Ontario

Deposit Insurance
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Sound Business and Financial Practices

Reference Manual

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Notice

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Reference Manual

Introduction

Ontario Credit Union System

Credit unions provide a wide range of financial services to individuals, small and medium-sized businesses, corporations and institutions throughout Ontario. Credit unions are formed among people with a common bond, such as a particular community, language, religion, ethnic background or place of work. Credit unions are cooperatives organizations, and are guided by the internationally recognized cooperative principles of equality, equity and mutual self-help. In accordance with these principles, credit unions are wholly owned by their members, and are governed by boards of directors selected from the membership. Unlike banks, credit unions are provincially licensed.

The following organizations and institutions service, regulate or assist Ontario credit unions:

Financial Services Commission of Ontario (FSCO): FSCO is a provincial government commission. It regulates financial institutions that are provincially incorporated, such as credit unions. FSCO approves incorporations, amalgamations and by-law amendments as well as performing other regulatory functions.

Deposit Insurance Corporation of Ontario (DICO): DICO is an "Operational Enterprise" Agency of the Province of Ontario. It is responsible to the Ontario government for protecting the deposits of members of the credit union and caisse populaire system. DICO provides deposit insurance for all Ontario credit unions.

Leagues: Most Ontario credit unions are affiliated with a provincial league. The leagues are provincially incorporated institutions that act as central bankers and trade associations for their members. They also provide members with access to liquidity pools, training, consulting and other services. The three leagues in Ontario are the Credit Union Central of Ontario (Ontario Central), L'Alliance des caisses populaires de l'Ontario (L'Alliance), and La Fédération des caisses populaires de l'Ontario (La Fédération).

Association of Credit Unions of Ontario: The Association represents a group of credit unions that are not affiliated with a league.

Credit Union Central of Canada (CUCC): CUCC is a national affiliation of provincial leagues and co-operatives. CUCC manages the national liquidity system, acts as advocate for the system with the federal government, and is the national trade association.

Fédération des Caisses Desjardins du Québec: La Fédération is the league of Quebec caisses populaires. La Fédération in Ontario is affiliated with Desjardins.

Credit Union Insurance Services (CUIS): CUIS provides insurance services and products, such as property and casualty insurance, to their members. It is a joint venture of the Co-operators Insurance Group and the Credit Union Members' Insurance Societies (CUMIS).

The Credit Union Bonding Program (TCUBP): TCUBP provides bonding insurance to Ontario credit unions. It is a joint venture of the Co-operators Insurance Group and the Credit Union Members' Insurance Societies (CUMIS).

External Auditors: These professional accountants express an opinion on the financial statements of the credit union and perform other audit or accounting functions.

Other Organizations: Various provincial or national organizations represent various groups of credit unions or credit union professionals, such as Credit Union Directors of Ontario (CUDO); the Credit Union Managers Association (CUMA); the Credit Union Professional Association (CUPA); the Ontario Association of Small Credit Unions; and the Advisory Council of Smaller Credit Unions established by Ontario Central for their members.

Legal Framework of the Ontario System

Ontario credit unions are regulated primarily by the Ontario Credit Unions and Caisses Populaires Act (the Act) and Regulations proclaimed under the Act. The powers of credit unions are also governed by DICO's by-laws, as well as each credit union's by-laws, articles of incorporation and lending licence. Other provincial and federal statutes, and the common law, create additional legal rights and obligations. The various parts of the legal framework are briefly discussed below.

Credit Unions and Caisses Populaires Act (the Act)

The Act is the main statute which governs the incorporation and operation of Ontario credit unions. The authority of the Act extends to regulations proclaimed under the Act, to guidelines and interpretative and administrative bulletins issued by FSCO, and the By-laws of DICO.

Non-compliance

When a credit union does not comply with the Act, FSCO or DICO may intervene. Under the Act, directors can be held personally liable for certain transactions if the transactions are illegal or improperly authorized. Serious offences against the Act committed by a director, officer or agent of the credit union are punishable by fines or imprisonment.

DICO By-laws

Three DICO by-laws directly affect Ontario credit unions:

- **By-law No. 3** prescribes conditions of deposit insurance, coverage, and guidelines for the advertising of deposit insurance coverage by credit unions. The **policy of deposit insurance**, issued pursuant to By-law No. 3 to each credit union, contains binding terms and conditions on the credit union.
- **By-law No. 5** prescribes standards of sound business and financial practices for credit unions, including policies and procedures for risk management. It defines the roles of the board of directors and management in carrying out sound business and financial practices.
- **By-law No. 6** prescribes guidelines for the reporting and accounting of impaired loans, according to Section 3025 of the *Handbook of the Canadian Institute of Chartered Accountants*. An Application Guide to By-law No.6 provides more detailed guidance on impaired loans including the specific and non-specific loan loss allowance.

Credit Union By-laws, Articles and Lending Licence

The articles of incorporation and by-laws of a credit union set out much of what a credit union can and cannot do, including who can become a member, how the credit union's profits may be distributed, and the types of loans the credit union can offer. The board of directors are responsible for ensuring that the credit union complies with the by-laws and the articles.

The lending licence together with the Act and Regulations, define the lending powers of a credit union. If a credit union or its staff contravene the terms of a lending licence, the credit union's lending powers can be revoked.

Other Laws and Acts

Credit unions must comply with all the laws of the province of Ontario and of Canada. The board of directors may be held responsible for any actions taken by a credit union which break the law. Relevant laws include the following:

- The **Ontario Human Rights Code**, which deals with discrimination in the treatment of employees and in hiring.
- The **Employers Health Tax Act**, which requires the credit union to remit health taxes.
- The **Income Tax Act, Canada Pension Plan** and **Employment Insurance Act**, which require the credit union to remit income taxes and Canada Pension Plan and Employment Insurance premiums.
- The **Pay Equity Act**, which ensures that staff and officers receive equitable compensation.
- The **Consumers Protection Act,** which sets out the disclosure requirements of borrowing costs for all credit agreements.
- The **Consumer Reporting Act**, which ensures that proper information is communicated to members about the credit union's products and services.
- The **Employment Standards Act**, which ensures that the credit union meets standards of fair employment.
- The **Bankruptcy and Insolvency Act** and **provincial creditor protection legislation**, which requires the credit union to observe the rights of debtors and creditors in dealing with the assets of a bankrupt individual.
- The **Ontario Health and Safety Act**, which sets out employers duties regarding the health and safety of employees within the workplace.
- **Employment law**, which governs cases such as wrongful dismissal, or the lack of a proper notice period.
- The **Personal Information Protection and Electronics Documents Act (PIPEDA)** which requires the credit union to observe privacy legislation surrounding the collection, use and disclosure of personal information of its members and employees and information obtained in its normal course of business; and
- The **Proceeds of Crime (Money Laundering) and Terrorist Financing Act** which requires the credit union to implement a compliance regime for identifying and reporting certain large and suspicious financial transactions

You can find a more extensive list of lending laws and statutes in Section 5100, Schedule 5.3. For a complete list of relevant laws, the credit union should consult its lawyers.

