to be able to issue enforceable "guidelines" or to be able to revise conduct and solvency (regulatory) expectations "outside of legislation or regulation". It is the responsibility of the Legislature and/or the Executive Council to establish the "rules" under which financial institutions operate; it is the board of directors of financial institutions that have the statutory responsibility to manage or supervise the management of their institutions, including the fiduciary duty to "act honestly, in good faith and in the best interests of the financial institution, and to exercise the care, diligence and skill of a reasonably prudent person under comparable circumstances", taking into account "the interests of shareholders, depositors … and … those to whom the directors owe a fiduciary duty." Guidelines should be just that – guidelines. If they are to have the force of law, the statute or the regulations should so provide.

Any proposal to expand FICOM's discretionary authority over credit unions, individually or collectively, needs to be thoroughly vetted, in line with the Government's stated policy objectives of "(promoting) sound risk management and appropriate/responsible risk-taking" while "(enabling) early detection and timely intervention and resolution of issues."

Credit Union Sector

1. Deposit Insurance

Credit unions across Canada (with the notable exception of Alberta, where the province statutorily provides an explicit government guarantee of the repayment of deposits) guarantee the repayment of deposits of depositors, by way of a joint and several guarantee. Unlike Canada's banks and trust companies, Canada's credit unions stand behind each other, provincially. Since the establishment of the Credit Union Reserve Board (now, the Credit Union Deposit Insurance Corporation of British Columbia ("CUDIC") in 1958, no member of any credit union in B.C. has lost one cent on deposit with a credit union in B.C. As importantly, not one cent of public money has ever been expended to remediate the affairs of a distressed credit union in B.C. Even in the recession of the mid-1980s, every penny spent to remediate distressed credit unions in British Columbia was provided by the credit union system!

Since 1990, the first line of defence beyond a credit union's own resources has been the fund maintained by a system-owned and controlled entity, Stabilization Central Credit Union of British Columbia ("Stabilization Central"). Stabilization Central has, in 25 years, drawn down its fund by approximately $1.5 million to assist credit unions, an average of $60,000 per year. And it has had to provide no financial assistance to any credit union in the past 15 years.

From 1968 to 1988, CUDIC's guarantee was unlimited and covered deposits of a type and of a term that was (and remains) broader than that provided by the Canada Deposit Insurance Corporation to federally-regulated financial institutions, principally banks and trust companies.

In 1988, in recognition of the B.C. Government amending the *Credit Union Act* to enable (not require) the Minister of Finance to guarantee borrowings by CUDIC to repair its guarantee fund, should its fund become impaired, CUDIC's guarantee was restricted to $100,000 per separate deposit. Parenthetically, the capacity granted to the Minister is identical to the authority of the federal Minister of Finance, in relation to CDIC. At $100,000, credit unions retained a perceptual competitive advantage over federally-regulated financial institutions, as CDIC's coverage was then limited to $60,000 (although banks could circumvent that limit through accepting deposits through subsidiary entities). That advantage was eliminated when CDIC's coverage was increased to $100,000 in 2005.

In 2008, at the height of the global financial crisis, the government re-established CUDIC's unlimited guarantee of deposits, where it sits, today. This was, at least in part, to stem the flow of deposits to Alberta, where credit unions and Alberta Treasury Branches offer an unlimited deposit guarantee. Further, it must be noted that both the Trade, Investment and Labour Mobility Agreement between B.C. and Alberta and the New West Partnership Agreement among B.C., Alberta and Saskatchewan provide for the extra-provincial operation of credit unions in each province in the other provinces. While no credit union in any of the three provinces yet operates, extraprovincially, the statutory authority of B.C. credit unions to do so has been adopted (but not yet proclaimed.) It would be inconceivable for a credit union incorporated in either Alberta or Saskatchewan (where depositors also enjoy an unlimited joint and several guarantee of their deposits) to operate in B.C., competing for deposits against credit unions that were limited in their deposit guarantee.

