Ministry of Finance Consultation Submission

September 2015

"Regulation of Financial Services in the Public Interest"

In June 2015 the Ministry issued an "Initial Public Consultation Paper" related to a review of the Financial Institutions Act & the Credit Union Incorporations Act. The paper posed questions and invited comment from stakeholders. We welcomed that invitation.

The review is undertaken every 10 years, pursuant to the legislation. The outlook should therefore be longer term. We also note that the FIA/CUIA have now been in place for 25 years and have stood the test of time well.

From a public policy perspective, we propose:

- Re-assertion of the limited role for government in the management of credit unions, consistent with the legislation and free market economics.
- Enhanced clarity of roles, transparency and accountability among regulatory authorities.

Public Policy Goals

The Ministry paper states that 'financial sector stability' and 'consumer protection' as the primary public policy objectives. These appear reasonable.

There may be some differing opinions on the best definition of the 'financial sector'. The paper presumes that the sector is, defacto, the entities covered by the two pieces of legislation; credit unions, insurers, insurance intermediaries and trust companies. Traditionally, these players have been the provincially regulated 'sector' but others are encroaching and the distinctions between who are in and who are out may need to be reconsidered.

In the last few years technological change has lead to several innovations in service delivery, sales and communications generally. Most notably, and substantially as a consequence of technological change, we have new players or 'ghost' service providers. Many of these operators are not included in the formal definition of the sector, but must be considered and potentially be included at some stage. (Examples are PayPal, Stripe, MoGo, Quicken Loans, and crowdfunding sites.)

Additionally, competitors from outside the province are now able to easily collect deposits, offer loans and sell insurance directly. How should these extra-provincial businesses be regulated?

In the pursuit of 'financial sector stability', the legislature must determine when non-traditional players should be regulated players. And in this context, the legislature must also (so as not to disadvantage regulated players) not place undue burden on regulated players.

When the FIA was drafted in 1988 there was discussion of the two basic options; regulate by institution or by activity. This former still makes sense only if the services continue to be delivered, by and large, through regulated institutions.

Consumer protection is a significant issue. This is a growing concern with respect to 'ghost' deposits, and the expansion of non-traditional payment methodologies and private lenders. Market conduct expectations must be similar across the board and the security of funds must be protected. Financial literacy is an important part of consumers protecting themselves, but government has a role in ensuring complete disclosure, fair treatment, and minimum standards. In our relationship with our members we actively engage them and educate. Consumer co-operatives have a built in bias to consumer education.

Solvency Regulation

The conceptual approach laid out in the FIA is primarily that of solvency regulation - legislation that sets minimum capital requirements, that may increase for institutions assuming more risk, so that the possibility of institution's insolvency is low. Supplementary limits are established for managing short term obligations (liquidity), and governance, but most of these relate back to the issue of long term solvency. On governance, the FIA sets out requirements for investment policies, audits, managing conflicts of interest, and selected other matters. The CUIA provides a complementary framework for ownership and governance of consumer co-operatives that provide financial services.

Consistent with Canadian administrative law, enterprises that are in compliance with the law are then free to otherwise do business and pursue economic opportunities as they may choose. This is fundamental to market-based free enterprise economies. In this context, owner/shareholders and their directors provide direction to management and determine the business risks to be taken on.

OECD Principles

The Organization for Economic Co-operation and Development has published Principles of Corporate Governance which provide a good benchmark when assessing the FIA/CUIA approach to regulation. Most notably, the first of these principles provides for the legislative realm:

> "The corporate governance framework should promote transparent and efficient markets, be consistent with the rule of law and clearly articulate the division of responsibilities among different supervisory, regulatory and enforcement authorities." (OECD, 2004)

We believe this statement provides significant cautions to the province of BC:

1. The public interest is emphasized as being the existence of a healthy marketplace. This is different from a 'stable financial sector'. From a credit union perspective, we would contend that credit unions serve to ensure certain markets are competitive and responsive, and not dominated by the oligopoly of the large national banks.
2. The rule of law asserts that the legislature is the source of all key directives and limits on the affairs of free enterprises. The rule of law provides clarity, consistency, and fairness to all market participants. New or revised requirements of financial institutions are introduced through legislation and regulation (and not by international regulatory committees, or individual regulators).
3. The FIA & CUIA should provide the key framework for the delegation of regulatory roles and powers. In this context, experiences in the past few years have demonstrated a need for greater specificity of delegation and accountability. The three key administrative authorities, the commission, superintendent, and the financial services tribunal, no longer appear as sufficiently independent (from each other), unbiased, and/or accountable.