Board, Management and Committee Roles

This section outlines the separate functions performed by the board, committees and management of a credit union. While each of these contributes greatly to the functioning of the credit union, **the board has the ultimate responsibility for the welfare of the credit union.**

Overview of Roles

The most significant responsibilities of the board are ensuring that the credit union meets the needs of its members by staying in business, planning the broad directions of the organization, and forming policy. The board appoints management to carry out policy and achieve results. Once board policy is decided, the board must give management the latitude to manage the day-to-day operations of the credit union. Management must be able to choose staff, allocate budgets and plan courses of action, provided these actions follow board policy. If the results are unsatisfactory, the board should resist the urge to take over management of the credit union, and instead encourage improvement or take steps to replace management.

The roles of the board, management and committees are discussed on the following pages.

Role of the Board

The board of directors of the credit union is ultimately responsible for ensuring that the institution is operated in a safe and sound manner.

Due to its responsibility, the board must supervise the management of the business and affairs of the credit union. To do this effectively, the board of directors will need to:

- approve new policies and annually review existing policies;
- review and approve the business plan annually;
- ensure that qualified and competent management is appointed to implement appropriate risk measurement techniques and risk management procedures;
- monitor performance to ensure the credit union adheres to the policies and the business plan;
- oversee member and community relations.

Most of these functions are discussed in detail in Section 400 of the Overview of DICO By-law No. 5. The last of these functions, overseeing member and community relations, is discussed below. The duties and legal responsibilities of individual directors, such as those set out in statute and common law, are discussed in Chapter 2.

Overseeing Member and Community Relations

The board of directors represents all members of a credit union, and has a duty to ensure members' deposits are secure and their rights are upheld.

The board also has a duty to ensure that the credit union continues to meet its members' needs. The board does this by promoting the credit union through public relations activities, membership drives and the selection of competent representatives for the board. The following practices will help the board fulfill its duties:

- The board should promote a positive corporate image to retain and attract members. Community involvement is an important influence on corporate image where community bonds exist.
- Individual directors should be willing to volunteer on board committees to solve special problems facing the credit union or respond to the changing needs of the members.
- When new directors are elected, the board should arrange an orientation session to introduce the new directors to credit union operations and their role as directors.
- The board should encourage and budget for directors' attendance at educational seminars, where necessary, to ensure the board is capable and effective.
- At least annually, the directors should evaluate the board's performance and outline areas for improvement. These areas should be reviewed at subsequent appraisal sessions.

Part of the board's role is to protect the legal interests of the credit union. Directors should therefore control important litigation directly, while delegating routine litigation, such as debt collection or trade matters, to management. The board can retain a lawyer, and may wish to retain more than one lawyer or law firm depending on the type of legal advice required. When selecting a lawyer, the board should consider qualifications and experience, as well as the conflict of interest rules described in Chapter 2.

Role of Management

Management is responsible for managing and controlling the day-to-day activities of the credit union.

Although the activities will vary according to the size and complexity of the credit union, management is responsible for:

- developing and recommending policies and the business plan for approval by the board of directors;
- communicating policies and the business plan to appropriate people working in the credit union;
- implementing policies and the business plan, and employing and training qualified and competent personnel;
- measuring the level of operational risk through an appropriate reporting system;
- managing operational risk through the use of appropriate procedures and corrective action.

The board should prepare a description of the general manager/Chief Executive Officer's (CEO's) job. The job description should include the core responsibilities listed above. The general manager/CEO's performance must be reviewed by the board each year. See Chapter 3 on Human Resources/Performance Appraisal.

Role of Committees

Committees are an important resource for the credit union, especially in smaller organizations where lending officers and internal auditors may not be on staff.

Duties and powers of the audit committee, the credit committee and the executive committee are defined in Part VII of the Act, and are discussed briefly below.

Other valuable subcommittees which the credit union may consider establishing, depending on its size, include a finance and budget committee, a strategic planning committee, a nominating committee and a compensation committee. See Schedule A for a summary of the recommended duties of these committees.

Volunteers

Directors working on committees are usually helped in their responsibilities by committee volunteers. Volunteers from among the members of the credit union add a broader perspective to the committee. The board recommends volunteers or associate members for committees. The people selected must be familiar with the affairs of the credit union.

Terms of Reference

To ensure a committee works effectively, its duties and responsibilities should be outlined in writing when the committee is formed. Outlining the terms of reference will avoid later disputes over the powers and responsibilities of the committee. The board establishes the terms of reference, and each committee member must review them. Sample Terms of Reference for an audit committee and a nominating committee are provided in the DICO publication *Sample Policies*. See the Appendix to Version A - Corporate Governance Policy.

Executive Committee

The board of directors can establish an executive committee or other subcommittee of the board to carry out some of the powers of the board. The members of the executive committee or subcommittees must be appointed by the board of directors, from among the directors, according to Section 109(4) of the Act. Some board powers, such as the power to appoint the general manager, may not be delegated to a board subcommittee. For a complete list of powers that cannot be delegated, see section 109(2) of the Act.

The Credit Committee

The duties and authority of the credit committee are prescribed in sections 110 to 124 of the Act, and Sections 24 and 25 of Regulation 76/95. The committee must comprise at least three people elected by the general members. The term of office for Credit committee members must be set out in the credit union's by-laws. Officers, directors and members of the audit committee may not serve on the credit committee.

The credit committee must meet at least monthly to consider all applications for loans. The committee must make prudent lending decisions within the lending limits provided in the credit union's lending licence or by-laws, whichever is more restrictive. According to Section 238(3) of the Act, members of the credit committee may be liable for deficiencies on loans that violate the by-laws or the Act.

Loan Officer

Under sections 122 and 123 of the Act, authority to approve loans may be transferred from the credit committee to a loan officer in two ways:

- A by-law may be passed which appoints a loan officer to assume all the duties of the credit committee, resulting in the elimination of the Committee.
- The credit committee may retain its advisory capacity, but delegate its lending authority and responsibilities to a loan officer.

When lending authority is delegated to a loan officer, the existence of a credit committee that conducts periodic loan reviews is an effective way of retaining control over the lending function. Requiring the credit committee and the loan officer to jointly approve loans that exceed certain dollar amounts also adds a measure of control.

Under Section 124 of the Act, the board of directors cannot overturn a decision of the credit committee or of the loan officer to reject a loan application.

The Audit Committee

Every credit union must form an audit committee. The committee must be either elected from the membership or established as a subcommittee of the board.

The requirement for an audit committee was introduced in 1994. Previously, credit unions were required to have a supervisory committee. The focus of the audit committee is broader than that of the supervisory committee. The powers and duties of the audit committee are set out in Sections 137 to 139 of the Act, and Section 26 of Regulation 76/95.

The main role of the audit committee is to assess and make recommendations on the effectiveness of various internal controls and policies relating to the physical safeguarding of assets, as well as accounting, lending and investment activities. The committee also liaises with the external auditor.

The audit committee helps the board make sure the credit union complies with policies and procedures and with regulatory requirements. Its role is therefore critical in ensuring the credit union follows sound business and financial practices.

An Audit Committee Checklist included in the Director's Handbook and is also available on DICO's website at www.dico.com

Schedule I.1
SUGGESTED DUTIES OF ANCILLARY COMMITTEES

Finance and Budget Committee

- Review and update financial policies and procedures.
- Recommend dividend and interest rebate policy.
- Research insurance and investment decisions.
- Provide expert analysis of budgets and performance reports.
- Provide financial advice to the board and management.

Strategic Planning Committee

- Research competition and market trends for growth.
- Survey members on branches/products.
- Review financial forecasts.