Confidence is key in the financial industry. A run on a deposit taking institution thankfully happens rarely. In B.C., the last such occurrence was 30 years ago; it was resolved both efficiently and effectively, by the system, using system resources.

However when a run occurs on a stand-alone financial institution, such as a bank, it can be very hard to stop, short of nationalization. A notable recent example is Northern Rock, a British bank, in 2008. That was seven years ago.

The Paper questions whether a limit on deposit insurance protection offered by B.C. credit unions should be reintroduced, even if any limit is revisited (subject to being increased?) every five or ten years?

The question ought to be: “What is the issue?” Why should the guarantee offered by credit unions to their depositors be reduced, today? Furthermore, doing so would unjustifiably raise the very real risk of precipitating a crisis in confidence.

As per its most recent (March 31, 2015) annual report, CUDIC’s retained earnings and accumulated other comprehensive income represent 0.903% of British Columbia credit union deposits and non-equity shares of $54.8 billion. Combined with a $30 million Credit Union Financial Assistance Agreement between CUDIC and Stabilization Central, the Fund represents 0.958% of British Columbia credit union deposits and non-equity shares. This *ex ante* fund compares more than favourably with CDIC’s ex ante fund, in respect of deposits it ensures, which stands at 0.42%. Further, CUDIC’s premium assessment rate is, today, more than 150% greater than CDIC’s rate assessed on its insured institutions!

It should be borne in mind that CUDIC’s fund would only be drawn upon if a credit union became insolvent. Its own resources would come into play long before the resources of its deposit guarantee fund are accessed. At year-end 2014, collectively, B.C. credit unions had retained earnings and (uninsured) equity shares of $3.9 billion, standing behind $54.4 billion of deposits. This equates to a level of risk-weighted regulatory capital of 14.9%, more than 85% in excess of the regulatory risk-weighted level of 8%.

As to the question posed by the Paper as to whether certain types of deposit products should not be guaranteed, such as deposits of more than 5 years to maturity or foreign exchange deposits, the question again should be “Why?” Does CUDIC’s guarantee need to mirror CDIC’s in regards to such offerings (setting aside the near impossibility of raising deposits of more than five years, in the current economic climate)?

In short, no limit should be reintroduced on the joint and several guarantee of deposits offered to members by B.C. credit unions, through CUDIC.

2. Credit Union Governance

The Paper questions whether changes are required to the governance framework of credit unions. The current framework is appropriate for democratically-controlled financial co-operatives. Any member satisfying the basic requirements of membership, as to being in good standing and having been a member for a specified period of time (usually a year) can seek office as a director. Any person may join a credit union in B.C. having an open bond of membership (and, with the consent of its directors, any closed bond credit union, too!) Being a member and seeking the endorsement of the credit union’s general membership should remain a requirement to be a director of a credit union. A credit union’s governance team needs to understand and empathise with its members. Experts do not necessarily do this. Credit unions need boards that understand their community and are a part of their community. Experts can be hired to advise management and boards of directors, as and when required.

No change should be made to the statutory provisions that permit a credit union to acquire the assets of another credit union, to open or close a branch, or to offer or discontinue offering any product or service. To do so would fetter the capacity of a board of directors to manage or supervise the management of a credit union. The approval of the memberships of both credit unions should continue to be required of their amalgamation, the creation of a new entity.

With respect to membership originated proposals or petitioning a credit union into a special general meeting, such occurrence have been few and far between, although they have been utilized more frequently of late. Consideration should be given to increasing the threshold number of members required to initiate a proposal or petition for a general membership meeting. Today, that threshold is the lesser of 300 members and 5% of a credit union's membership, a threshold established in the mid-1980s. It is proposed that the threshold be revised to 100 members or 1% of a credit union's membership, whichever is the greater. This proposed threshold should not be unattainable, while it would ensure that a significant number of members need to support such an initiative.

