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Corporation of Ontario
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Guidance Note: Investments

DICO considers a complex credit union to have the following characteristics:

1. The total assets of the credit union as set out in the audited financial statements of the credit union that were placed before its members at the most recent annual meeting are greater than or equal to $50 million; or

2. The credit union participates in commercial lending.

If either of the above two conditions exists, DICO will consider the credit union to be a "complex" credit union and subject to the guidance expectations for a complex credit union.

This guidance note is for use by complex credit unions and will be used by DICO to assess whether a credit union is managing its investments in a prudent manner.

Less complex credit unions should refer to the subsection 60, 62-66 of the Regulations for eligible investments and also apply the principles outlined in this guideline as appropriate in managing those investments.

This guidance note outlines the basic elements that will be considered by DICO in assessing the effectiveness of a credit union's risk management framework for investments.

Contents

Introduction

The Board of directors of a credit union is required to establish, and the credit union is required to adhere to, market risk policies, standards and procedures that a reasonable and prudent person would apply to avoid undue risk of loss while obtaining a reasonable return in respect of its portfolio of investments.

Policy

Section 61 of the Regulations[1] authorizes a Complex credit union to hold any investments authorized in its investment policies subject to any conditions, limitations or exceptions outlined in the Act and Regulations.

These policies should take into account:

- the knowledge and expertise of the credit union's management and staff
- the business environment in which the credit union operates
- the credit union's risk tolerance
- the level of the credit union's capital (ability to absorb losses)

At a minimum, credit unions are expected to establish an investment policy that addresses:

- authorized types, limits and concentration of investments;
- defined and prudent levels of delegated decision-making authority;
- documented criteria for making investment decisions;
- monitoring the value and investment returns of the investments;
- identifying, measuring and establishing appropriate accounting provisions for market impairments; and
- frequency, form and content of reports to the Board

Procedures

Each credit union is required to have written internal procedures outlining how investment policies will be implemented, monitored and reported to the Board. Credit unions should ensure that the policies are implemented by employees who have the appropriate level of expertise.

Authorized types, quality, limits and concentration of investments

Credit unions are expected to identify all authorized investments in policy and establish limits on the volume and quality of investments by category. To be considered prudent, credit unions are expected to establish lower limits for higher risk

[1] Regulations to the Credit Unions and Caisses Populaires Act, 1994

investments such as equity investments, mutual funds and commercial paper, compared to lower risk investments such as government bonds and bankers' acceptances. Credit unions are encouraged to establish aggregate limits on investments by category and risk. In order to mitigate risk, credit unions are also encouraged to establish portfolio limits for higher risk categories of investments. Credit unions considering investments in subsidiaries or joint ventures should establish a policy framework outlining the criteria and process for the evaluation and implementation of these investments. Policies should be established in advance to ensure appropriate analysis and due diligence is undertaken prior to any legally binding commitment being made with respect to the proposed transaction.

Section 61(2) of the Regulations restricts investments in derivative instruments to the management of a credit union's interest rate risk. Where derivative instruments are authorized, policy must address when and how derivatives may be used and specify limits on the amount, duration and aggregate value of the derivative contracts. The policy must also provide overall guidance on the use of derivatives and extend and frequency of Board reporting.

Note: investments in different mutual funds either issued by the same mutual fund company or by different mutual fund companies are treated as separate investments for the purposes of the limit on single investments.

Defined and prudent levels of decision making authority

The credit union's policy must identify delegated approval levels for all authorized investments. Approval levels should be established for amounts and types of investments that may be purchased and sold or redeemed based on the staff member's expertise and seniority. The delegated level of authority should reflect the nature and risk of each investment category. Higher risk or large value investments should require more senior levels of approval including joint approval where appropriate. Redemption or sale of investments resulting in a material loss should be specifically identified for approval by senior management.

The Board may wish to retain approval authority for certain large investments or categories of investments.

Documented Criteria for making investment decisions

For each type of investment, documented criteria should be established for making investment decisions. For example, when considering investments in financial instruments, the criteria should include:

- policy limits set out in the investment policy;
- the anticipated rate and volatility of return;
- the quality of the investment (i.e. credit rating of the instrument as determined through a bond/market rating service);
- early liquidation discounts/penalties;
- the term structure of the investment; and

- the extent of portfolio diversification.

Subsidiaries

When making investments in subsidiaries, credit unions are expected to include consideration of the:

- level of membership support for this type of business activity;
- level of start-up costs and expected payback period;
- level of management expertise and time required to control the subsidiaries' activities;
- level of expected business growth and profitability;
- costs for alternative procurement of services to be offered by subsidiary;
- potential reputational risk; and
- potential increase in legal liability.

Real Estate

Investments in real estate must comply with the limitations and restrictions set out in the Section 62 of the Regulations. Credit unions should require Board approval for the purchases of improved real estate as defined in Section 63 of the Regulations. Investment decisions should be based on an objective analysis of the purchase. The analysis should be documented in a detailed report to the Board recommending the investment, and should consider/include:

- the purpose for the purchase (for use in operations or for income producing purposes);
- a comparison of purchase and carrying costs and benefits of the property;
- a comparison with other possible investments;
- an appraisal of the property, prepared by a professionally accredited appraiser;
- the zoning of the property;
- an environmental audit of the property; and
- any transaction costs involved.

Risk Measurement and Board Reporting

At a minimum, credit unions are expected to establish risk and performance measures of the investment portfolio that include:

- measurement of dollar volumes and investment portfolio mix by investment category;
- measurement of the quality and return of investments;

- measurement of the market value of risk bearing investments in financial instruments; and
- identification and monitoring of large investments and investments to connected and restricted parties.

Actual performance should be compared to financial targets in the annual business plan and the budget, so that management can determine whether the credit union is meeting its investment goals. Management should also assess and report whether there are material variances from the plan which need to be addressed.
Credit unions are expected to establish appropriate reporting requirements of investment activities. At a minimum, an investment report should be submitted to the Board confirming compliance with policy and summarizing the performance of all investments by category including derivatives.

Credit unions are encouraged to establish additional reporting requirements for individual higher risk or large value investments.