THE ROLE OF GOVERNMENT

The FIA and CUIS are modelled upon the fundamentals of Canadian Administrative Law. In short, the legislature has the power to place limits upon an otherwise free person. Solvency regulation is asserted. Those limits are carefully crafted and then administrative powers are specifically delegated to boards, tribunals and administrative officers. Those administrative decision-makers only have the powers explicitly delegated.

Under the FIA and CUIA, simply put:

- The commission has the power to issue and revoke business authorizations, to issue certain orders to individual financial institutions, and to approve major re-organizations or the winding up of an institution.
- The superintendent collects information, monitors compliance, and makes reports/recommendations to the commission.
- The tribunal sits infrequently to review a select number of administrative decisions made by the other two if there is an appeal of a certain limited number of decisions.
- The Credit Union Deposit Insurance Corporation has a board that is a subset of the commissioners and a CEO that is the superintendent.

In the recent past there has been animated discussion about the role of government and proposals for increased solvency requirements and introduce ‘enhanced’ governance in financial institutions. Most of these proposals arose as a consequence of the 2008 international banking crisis. However, and this should be emphasized, the credit union sector performed well throughout this period.

International banking arrangements have been subject to scrutiny and a variety of new requirements have been placed upon large banks. These include the BASEL III capital regime.

At the same time, regulatory authorities in British Columbia have adopted a more interventionist posture. FICOM has published a “Supervisory Framework”, a “Governance Guideline”, an “Internal Capital Targets Guideline”, and a “Residential Mortgage Underwriting Guideline”. And CUDIC has adopted a new variable rate approach to deposit insurance assessments that reinforces ‘compliance’ with guidelines.

The FICOM “Supervisory Framework”, and the attendant guidelines, are not consistent with the policy perspective of the FIA. The approach (1) asserts new requirements on all credit unions (which should be done by legislation and regulation) and (2) inserts the superintendent more directly in the management of the business affairs of the financial institutions (which is under law the primary responsibility of directors and management).

While the FIA creates a variety of administrative authorities, the commission, superintendent, The Financial Services Tribunal and CUDIC, to the credit union system these are now all ‘FICOM’. There is not adequate separation of roles and responsibilities consistent with the OECD principle above. There is also a loss of transparency in the conduct of these authorities, partly due to the structures established by the legislation and partly due to the manner in which certain duties are discharged.

Examples:

1. In January of 2014 the a FICOM notice (CU-14-001) was published. “This notice is to advise that Central 1 Credit Union (Central 1) has been identified as a domestic systemically important financial institution (D-SIFI) in the context of the Canadian credit union system.” The notice asserted a list of ‘implications’ which substantially altered that which was laid out in the Liquidity Management Regulation, with consequences for Central 1 and all member credit unions (with an estimated annual cost to credit unions of $25M annually).
    a. The decision-making authority was not disclosed.
    b. The legal authority under the FIA for such an action is not disclosed.
    c. The position of ‘FICOM’ essentially revised the capital requirements regulation and the liquidity requirement regulation without consulting the LGIC.
    d. The FIA provided no effective appeal provision.
2. In September 2013 FICOM issued a Governance Guideline. The guideline set out a large number of ‘expectations’ and the covering letter stated that there was “a 24-month transition period for each credit union to implement the guideline's principles and standards.”
    a. The decision-making authority, commission or superintendent, are not disclosed. A footnote states “References to FICOM may include the staff, the Superintendent and/or the Commission.”
    b. The legal authority under the FIA or CUIA for such an action is not disclosed, nor how the specifics related to the existing regulations.

    c. The positions advanced by 'FICOM' essentially revised the Credit Union Incorporation Act regulation and the Credit Union Directors Election Regulation without consulting the LGIC.
    d. The expectations of 'compliance' are clear.
    e. The FIA provided no effective appeal provision.
3. FICOM/CUDIC introduced a new methodology for calculating deposit insurance assessments in 2014. All notices are on FICOM letterhead and correspondence is signed by the superintendent as the CEO of CUDIC.
    a. The assessment is based upon a risk score, and 50% weighting is given to a qualitative evaluation by the superintendent.
    b. The assessment methodology asserted an array on new performance targets, well above those set out in the legislation and regulations.
    c. The FIA provided no effective appeal provision should a credit union wish to dispute either the assessment methodology or the score.

The FICOM/CUDIC variable deposit insurance assessment policy, implemented in 2014, has effectively introduced a new independent set of financial penalties that are used to 'enforce' compliance with FICOM guidelines. We do not believe that this was intended under the FIA/CUIA.