Nominating Committee

- Research board's replacement needs in terms of skill, experience and diversity.
- Promote rotation of directors.
- Survey members and obtain nominations in advance of election meeting.
- Advertise candidates and promote general election.

Compensation Committee

- Review/approve job description and a standard evaluation process for the general manager.
- Research competitive salary ranges for the general manager in the industry.

Policy Development Committee

- Annually review existing policies to ensure they continue to be relevant.
- Recommend necessary changes to existing policy to the board.
- Recommend new policies to the board.

DICO By-law No. 5: Standards of Sound Business and Financial Practices

A credit union cannot avoid financial and other types of risk, but the board and management can reduce risk through sound risk management practices. **DICO By-law No. 5: Standards of Sound Business and Financial Practices** was created specifically to help credit unions manage risk. The by-law prescribes three tools for managing risk.

Risk Management Framework

The first of these tools, the **Risk Management Framework**, provides an overall approach to analyzing and managing risk. It includes four broad tasks: setting policy, planning, measuring risk and performance, and managing risk through corrective action and operational procedures. It defines the roles of the board of directors and management in putting in place sound business and financial practices. The framework is discussed in more detail later in this chapter.

Standards

The second tool is the **standards of sound business and financial practices**. There seven standards that set minimum requirements for policies and procedures in specific areas of credit union operations. The standards deal with the following topics:

1) Governance
2) Capital Management
3) Credit Risk Management
4) Market Risk Management
5) Structural Risk Management
6) Liquidity Risk Management
7) Operational Risk Management

Self-Assessment

The third tool is **Self-assessment** which helps management and the board gauge the level and effectiveness of the credit union's risk management activities and business and financial practices. By-law No.5 requires an annual self-assessment of compliance to the standards and completion of a board resolution.

Complying with DICO By-law No. 5

All credit unions are required to comply with By-law No. 5 as a condition of obtaining deposit insurance coverage. Where a member institution is in non compliance with the standards, DICO may amend or supplement the standard terms and conditions in the Policy of Deposit Insurance issued to credit unions to address specific risks.

Supervision

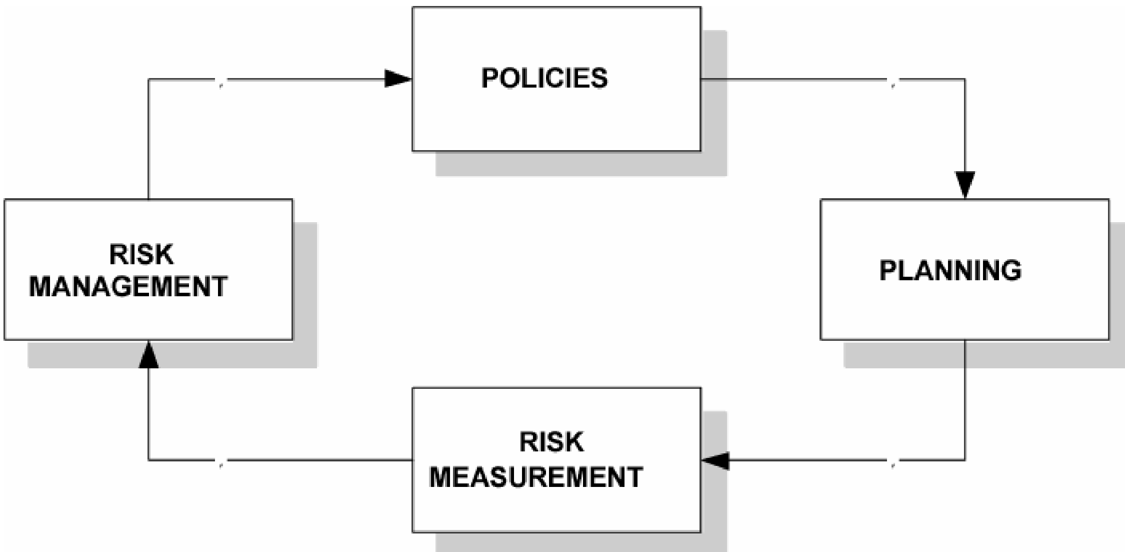
Where a member institution's non-compliance with By-law No.5 represents an unacceptable level of risk, DICO may place a credit union under supervision. In this case, DICO works closely with the board of a credit union under supervision to correct specific operational problems.

Administration

Where there is a high risk that the credit union will fail, DICO may place a credit union under administration. DICO directly manages credit unions under administration by removing the board and operating the credit union in a manner which reduces the risk of claims against the deposit insurance reserve fund.

Risk Management Framework

The Risk Management Framework provides an overall approach to analyzing and managing risk. Using the Risk Management Framework is a sound business and financial practice for the board and management of a credit union. The framework is designed to protect both depositors and the financial health of the credit union over the long term.



An effective Risk Management Framework has four parts – policies, planning, risk measurement and risk management -- which are discussed below. **A Risk Management Framework should be cost effective and appropriate for the size and complexity of the credit union's operations.**

Policies

The first part of an effective Risk Management Framework is the establishment and annual review of policies approved by the board.

Policies put limits on the amount of business risk a credit union can assume. They also summarize the organization's thinking on each of its key activities. Policies should support the credit union's mission and values.

The board of directors will establish written policies and procedures in the following areas of risk management:

1) Governance
2) Capital Management
3) Credit Risk Management
4) Market Risk Management
5) Structural Risk Management
6) Liquidity Risk Management
7) Operational Risk Management

Policy Review

Each year, the board should review all policies to ensure they continue to be relevant. Where policy amendments are needed they should be recorded and delegated to management for completion by a specific date. The board must approve all new policies and policy amendments. The board should set a deadline for completing the task.

The board should consult Sections 104, 190 and 191 of the Act, Sections 50, 78 and 87 of Regulation 76/95, and the FSCO *Guideline for Prudent Investment and Lending Policies and Procedures for Ontario's Credit Unions*.

This manual discusses key board policies in detail. Credit unions can also get help in developing policies from the DICO publication *Sample Policies,* and from league manuals.

Planning

Establishing an annual business plan will help the credit union by setting goals and objectives that will ensure its financial health over the long term. This is the second part of a Risk Management Framework.

The credit union's management should develop the annual business plan with direction from the board. The board must approve the plan. The annual business plan often includes typically include:

- priorities and objectives for the year;
- a strategic financial plan which address all financial areas of operation;
- a product offering and marketing plan;
- a human resources plan;
- an operational budget.

Management should develop strategies and action plans to achieve each of the priorities and objectives for the year. They should compile the strategic financial plan from a study of various operational areas, and include **financial targets** for each financial area of operation.

Chapter 1 discusses the elements of the annual business plan.

Risk Measurement and Reporting

The third part of a Risk Management Framework is a reporting system that measures performance and business risk relative to the business plan and to historical trends.

A reporting system should include:

- the periodic measurement of financial performance indicators, relative to the business plan and to historical figures;
- the periodic measurement of business risk, relative to the business plan and to historical figures;
- the development of risk measurement techniques necessary to measure these performance indicators and measures of business risk;
- regular reports to the board, which enable directors to monitor performance and business risk and ensure the credit union adheres to the policies and the business plan.

A timely and reliable reporting system will allow management and the board to take appropriate action to address variances in performance and business risk.

