

# The Ontario Credit Union Legal Bulletin

A Newsletter from the Financial Institutions Services Group of RZCD Law Firm LLP

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### ***CLARIFICATION REGARDING NON-CMHC-INSURED HIGH-RATIO MORTGAGES***

We have been advised by the Senior Vice President and General Counsel of Genworth Financial Mortgage Insurance Company Canada ("Genworth") that he has received a number of expressions of concern from credit unions about the Draft General Regulation that reflect a consistent misinterpretation of that regulation and our February 2009 newsletter on it, and that some further clarification is therefore required.

A high-ratio mortgage insured against default is not the same thing as a mortgage-backed security. Paragraph 2 of section 17(4) of the Draft General Regulation, which provides a 35% risk weighting for mortgage-backed securities that are fully and specifically secured by residential mortgage loans but are not guaranteed by the Canada Mortgage and Housing Corporation ("CMHC"), therefore does not apply to a credit union's high-ratio mortgages where the insurance against default is not provided by CMHC.

Many of the providers of default insurance on high-ratio mortgages other than CMHC have back-stop guarantees provided by the federal government. In Genworth's case, for instance, this back-stop federal government guarantee is for 90% of the insured amount. The applicable section of the General Regulation regarding this 90% of each Genworth-insured mortgage is therefore paragraph 6 of section 17(2), which provides a 0% risk-weighting for that guaranteed portion of the mortgage.

Many of the providers of default insurance on high-ratio mortgages other than CMHC also have external credit ratings. Genworth, for instance, has an external credit rating that would entitle it to a 20% risk-weighting pursuant to the table found in section 5 of the Draft Guideline. The applicable section of the General Regulation regarding the remaining 10% of a Genworth-insured mortgage not subject to the federal government guarantee is therefore not paragraph 4 of section 17(6), which would assign it a 100% risk-weighting, but section 17(8), which assigns it the 20% risk weighting to which Genworth is entitled under the Draft Guideline due to its external credit rating.

An example may be instructive. Let us assume that a credit union has a Genworth-insured high-ratio mortgage of \$200,000. This is a high-ratio mortgage insured against default, not a mortgage backed security, so the 35% risk weighting, which would value that asset at \$70,000 (\$200,000 x 35%) for risk-weighting purposes, does not apply. Genworth, as mentioned, has a federal guarantee of 90% of the insured amount of \$200,000, so the guaranteed \$180,000 (\$200,000 x 90%) is valued for risk-weighting purposes at \$0 (\$180,000 x 0%). The remaining \$20,000 (\$200,000 x 10%) is entitled to a risk-weighting of 20% due to Genworth's external credit rating, and is therefore valued

for risk-weighting purposes at \$4,000 ( $\$20,000 \times 20\%$ ). The entire \$200,000 mortgage is therefore valued for risk-weighting purposes at \$4,000 ( $\$0 + \$4,000$ ), exactly the same as under the current regulation. The overall risk-weighting of a Genworth-insured mortgage is 2%.

We hope this clarifies the situation for you, and allays any concern you might have about the ongoing value for risk-weighting purposes of the credit union's high-ratio mortgages insured against default by an entity other than CMHC.

***SUPREME COURT OF CANADA RELEASES A DECISION HAVING  
IMPORTANT IMPLICATIONS FOR FINANCIAL INSTITUTIONS –***

***B.M.P. GLOBAL DISTRIBUTION INC. v. BANK OF NOVA SCOTIA – 2009 SCC 15  
(CanLII)***

The Supreme Court of Canada released its decision in this case on April 2, a decision for which banking law lawyers have been waiting with bated breath for months.

This was a case in which the payee of forged cheques (BMP) sued its own bank (BNS) for damages for returning the funds to the payor's bank after the payor's bank (RBC) had lost recourse through the clearing system. At the trial level (the BC Supreme Court), the court held that BNS had breached its account agreement with BMP and was liable to pay BMP substantial damages for the breach of contract (\$777,336), even though BMP ultimately did not have a legal right to receive the proceeds of the forged cheques.

Financial institutions and banking law lawyers were surprised by the trial decision. Fortunately, the BC Court of Appeal reduced the damages to nominal damages (\$101). At the Supreme Court of Canada, the court re-affirmed the Court of Appeal's decision, much to everyone's relief.

It is not uncommon for managers of our Credit Union clients to receive a call from another financial institution, asking the Credit Union to return funds to it that were proceeds of allegedly forged or materially altered cheques drawn on its customer's account and cashed at the Credit Union by a member of the Credit Union, even though the other financial institution may have "lost recourse" on the items, *i.e.*, lost the right to return them through the clearing system because the specified time limit for returning them had expired. The other financial institution provides the Credit Union with some credible evidence of the allegedly fraudulent transaction, and then offers to give the Credit Union an indemnity covenant to indemnify the Credit Union against any claims that may be made against it as a result of the Credit Union returning the funds, including claims that may be made by the Credit Union's member.