With respect to the approval of major transactions, the FIA should be amended to require that any financial instruction proposing to demutualize, including credit unions, be required to identify to its shareholders the amount of any bonus, fee, commission, or remuneration of any kind to be paid, directly or indirectly, to its directors and/or senior officers if the transaction comes to fruition.

A technical amendment to the CUIA is required to permit credit unions to revise their constitutions. A drafting error limits the capacity of credit unions to revising their rules, not their constitutions or their common bonds. Credit unions should, by way of a special resolution approved by 2/3rds of those members voting on the resolution, be able to revise not only their rules but their constitution and common bond, as well.

3. Capital Requirements

The Paper questions whether B.C.'s current capital framework is adequate and whether those requirements should benchmark national and international standards, perhaps giving consideration to differing size and complexity of the institutions.

With some minor modifications, the current framework is adequate. B.C. should certainly not simply adopt national or international standards. It must be remembered that the capital approach introduced in 1988 by the Bank for International Settlements ("BIS") was designed for national banks, doing business internationally! No less a person that the former Governor of the Bank of Canada, David Dodge, has opined that Canada should not unquestioningly apply BIS standards to its national banks. So, why would provincial governments consider doing so?

The adoption of BIS-type risk-weighted capital requirements by B.C. in 1990 recognized the low risk inherent in the loan portfolios of B.C. credit union, principally residential mortgage and commercial loans, secured by real property. Twenty-five years ago, B.C. credit unions generally had a lower level of capital and commercial lending expertise than they do today. At that time, it may have been warranted to impose a regulatory capital penalty on a credit union's investment in commercial loans. In 1990, that penalty level was reached when commercial loans exceeded 20% of a credit union's unweighted loan portfolio. (Today, the threshold is 30%). The capital penalty is punitive, requiring credit unions to hold twice as much capital against a commercial loan over 30% of its portfolio as one under the threshold, and nearly 500% more than against a residential mortgage loan of less than 75% loan to value. Under federal capital requirements, banks incur no such penalty, so it is twice as expensive for a credit union to make a commercial loan where more than 30% of its book is commercial. This is especially problematic for rural credit unions, where a credit union is often the only financial institution. The risk concentration penalty should be repealed.

In 2007, the federal regulator, the Office of the Superintendent of Financial Institutions ("OSFI") revised its capital adequacy formula to permit banks and federally-regulated trust companies to risk weight residential mortgage loans granted by such institutions, at 0.35, where such loans do not exceed 80% of the value of the mortgaged property. Previously, only loans that did not exceed 75% of the value of the mortgaged property could be risk weighted at 0.35. Credit union regulators in provinces other than B.C. followed suit. In not following OSFI's lead in adjusting that risk weighting, B.C. has placed its credit unions at a completive disadvantage, requiring that a B.C. credit union hold more than 185% more capital against residential mortgage loans exceeding 75% loan to value but not exceeding 80% loan to value. The Capital Requirements Regulation should be amended to provide that residential mortgage loans with a loan to value ratio not exceeding 80% be risk weighted at 0.35

As noted, credit unions are not stand-alone entities. They are part of a provincial system, supported by their central credit unions, Central 1 Credit Union (which manages their statutory liquidity reserves and Stabilization Central, which offers operational and financial assistance, as required to credit unions that may suffer financial trials) and the deposit insurance corporation, which administers their joint and several guarantee. For that reason, in 1990, the government recognized that the retained earnings of the three should be classified as "system capital" and be eligible to be counted as secondary capital, *pro rata*, in determining the regulatory capital bases of credit unions. (The portion of the retained earnings of each was reduced in 1996 to 50% from 100%). Recognition of the system that supports each and every credit union remains valid; system capital should continue to be recognized as eligible secondary capital in calculating the regulatory capital base of credit unions

Section 64 (8) of the CUIA provides that "without first receiving the written approval of (FICOM), a credit union must not redeem or purchase or otherwise acquire equity shares issued by the credit union if the redemption, purchase or other acquisition would reduce the credit union's capital base to an amount less than the amount that constitutes an adequate capital base for that credit union in accordance with the regulations under section 289 (3) (f) of the *Financial Institutions Act.* This provision ensures the permanence of membership shares and warrants their continued inclusion as primary capital in determining a credit union's regulatory capital base.