Board Reporting

The final product of the reporting system is the preparation of regular reports to the board on the credit union's performance and its exposure to risk. Management should prepare a report for each financial area of operation. These reports must summarize:

- performance and the level of risk;
- variances from the annual business plan and the budget;
- any non-compliance with regulatory requirements or with the credit union's policies and lending licence.

The level of detail required and the frequency of individual reports should be set down in board policy. They will vary depending on the size and complexity of each credit union.

Reports are normally provided to directors at least one week before board meetings. Management should be prepared to follow up on any questions raised by the reports. The scope and content of board reports is summarized in Appendix I at the end of the Introduction.

Management and the board should also monitor reports received from people outside the credit union, such as auditors, inspectors and examiners. Appendix I lists the external reports that should be reviewed by the board and management.

The risk measurement and reporting system will need to use techniques to measure performance and business risk. These techniques and the requirements for board reporting are discussed in detail in this manual. Performance and risk measurement indicators are also discussed throughout the manual.

Risk Management

Risk management is a sound business and financial practice for a credit union, and the fourth part of a Risk Management Framework. Risk management involves establishing management procedures to control or respond to operational risk, and to ensure the credit union complies with its policies and business plan, and with regulatory requirements.

Corrective Action

As a follow-up to the risk measurements discussed in the previous section, the board should direct management to investigate all significant variances in risk or performance relative to the annual business plan, and respond with corrective action. Management must also respond to any contravention of board policy or regulatory requirements, or other exceptional risk.

Management must investigate favourable and unfavourable variances. In some cases, a favourable variance can result from an unfavourable cause. For example, an unexpectedly high volume of loans may indicate lower standards for loan approvals. After investigating a variance, management must determine what, if any, action is appropriate.

One way to decide upon a course of action is to compile various solutions to the problem and list the costs and benefits of each. The costs and benefits of each solution can then be compared. In some cases, no action may be the best option. However, this will not be the case where a regulatory requirement is not being met. Where a corrective strategy requires a course of action not contemplated by existing policy, board ratification and committee ratification (where applicable) must be obtained.

Management must report back to the board promptly on the cause of the variance, whether it needs to be addressed, and if so, the action they recommend.

Operational Procedures

Operational procedures should be written down. Written procedures result in higher staff productivity and better control of resources. They can also assist new managers and employees learn their jobs more quickly.

Procedures are different from policies. Board-level policies are broad and conceptual in nature, while operational procedures are specific and detailed.

The board can delegate the writing of detailed procedures to management. However, under Section 191 of the Act, credit and investment procedures must be approved and reviewed each year by the board.

To ensure procedures are complete and detailed enough, the board should consult appropriate sections of the Act and Regulations. Specifically, the board should consult Sections 104, 190 and 191 of the Act, Sections 50, 78 and 87 of Regulation 76/95, and FSCO's *Guideline for Prudent Investment and Lending Policies and Procedures for Ontario's Credit Unions*. Recommended procedures for each operational area are also discussed under the Risk Management sections of Chapters 4 to 8, and throughout Chapter 9.

Operational procedures should be cost effective and appropriate to the size and complexity of the credit union's operations.

Appendix I.1: Reports to the Board

Report	Scope	Frequency
Minutes	• Minutes of previous board meetings • Minutes of committee meetings	Every board meeting
Governance	• Compliance with the Code of Conduct • Performance of the general manager • Report on the general competency and quality of staff	Annually
Capital Management	• DICO By-law No. 5 reporting requirements	Every board meeting
Credit Management	• DICO By-law No. 5 reporting requirements • Regulatory reporting requirements, (Section 24 of Regulation 76/95)	Monthly
Market Risk Management	• DICO By-law No. 5 reporting requirements • Regulatory reporting requirements, (Section 198(4) of the Act)	Every board meeting
Liquidity Risk Management	• DICO By-law No. 5 reporting requirements • Regulatory reporting requirements, (Section 134 of the Act)	Every board meeting
Structural Risk Management	• DICO By-law No. 5 reporting requirement • Regulatory reporting requirements, (Section 80 of Regulation 76/95)	Every board meeting At least quarterly
Operational Risk Management	• DICO By-law No. 5 reporting requirements	As necessary
Internal Controls (prepared by the audit committee)	• Effectiveness of internal controls • Regulatory reporting requirements set out in Section 26 of Regulation 76/95 • Can also include the Report of the Internal Auditor, where appropriate	At least quarterly Refer Audit Committee Checklist
Reports by other committees	• Activities and progress of the committee	As necessary
Report of the External Auditor	• Compliance with generally accepted accounting principles (GAAP) • Report made in accordance with Section 172 of the Act (for example, a derivative report or management letter)	Annually
Examination and OSV reports by FSCO or DICO	• Regulatory compliance • Risk assessment • Compliance with sound business and financial practices	As advised

Governance

(Planning)

Executive Summary

Planning is an integral function of directing and managing a credit union. The planning process is usually considered a process to develop operational budgets. However, the benefits of a comprehensive planning process (defined in this chapter) are far greater, and can include:
a clear sense of vision and purpose;

- the establishment of an organizational mission statement;
- enhancement of management's ability to anticipate future events, and to avoid management by crisis;
- a realistic self-assessment of the organization;
- stimulation of new business ideas on a regular basis;
- promotion of cooperation within the organization to achieve common goals;
- a benchmark against which to monitor performance and to evaluate the need for change;
- contribution to the future viability of the credit union by empowering the board and management to direct the credit union over the long term.

Planning is not an exact science but an interactive process of creative thinking and team building. The board is ultimately responsible for the existence and monitoring of the annual business plan, however, the process works best when all members of the organization are involved in the process. This chapter reviews the annual planning process, as well as the elements of an annual business plan.

Planning Process

Directional Planning → Strategic Planning → Tactical Planning

On an annual basis, the board of directors and management must conduct an annual planning process. The annual planning process involves three planning elements: a directional plan, a strategic plan and a tactical plan.

Directional planning consists of the development of broad business objectives and performance targets for the credit union based on an evaluation of the economic environment and the corporate philosophy of the organization, over a long term time horizon, such as three or five years. This stage, conducted mainly by the board, results in the formulation of a "directional plan"; one which will determine what the organization should achieve in the long term.

The second phase of corporate planning consists of "strategic planning". This phase produces a plan which outlines courses of action or strategies, recommended over the short and medium term, to achieve objectives outlined in the directional plan. Generally, the "strategic financial plan" sets priorities and objectives for the year, and financial targets for all areas of operation.

The final step in the planning process is "tactical planning", which includes the development of a product offering plan, a marketing plan, a human resource plan and an annual budget. The annual budget authorizes expenditures for specific programs and projects identified in the strategic financial plan, to be implemented in the forthcoming fiscal period. This phase of planning is conducted by management. The tactical plans, including the budget, must be approved by the board.

Risk Measurement

However, the process does not end here. Management and the board need to regularly monitor performance and risk in order to properly assess whether the credit union is meeting the goals and objectives as set out in the business plan. This involves continuous monitoring of risk and performance by management, with regular reports to the board. For a list of required board reports and their frequency, refer to Appendix I-1 in the Introduction of this Reference Manual. The topic of risk management is covered in more depth throughout this Reference Manual (Refer to Sections 4400, 5400, 6400, 7400 and 8400 on Risk Measurement and Board Reporting).