The concern about the trial decision was that it might have discouraged financial institutions from intervening to assist a defrauded customer (especially if the financial institution has already passed the loss to its customer by way of the typical "account

verification” clause, which requires the customer to give the financial institution notice of the fraudulent transaction within 30 days after receiving the statement disclosing it to request reimbursement for the transaction from the financial institution). Why should it bother to make a request of the collecting financial institution and offer to give an indemnity covenant? It also might have discouraged collecting financial institutions from agreeing to co-operate and accept the indemnity covenant. From a broader societal perspective, this informal kind of resolution of claims with respect to fraudulent transactions has proven to be a much less costly and more efficient way of preventing persons from benefiting from their own fraud or the fraud of others than going to court. Absent the intervention and co-operation of the financial institutions, our courts could be clogged with fraud claims litigated by the defrauded customers or members.

The Supreme Court of Canada took the opportunity in this case to clarify some legal issues in banking law, for which we should all be grateful. The lessons we can draw from the Court’s decision are the following:

1. If your member has been victimized by a forged or fraudulent cheque, and comes to you for help, don’t automatically assume that there is nothing you can do for him or her, on the ground that recourse has been lost under the CPA Rules, and the collecting financial institution is insulated from the claim by the “deemed holder in due course” provision of the *Bills of Exchange Act* (Canada) (s. 165(3)) (“Collecting Bank Protection”). If your member has solid evidence that the cheque was forged or fraudulent, call the collecting bank and find out if the proceeds the cheque are still on account to the credit of the payee. By all means, if the funds are “gone”, the CPA Rules and the Collecting Bank Protection provide a good defence to claims based on the law of negotiable instruments, and the collecting bank will likely have a good defence to any restitutionary claim for money paid by mistake. However, if the funds are there, a restitutionary claim may be available, as the Supreme Court has confirmed, once again, that the CPA Rules and the Collecting Bank Protection are irrelevant to such claims. Offer the collecting bank an indemnity covenant in exchange for payment over of the claimed funds. The result of this case means that it will not have a good reason to refuse to help you and your member.
2. Of course, if you are the “collecting bank”, the flipside applies. In an appropriate case, you do not have a good reason to refuse to assist the drawee financial institution and its customer, provided, of course, that you get the appropriate indemnity covenant (just in case the bank is wrong). The Supreme Court of Canada ruled that even though a collecting bank may have a legal right to *refuse* to repay funds to the drawee bank because:

(a) it is a “deemed” holder in due course under section 165(3) of the *Bills of Exchange Act* (Canada) (the “BEA”); and

(b) the drawee bank has lost recourse under the CPA Rules;

*it is not obligated to rely upon these grounds, and the payee has no legal right to compel its bank to do so.* The Court clarified, again, that the CPA Rules apply only to relations between CPA members. They do not give other persons or entities rights, and, in any event, the Court held that the BNS operation of account agreement did not incorporate the clearing rules for the customer's benefit. The Court also said that, in the typical situation, your account agreement will contain provisions that either explicitly or implicitly permit you, acting as a collecting financial institution, to charge back amounts credited to a customer's account for a cashed payment item, whether before or after you have received initial "settlement" of the item (*i.e.*, whether or not the drawee bank has lost recourse on the item).

The BNS account agreement was held to entitle BNS, as collecting bank, to respond favourably to RBC's demand for repayment on restitutionary principles, if there were funds in the account that could be returned. The rightful owner, the payor of the forged cheque, had a legitimate claim against the recipient, and the Court held that BNS had no duty to prefer the interests of its customer over those of the drawee bank and its customer. The Court took a dim view of the essence of the payee's claim; it insisted on being allowed to keep the funds represented by the forged cheques, even though it had given no consideration for them, and even though the fraud was beyond dispute. It held that the payee did not "lose anything" because of the decision by BNS to return the funds to RBC. It had no right to receive the funds anyway.

Speaking for the entire Court. Deschamps, J. said: "The trial judge was of the view that BMP and the holders of the related accounts had suffered 'a loss of their right to demand repayment from the BNS or the BNS' debt to them by reason of the BNS' wrongful charge backs against their respective bank accounts' (para. 423). In my view, BNS was entitled to object that since the cheque was forged, the funds could be and were returned to their rightful owner. The deposit of the forged instrument could not result in a debt to BMP in this case. Therefore, BMP did not lose anything, because the funds had to be returned to RBC. The trial judge's conclusion that BMP had lost the right to demand payment of a debt owed by BNS is erroneous, because the credit entry in the account had been made by mistake."

We would, of course, be pleased to assist a Credit Union client that finds itself on either side of such a problem.

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The Ontario Credit Union Charitable Foundation's Golf Tournament is coming up, on June 15, 2009. Penny and Geoff are pleased to be Gold Sponsors of this most worthy event, and look forward to seeing many of you there!

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