In our view, framework for provincially regulated financial institutions under the FIA/CUIA is good but requires revisions in order to fully comply with the OECD principles.

- Consistent with the rule of law, requirements placed upon provincially regulated financial institutions should be done in the legislation and regulations. This is the basic form promoted in the FIA & CUIA. For example, if there are requirements for additional disclosure to credit union members these should be well drafted and added to those already in Section 2 of the Credit Union Incorporation Act Regulation.
- The key regulatory roles and responsibilities should be separated and discharged independently, without bias and with all decisions being open to an efficient appeal mechanism. Delegated authorities should be respected and all actions should identify the authority taking action and the delegated powers under which the action is being taken.
- Consistent with core principles published by the Basel Committee on Banking Supervision and the International Association of Deposit Insurers, the administration of CUDIC should be separate and distinct from the regulatory authorities.
- The commission should not be too reliant upon the superintendent. The commission may need to be supported by its own secretariat to provide sufficient independence from, and reliance upon, the superintendent.
- The composition of the commission should be reconsidered to provide for greater independence and a body knowledge and skills that can adequately challenge the superintendent.
- Broader provision should exist for appeals and reviews of all actions taken by administrative authorities, especially actions taken where no delegated authority explicitly exists. Credit unions should not have to pursue lengthy and potentially costly court challenges.
- Each administrative authority should be required to publish annual reports to the public on the manner in which they have discharged the authority delegated by statute and related performance measures.

Guidelines

The Ministry paper makes reference to FICOM guidelines. We see no problem with guidelines per se, but we object to these being turned into new requirements. Performance requirements for credit unions should be set in the legislation or regulations.

We recognize that the superintendent and her staff may have good suggestions and recommendations. We welcome these. However, the primary stakeholder in our business is not the regulator, it is our shareholder owners. Our board and management have the responsibility to manage the various business risks and ensure we comply with the FIA and CUIA. In a free enterprise economy, that is the bargain.

Implicitly, in any credit union, a board should be able decline to implement recommendations of the superintendent. This option should be available without threat of penalty, harassment or increased deposit insurance assessment. This is the right of ownership.

Lastly, the guidelines that have been published are open to various interpretations, which good policy analysis and legislative drafting would likely avoid.

If the superintendent views certain conduct as presenting a higher solvency risk, she has several tools at her disposal. These include:

- Require extra reporting on the matter to the superintendent.
- Initiate an examination to assess the risk.
- Recommend to the commission to place a condition on a business authorization.
- Recommend to the commission to place a credit union under supervision
- Recommend to the commission that the financial institution be placed under administration.

We see no good reason to place the publication of guidelines in the statute, to do so would undermine the framework now in the statute. The legislature and LGIC set the requirements for all credit unions; the commission may introduce conditions on an institution in some circumstances, pursuant to the legislation.

Further, we argue that the variable deposit insurance assessment policy should be reconsidered so that it is not used to compel credit unions to 'comply' with FICOM guidelines.

Auditor General's Report

In March 2014 the Office of the Auditor General issued a report on Credit Union Supervision in BC.. The first recommendation in that report was to the Ministry and related to the planned review of the legislation and the consideration of international principles. To this we echo the message with more emphasis on the OECD principles as quoted above.

An exceptional amount of commentary was provided on the staffing problems at FICOM. What was implied was that the superintendent was unable to fulfil all of the duties and responsibilities set out under the legislation. However, this was not well documented. Credit unions have expressed concerns about the timeliness of some administrative approvals, and other actions.

What is missing from the OAG report prompts us to suggest that the commission and superintendent be required to provide more comprehensive annual reporting to the public (and industry), to respect the principle of greater transparency and accountability.

We suggest that the FIA require annual reporting on key indicators related to the administration of the Act. These may include: examinations completed (s212), inquiries (s213), special examinations (s214), investigations (s215), commission approvals of business authorizations & revocations, commission orders & consents, filings processed (I&LP amendments, special resolutions, PIRs, etc).

Insofar as the commission and superintendent are doing important work in the public interest, we suggest that annual reporting would enhance the position of the credit union system and other regulated entities. Similarly, CUDIC reporting may be enhanced, to potentially include management commentary and summary information on the insured institutions (some of which was done annually until @2008).

Lastly, the Auditor General's report says that the superintendent's office has been unable to complete all the work expected of it in a timely manner and with a sufficiently skilled workforce. This suggests that Stabilization Central Credit Union should be asked to play a larger role in support of the larger public policy objectives.

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