Planning Tools

DICO has established a list of resources which can be used in developing a business plan. This list, which incorporates various types of planning resources, can be found on DICO's website (www.dico.com). The list is also presented in the DICO publication Dialogue (1998, Volume 3, Number 2).

Credit unions can also consult their league, external consultants or other credit unions in order to obtain assistance in formulating the business plan.

Directional Plan

Directional Planning → Strategic Planning → Tactical Planning

The first step of the planning process is to determine the credit union's long term directional plan. This process includes establishing the broad business objectives for the credit union, as well as its general direction for the future. The directional plan should envision a longer time horizon than just the upcoming year. Generally, such a plan should be three to five years in length. There is no need to develop a directional plan if it has recently been established, i.e. from the previous years planning process. However, it must be reviewed and updated given the performance and progress of the credit union, as well as changes to the environment during the previous year.

The steps for establishing a directional plan are as follows:

- Review and revise, if necessary, the credit union's mission statement (or its long term goals).
- Prepare a brief summary of the organization's internal strengths and weaknesses and its external environment.
- Identify immediate and long-term opportunities or threats facing the credit union.
- Compare internal resources against the external environment and establish a list of priorities and objectives to meet the credit union's missions statement (or long term goals).

Mission and Vision Statement

To assist in the planning process, it is recommended that the board review and, if necessary revise, the credit union's mission statement. The mission statement is defined as the credit union's statement of long-term purpose, or its reason for existence. Its most significant benefit is that it permits management and other stakeholders to visualize the credit union's purpose.

If a mission statement does not exist, the credit union should consider establishing one. A mission statement should provide a picture of the credit union's primary purposes and general direction. For a credit union, the mission statement should answer the following basic questions:

- Who is our membership?
- What are our members' greatest needs?
- What are our members' expectations?
- How do we satisfy those needs and expectations?

Specifically, the board must determine the key reason why its members belong to the organization, and what they expect to attain from membership. For example, it may be for a sense of community, financial gain, financial services, convenience, or a combination of these factors. It should also address what members expect from the credit union, and how those expectations can best be met. The mission statement should also briefly state what the credit union does best to satisfy those needs.

A credit union's purpose or mission is dynamic, that is, it changes over time; consequently, so will the mission statement. Therefore, it should be reviewed periodically, (preferably at the commencement of the planning process) to ensure it still reflects the mission and purpose of the credit union.

The types of changes a mission statement should respond to include:

- a change in the membership;
- a fundamental change in members' needs or expectations;
- a fundamental change in how the credit union serves its members' needs.

In defining the mission statement, the board must balance members' expectations against economic constraints. The board must not endorse a mission which is reckless or self-destructive, i.e. one which threatens the economic viability or continued existence of the credit union. Fiscal responsibility is required in this regard, as the board of directors have various legal duties towards the credit union and its well being.

Vision Statement

Another term familiar to business planning is a vision statement. A vision statement is a statement that provides a picture of a desired future for the organization. A vision statement can be an effective tool, as it can help employees, customers and other stakeholders to visualize an organization's long term plans. A vision statement can also be used as part of the board's directional planning process, such as by providing more detail to the mission statement. It should be noted that some organizations use vision and mission statements interchangeably.

Once the credit union's mission is confirmed or revised by the board, the next step is to conduct an analysis of the internal strengths and weaknesses of the organization relative to the external environment.

External Environment

An environmental analysis, or scan, should include a review of the major external variables affecting the credit union, such as various political, economic and technological factors. Refer to Schedule 1.1 for a sample list of factors to be considered. This information must be researched annually in order for the board to determine what market opportunities and threats the credit union faces. The board would normally assign management with the task of preparing the environmental schedule.

The sources of information used to assemble the schedule should be noted. These sources should be reviewed by the board for reliability. It is recommended that regional industry statistics be obtained from the municipality, the local government employment offices, or from the provincial government. Information is also available from the credit union system (e.g. Credit Union Central of Canada produces the Environmental Scan and DICO produces the System Outlook). In some instances, it may be more convenient for management to purchase the information on an annual basis from an economic consulting agency (e.g. the Conference Board of Canada).

Once the external environment schedule has been completed, the various environmental trends should be identified by the board, and labelled as either "opportunities" or "threats". Opportunities are defined as events which create a positive environment for the credit union to grow, increase its earnings or improve its service to members. Threats are defined as events which have a negative impact on these results. The credit union should prioritize the most outstanding opportunities and the most serious threats that it appears to be facing. This list will be used to identify the main priorities and objectives of the credit union for the year.

Schedule 1.1
ANALYSIS OF EXTERNAL ENVIRONMENT

Political And Regulatory Environment

- What changes are expected in federal, provincial or municipal legislation that will significantly impact operations; e.g. changes in municipal property taxes?
- Are the credit union's by-laws adequate to effectively service its members? If not, what changes are required?

Economic Environment

- Is the credit union dependent on a single employer or industry?
- What is the state of the local and regional economies? Are they expanding or are they in recession? Is a change expected in the next year?
- What kind of interest rate trends have been experienced over the past few years and what impact have interest rate changes had on the profitability of the credit union?
- What are the current and forecast unemployment rates locally?
- What has been the trend in the housing market locally? (e.g. change in market values, number of new building permits in the community?)
- If a credit union has an employer bond of association:
  - Is the company's growth threatened by any economic or market development for the industry/employer?
  - How are labour/management relations (i.e. is there a possibility of a strike or lock-out)?

Social And Cultural Factors

- What are the demographic trends for existing or potential new members?
- What are the types of employment and average salary levels of members and persons eligible for membership?

Competitive/Technical Environment

- What is the competition doing?
- Are they installing ATMs or providing network banking?
- Are they moving into the area or are they closing branches?
- Are they increasing advertising or other marketing strategies?
- What new financial products are the competition offering and how do they compare to the credit union product offerings?
- What new technology is available through the competition (e.g. credit or debit cards, home banking)?
- Are members using the competition for other services? Which ones?
- Would members utilize telephone or computer banking services?
- What fees or commissions are being charged to members? Are fees or commissions competitive with rates charged by other institutions?
- What other fees or commissions could the credit union be charging?

Internal Resources

Annually, an evaluation of the strengths and weaknesses of the credit union should be undertaken. This review consists of assessing the internal resources of the credit union. The benefits of such an evaluation include the following:

- Helping management and the board to focus on what the credit union does best in order to create market opportunities and build a unique service reputation.
- Permitting the credit union to identify weaknesses which may impede its ability to succeed.
- Alerting the board of performance problems which may be beyond the control of the general manager.

Schedule 1.2 details a sample list of factors which could be considered as part of an internal assessment, including a review of the credit union's financial resources, human resources and the credit union's past performance. Management should research these factors and create a list or summary of the state of the credit union's internal resources.

Once a list of the credit union's internal resources is documented, each factor must be assessed as either a strength or a weakness. A strength is defined as a factor which enables the organization to excel, i.e. to increase its financial stability and profits or to meet its members' needs. Strong internal resources permit a credit union to respond easily to change; i.e. to neutralize external threats or to take advantage of opportunities. Conversely, a weakness is a factor which constrains or limits the strategic choices of an organization. Weak internal resources prevent a credit union from capitalizing on opportunities, or from overcoming threatening situations.