As with any financial institution, credit unions maintain collective loan loss provisions. These provisions are tantamount to earmarking a portion of a credit union's retained earnings, as the first line of defense against losses incurred on loans. While the federal regulatory scheme permits banks to include such reserves in determining their regulatory capital base, the Capital Requirements Regulation does not permit credit unions to do so. In line with federal treatment of such allowances, such reserves should be recognized as secondary (Tier II) capital of B.C. credit unions.

4. Liquidity Requirements

Credit unions are not internationally active. Today, all first-tier (local) credit unions in Canada are regulated, provincially. Furthermore credit unions, as financial cooperatives, co-operate in managing their liquidity reserves.

If a bank has a liquidity problem, its recourse is to the Bank of Canada. If a B.C. credit union has an issue with liquidity, its recourse is to its central credit union, Central 1. The Liquidity Requirement Regulation recognizes the value of this approach, requiring the pooling of statutory liquidity reserves with Central 1. As noted above, depositor confidence lies at the core of the stability of any financial system. It is far more likely that a liquidity crisis will lead to the failure of a financial institution more rapidly than solvency. Credit unions have worked together throughout Canada at the central level for over sixty years to mitigate liquidity risk – if a large credit union has a problem, it is unlikely it will be limited to one province… all credit unions will be tainted. In liquidity management, prevention is far better than cure.

The Paper questions whether B.C.'s liquidity requirements should reflect national and international standards and be more principles based. This question ought not to be conjunctive. B.C.'s regulatory scheme should be tailored to the industry being regulated, not simply follow national or international standards. That should not detract from the adoption and adherence to a principles/risk-based approach. Objectivity, clarity and certainty in the regulation of credit unions is supported.

5. Responsibility and Regulation of Central Credit Unions

Stabilization Central was created by the B.C. credit union system in 1989 to oversee the rehabilitation of credit unions that may encounter financial difficulties, when CUDIC was, in effect, nationalized. At that time, the government recognized that government had no role to play in administering the system's bankers' fidelity bond insurance program or in rehabilitating credit unions. Stabilization Central was created to be the system's self-regulatory vehicle and any credit union coming under supervision, voluntarily, was to be supervised by it.

Amendments to the FIA in 2008 and a decline in FICOM's co-operation with Stabilization Central drastically reduced the latter's capacity to function as a self-regulatory organization (an "SRO"). The Ministry is urged to pursue with Stabilization Central whether or not there are protocols, if not statutory capacity that could be reinstated, to enable Stabilization Central to function effectively as an SRO.

6. Taxation

As co-operatives, credit unions are primarily reliant upon retained earnings to constitute their capital base. At year-end 2014, retained earnings comprised roughly 80% of the capital base of the B.C. credit union system. These retained earnings amount to proportionately twice the level of earnings retained by banks, which are much more reliant on contributed capital, common and preferred shares and subordinated debt. In order to grow and sustain/enhance their role in the community, credit unions need to build retained earnings to twice the level of banks. This is very difficult, as credit unions are proportionally much smaller than banks in Canada and do not benefit from the economies of scale that larger financial institutions can achieve. By way of example, the largest credit union in Canada, Vancouver City Savings, is 1.7% the asset size of the Royal Bank of Canada. If credit unions are required to pay higher tax rates than their competitors, Canada's banks, in addition to proportionally higher deposit insurance premiums than do banks, this exacerbates this situation and places credit unions at a distinct disadvantage to helping British Columbians grow the province's economy and enrich their lives.