Finally, the credit union should prioritize its most outstanding strengths and weaknesses.

Schedule 1.2
ASSESSING THE INTERNAL ENVIRONMENT

Financial Resources

- What is the adequate level of capital for the credit union? Is the credit union at that level? Does it have sufficient capital to com-ply with section 12 of Regulation 76/95?
- Is the organization earning profits? Are earnings strong?
- Is the credit union earning sufficient income from fees and commissions?
- What is the organization's interest rate exposure? Is this being managed?
- Are assets of good quality, i.e. few non-performing loans, adequately secured?
- Does the organization have sufficient capital and liquidity available for growth?
- What percentage of assets are earning assets?
- What is the mix between mortgage and non-mortgage loans? Is this mix profitable? Is it safe?

Human Resources

- Are staffing/recruitment practices in line with the business needs of the credit union?
- What is the average education and experience level per employee within a job class?
- How many training hours per annum does the average employee receive?
- Are employees encouraged to improve their skills through training?
- What comments have been received regarding service quality from member questionnaires?
- Is a succession plan in place for key staff members?
- How does the ratio of salaries to average assets compare for the industry?
- What is the turnover ratio of employees per annum?
- What is the absenteeism rate of employees per annum?

Managerial Performance

- Is the general manager/chief executive officer (CEO) evaluated annually relative to predetermined performance objectives?
- Did the general manager/CEO meet predetermined performance objectives?
- Did the general manger/CEO ensure the credit union's compliance with regulatory requirements and board policy?
- Does the general manager/CEO keep the board well informed of operations?
- Did the general manager/CEO provide the board with a report on the general level of staff competency?

Schedule 1.2 (continued)
ASSESSING THE INTERNAL ENVIRONMENT

Member Composition

- Is the bond of association closed or open? Can membership be expanded? Can new share capital be obtained?
- What are the membership demographics (i.e. employment, age, family size, ethnic background)? Are needs for financial services growing or declining? For which services?
- What potential exists for cross selling services to existing members?
- What percentage of members use the ser-vices of other financial institutions? Can members be convinced to transfer these services?
- Do members have high service expectations?
- Are members actively involved in promoting the organization to the community?

Facilities/Technology

- Are branches conveniently located? Are all branches profitable?
- Does the organization rent or own premises? Is this the most cost effective choice?
- Does the credit union have computer facilities?
- Will these facilities meet anticipated technology needs for the next three to five years? Will they meet the needs for future products?
- Has the credit union explored new technologies? Does it offer banking via ATMs, telephone, or computer?
- Can network services and EFT/POS be made available to members if required?
- Has the credit union explored opportunities to cooperate with other organizations or credit unions to improve service or reduce costs, e.g. shared processing, networking, back-ending?

New Products/Marketing

- Are products competitively priced and profitable?
- Does the credit union offer unique ser-vices that competitors do not?
- Does the credit union perform annual market and product research to improve its reputation within the community?
- Are promotional offers made periodically?
- What is the cost/price structure of products?

Sound Business and Financial Practices

- How did the credit union perform on its assessment of compliance to DICO By-law No. 5?.
- Were any practices identified which require improvement?

Historical Trend Analysis

Another tool to assess internal resources is the use of trend analysis. Trend analysis involves analyzing past data to establish predictions about future performance. Assumptions about future performance can greatly improve the planning process. The level of analysis should be cost effective and appropriate to the size and complexity of the operations of the credit union.

Trend analysis of key balance sheet and income statement items is useful in assessing an organization's financial strengths and weaknesses. It is recommended that on annual basis management present trend analysis to the board as input for the directional plan, and for later consideration by the board and management in the strategic plan. When analyzing past data, credit unions should review at least three to five years of financial data in order to identify trends on deposits, loans, share capital, operating expenses, impaired loans, etc.

Two types of trend analysis should be performed on the financial statements: these are generally known as ratio analysis and historical trend analysis. Ratio analysis (or common sizing) consists of calculating ratios of balance sheet items or income statement items to average total assets. This technique reduces all financial statement items that are being analyzed to a common denominator.

Ratio Analysis

Ratio analysis of income statement items in relation to total revenue (as opposed to average assets) is not recommended due to the fluctuation in revenue caused by interest rates. Operating expenses, as a percentage of total revenue, for example, will fall when interest rates rise. The ratio makes it appear that relative operating costs are declining when in fact just the opposite may be happening.

Historical Trend Analysis

Historical trend analysis consists of measuring the percentage increase or decrease in key balance sheet and income statement amounts from year to year in order to determine growth trends and to explain the inter-relation of financial variables. This can be done by comparing the ratios of balance sheet and income statement items (discussed above) for different years.

Finally, the data must be reviewed to draw the correct conclusions. For example, where financial trends are deteriorating, the board and management should list these as organizational weaknesses, and devise strategies to stabilize or "turn around" identified problem situations. For examples of ratio analysis and historical trend analysis, refer to Schedules 1.3, 1.4 and 1.5.

Schedule 1.3
SAMPLE RATIO ANALYSIS - BALANCE SHEET

ASSETS	**Balance $000's**	**Mix (as a % of Assets)**	**Income/ Expense $000's**	**Yield/Cost**
Cash & Deposits	$260	0.97%	$6	2.31%
Securities (w/100 day or less maturity)	4,000	14.85%	120	3.00%
Other Investments	1,000	3.71%	37	3.70%
Loans:				
Personal	10,100	37.49%	1045	10.35%
Residential Mortgage	10,000	37.12%	650	6.50%
Commercial	1300	4.83%	84	6.46%
Institutional	143	0.53%	13	9.09%
Unincorporated Assoc.	0	0.00%	0	0%
Agricultural	33	0.12%	3	9.09%
less Allowances	96	0.36%		
Total Loans	**21,480**	**79.73%**	**1796**	**8.36%**
Capital (Fixed) Assets	53	0.20%		
Intangible Assets	0	0.00%		
Other Assets	147	0.55%		
Total Assets	**26,940**	**1%**		
LIABILITIES				
Deposits:				
Demand	8,917	33.1	83.6	0.94%
Term	8,060	29.92	302.7	3.76%
Registered plans	7,522	27.92	310.7	4.13%
Dividend bearing	2	0.01	0	0%
Other	0	0	0	0%
Total Deposits	**24,501**	**90.95**	**697**	**2.84%**
Total Borrowings	614	2.28	17	2.77%
Other Liabilities	326	1.21	0	0%
Total Liabilities	**25,441**	**94**		
EQUITY				
Membership Shares	1,190	4.42	0	0%
Retained Earnings	1,756	6.52	0	0%
Risk Capital	239	0.89	23	9.62%
TOTAL LIABILITIES & EQUITY	**26,940**	**100%**		

Schedule Instructions
The balance at the fiscal year end should be entered in the balance column. The balance as a percentage of total assets should be entered in the mix column. The income/expense related to the individual asset/liability should be entered in the income/expense column. The income/expense as a per cent of the average individual asset/liability is entered in the yield column. For example, $650 income on residential mortgages was earned on residential mortgages of $10,000 for a yield of 6.5%.

Schedule 1.4 *SAMPLE RATIO ANALYSIS - INCOME STATEMENT*		
Total Assets = $26,940,000	**Amount ($000's)**	**% of average assets**
Loan Interest Income	$1,796	6.67%
Investment Income	164	0.61%
Total Interest And Investment Income	1,960	7.28%
less: Interest Expense on Deposits	748	2.78%
less: Other interest expense and dividends	18	0.07%
Financial Margin	1,194	4.43%
less: Loan Costs	48	0.18%
Other (Non-interest) Income	196	0.73%
Gross Margin	1,342	4.98%
Salaries and Benefits	576	2.14%
Occupancy	64	0.24%
Computer, office equipment	30	0.11%
Administration	244	0.91%
Other	150	0.56%
Total Operating Expenses	1,064	3.95%
Non-recurring Gains/(Losses)	0	0.00%
Extraordinary Gains/(Losses)	0	0.00%
Net Income Before Income Tax	278	1.03%
less: Income Taxes	92	0.34%
Net Income (Return On Assets)	186	0.69%

Schedule 1.5 *SAMPLE HISTORICAL TREND ANALYSIS* *($ 000's)*					
	Period Ending	**Period Ending**	**Period Ending**	**Period Ending**	**Period Ending**
BALANCE SHEET RATIOS					
Total Assets	$29,349	$27,686	$27,145	$27,281	$26,940
% growth over previous year	-3.3%	-5.7%	-2.0%	0.5%	-1.2%
Loans	$23,184	$23,519	$22,981	$22,141	$21,479
% growth over previous year	-1.5%	1.4%	-2.3%	-3.7%	-3.0%
Allowance for doubtful loans	$86,000	$89,000	$76,942	$79,942	$96,774
% growth over previous year	3.6%	3.5%	-13.5%	3.9%	21.1%
Deposits	$27,115	$25,448	$24,941	$24,878	$24,501
% growth over previous year	-3.2%	-6.1%	-2.0%	-0.3%	-1.5%
External borrowings	$591	$554	$429	$544	$614
% growth over previous year	-15.0%	-6.3%	-22.6%	26.8%	12.9%
Membership Shares	$1,029	$1,185	$1,214	$1,202	$1,190
% growth over previous year	-1.2%	15.2%	2.4%	-1.0%	-1.0%
INCOME SHEET RATIOS					
Interest and investment income	$1,638	$1,750	$1,826	$1,894	$1,959
% growth over previous year	4.8%	6.8%	4.3%	3.7%	3.4%
Financial Margin	$1,080	$1,100	$1,165	$1,241	$1,245
% growth over previous year	3.3%	1.9%	5.9%	6.5%	0.3%
Fee and other income	$167	$141	$199	$152	$197
% growth over previous year	10.6%	-15.6%	41.1%	-23.6%	29.6%
Gross Margin	$1,240	$1,299	$1,328	$1,345	$1,342
% growth over previous year	2.3%	4.8%	2.2%	1.3%	-0.2%
Total Non-interest expenses	$993	$1,049	$1,075	$1,085	$1,063
% growth over previous year	0.8%	5.6%	2.5%	0.9%	-2.0%
Net Income/(Loss) after taxes	$247	$250	$253	$260	$279
% growth over previous year	3.0%	1.2%	1.2%	2.8%	7.3%

Identifying Long Term Objectives

By this stage, the board, with management's assistance, has documented the following:

- A mission statement.
- A brief summary of the credit union's external environment: immediate and long-term opportunities or threats facing the credit union.

- A brief summary of the credit union's internal resources: strengths and weaknesses of the credit union
- Conclusions based on historical trend analysis.

With these in place, the board and management are ready to establish the major strategic objectives for the credit union in the upcoming years. The objectives of the credit union should include some or all of the following:

- Actions that must be taken to meet the credit union's mission statement.
- Opportunities identified in the environmental analysis, which if exploited, can achieve the purposes set out in the credit union's mission statement.
- Actions to address the significant threats identified in the environmental analysis.
- Actions to address the significant weaknesses identified in the assessment of internal resources.

This analysis can be conducted by comparing the interaction between strengths and weaknesses on the one hand, and opportunities and threats on the other. Schedule 1.6 outlines examples of objectives and possible strategies that may be elected under positive and negative scenarios when a credit union faces a variety of internal weaknesses. The board should prepare a list of the long term objectives it has identified, and meet with management to discuss them.

Schedule 1.6
SAMPLE ANALYSIS OF LONG TERM OBJECTIVES

Strength, Weakness Opportunity or Threat	**Contributing Factor**	**Priority/Objective**
Forecast demand for loans is high due to economic boom	Low level of equity limits growth	**Increase equity**
New geographic market has opened	Lack of trained personnel to undertake expansion	**Expand staff**
Deposit base is growing rapidly	Membership is aging and does not require loans	**Focus on asset growth**
Shrinking profit margin	Interest rate compression	**Increase fee and commission income**
Rising interest rate trend	Excess fixed rate loans	**Close interest rate gap**
Competitors are increasing promotional offers and luring away members' business	Net income is too low to offer promotions	**Refocus marketing efforts**
Economic downturn forecast	High risk loans	**Improve asset quality and collection practices**

The next step will be to identify objectives and priorities for the upcoming fiscal year. Management will then investigate strategies, options and action plans to achieve the priorities and objectives, and present these to the board for final approval. This step is discussed in greater detail in Section 1300 on the Annual Business Plan.

Annual Business Plan

There are numerous approaches for developing an annual business plan, as well as a variety of different elements to be included in a plan. It is recommended that at a minimum, the following basic elements be included in the credit union's business plan:

- Priorities and Objectives for the Year
- A Strategic Financial Plan which addresses all operational areas:
  - Profitability
  - Capital
  - Credit
  - Investments
  - Asset/Liability Management)
  - Liquidity
- Product Offering Plan, Marketing Plan and Human Resources Plan
- Operational Budget, which incorporates all of the above.

Board and management can tailor these elements to fit the circumstances of their credit union. However, all of these elements should be present in one form or another when developing the business plan. **The plan should be appropriate for the size and complexity of the operations of the credit union.**

Strategic Financial Plan

Directional Planning → Strategic Planning → Tactical Planning

As part of the annual planning process, management should develop a strategic financial plan which will address the current year's priorities and objectives identified by the board. The strategic financial plan should include:

- strategies and action plans to address each priority and objective identified by the board;
- financial targets for each operational area.

Strategies and Action Plans

Developing strategies and action plans involves the following management tasks:

- Investigate and develop strategic options to address each priority/objective (see the sample strategies provided in Schedule 1.7).
- Where necessary, analyze and select the best option to reach each objective.
- Document detail of the final strategies in action plans.

If the board has not already done so, management should develop one or several strategies to achieve each priority/objective identified by the board.
It is recommended that some form of analysis be conducted to determine the merit and benefit of each strategic alternative or option. Such analysis should take into account both qualitative and quantitative factors. Techniques for quantitatively comparing strategic options include:

- cost/benefit analysis;
- contribution to profit;
- positive cash flows analysis;
- internal rate of return analysis.

Finally, the selected strategies should be documented in action plans, setting out sufficient detail to assist in the development of budgets and specifying the necessary actions to be taken to implement the strategy.

Schedule 1.7
SAMPLE ANALYSIS OF STRATEGIES

Priority/Objective	**Strategies**
Increase equity	• Limit dividends • Offer non-membership shares (risk capital)
Expand staff	• Form joint venture with credit union in the area • Recruit staff
Asset growth	• Broaden membership base/bond of association
Close interest rate gap	• Promote asset/liability pricing & matching (See Chapter 7)
Improve marketing efforts	• Offer promotions only on higher yield products • Introduce new products
Improve non-interest income	• Introduce reasonable and competitive fees and commissions
Improve asset quality	• Cease offering higher risk loans • Increase monitoring of loans and strengthen security requirements

Key Financial Targets and Plans

DICO By-law No. 5 identifies five areas of financial planning:

- Capital Management
- Credit Risk Management
- Market Risk Management (Investments)
- Structural Risk Management (Asset/Liability Management)
- Liquidity Risk Management

Establishment of key financial targets for each of these areas of operational risk should be undertaken annually by management and the board as part of its planning process. Key financial targets are the financial goals critical to each area of operations, and it is essential that these are addressed in the Strategic Financial Plan. For instance, for capital management, the key financial targets are capital level and return on earnings.

The setting of these performance targets should reflect the priorities and objectives for the year established by the board as part of this planning process, and the strategies and actions plans developed by management. The following factors should also be considered when establishing desired goals for key financial performance areas:

- minimum regulatory requirements;
- competitor results;
- actual results of the industry and peer groups;
- the credit union's previous performance and future outlook.

Management should also develop plans or tactics to reach these targets, in a similar fashion used when developing plans to meet the objectives and priorities of the credit union (Refer to "Strategies and Action Plans" found at the beginning of this section). The comprehensiveness of these plans should depend on the complexity of the strategy needed to meet the target, and on the resources available to the credit union.

Monitoring Financial Performance and Risk

The business plan assists the credit union by providing one of the basis against which performance can be measured and monitored. Financial performance can be monitored by comparing actual performance results to the performance targets established by this process. This is discussed in more depth in each of the five operational chapters (refer to Sections 4400, 5400, 6400, 7400 and 8400 on Risk Measurement and Board Reporting).

Schedule 1.8 *KEY FINANCIAL TARGETS* *FOR THE PERIOD ENDING ______*		
Profitability & Capital:	**Target**	**Actual**[1]
Net income		
Projected year end capital		
Credit:		
Loan volume, by loan category		
Loan portfolio mix, by loan category[2]		
Loan yields, by loan category		
Loan delinquency, by loan category[2]		
Loan impairment, by loan category[2]		
Investments:		
Volume by investment category		
Investment portfolio mix		
Return on investments, by category[2]		
Asset/Liability Management:		
Balance sheet mix, by category[2]		
Asset growth		
Liability growth		
Capital growth		
Financial margin		
Liquidity:		
Volume of liquid assets		
Planned excess liquidity		
Volume of borrowings for liquidity purposes		
Return on liquid funds		
[1] To be measured regularly throughout the year. [2] Add a row for each separate category.		

Finalizing the Strategic Financial Plan

Before finalizing the strategic financial plan, management may want to report back to the board for approval of their strategies, action plans and financial targets.

After approval is received, action plans and financial targets can be compiled to form the strategic financial plan. The plan can then be used to:

- prepare the product offering, marketing and human resources plans;
- prepare the operational budget;
- implement strategies throughout the year.

Tactical Plans

The tactical plans are the end product of the planning process. They incorporate the information gathered and analyzed throughout the first two stages of the planning process. This includes the objectives and priorities for the year and the strategic financial plan (selected strategies, action plans and financial targets) established in the strategic planning phase identified earlier in this chapter.

Tactical plans are important because they are used as the guides for implementing the annual business plan, and as the basis with which to measure the credit union's success in meeting that plan.

The recommended tactical plans are as follows:

- the product offering plan;
- the marketing plan;
- the human resources plan;
- the operational budget.

Management will need to review the strategies, action plans and financial targets developed during the strategic planning phase when developing the tactical plans.

Product Plan

One of the most frequent issues to be examined in the annual planning process is the adequacy of current products, services and facilities. The fundamental criteria for determining a credit union's need for new products are member demand and profit contribution. The following provides an overview of the recommended approach to investigating the viability of additional products.

Each year, the board and management should investigate opportunities for broadening the credit union's lending, cash management and other products and services. Recommendations derived from such investigations should be summarized in the Product Plan. Use of member questionnaires is an important determinant of what products members want. Refer to Schedule 1.9 for a sample list of products that may be offered by credit unions.

Schedule 1.9
CREDIT UNION PRODUCT SCHEDULE

Lending Products	Cash Management Services	Other Services
• Mortgages o months o variable o fixed • Consumer Loans o Demand o Term • Commercial Loans o Term o Mortgages • Agricultural Loans • Lines of Credit	• Chequing Accounts • Deposit Accounts • T-Bill Accounts • OHOSP's • RRSP's, RRIF's, Annuities* • Foreign Exchange Accounts • Payroll Services • Money Orders • Travelers' Cheques • Credit Cards, Debit Cards • Canada Savings Bonds • Mail Deposits	• Income Tax Planning • E-filing of tax returns • Wills and Estate Planning • Financial Planning • Mutual funds (appropriate staff licencing required) • Insurance products (e.g. travel, credit, life)* • Bill payment • Safety deposit boxes • ATM's, telephone banking, computer banking

* These products may be offered to members through an agency agreement with a trustee, an insurance company or a league.

In order to conclude whether new products are economically worthwhile, some form of financial analysis should be undertaken, such as contribution analysis. Contribution analysis quantifies the net benefit or profit contribution, if any, resulting from a new product. Schedule 1.10 provides a sample contribution analysis for a new lending product.

Schedule 1.10 *SAMPLE CONTRIBUTION ANALYSIS*	
Lending Product:	
3 YEAR FIXED RATE PERSONAL LOAN	
Contribution per $1,000:	
Interest income at 10%	$100
Interest expense on source of funds at 6%	(60)
0.5% bad debt expense (based on historic experience)	(5)
Income Contribution	$35
	or 3.5%
The analysis assumes that no additional costs are required for offering this product, i.e. additional staff need not be hired. If further costs are in fact incurred (i.e. promotional expense), these should be included in the product analysis. Depending on their nature, they may be fixed (improved computer facilities) or variable costs (part-time staff wages).	

Note that the example of variable cost analysis relating to a lending product is fairly simple - the profit contribution is the spread in interest rates less estimated bad debt expense. Since the contribution margin is positive, the credit union will earn a net benefit from three year fixed rate personal loans which will in turn contribute to overhead and profit. The product would be economically viable, assuming there is member demand for it and sufficient deposit funding. Conversely, if profit contribution were negative, management may wish to avoid offering the product.

In order to optimize overall earnings, the credit union should rank its products by profitability and maximize the sale volume of those products which have the highest profit contribution. During the year, funding costs may have to be increased in order to attract incremental funds with terms corresponding to desired loan maturities. Interim monitoring of profit contribution of products is recommended. Shifts from planned asset targets may be justified as a result of shifts in profitability, however, board approval for such changes is required. Deviations from asset targets may result in unacceptable changes to portfolio risk.

Other Income

Credit unions can supplement their income through the use of service fees and commissions. Where reasonably priced, fees and commissions represent a fair charge to members for services performed by the credit union and its staff, such as fees for obtaining reports of a land appraiser, or for maintaining a commercial account.

Schedule 1.11 illustrates sample lending fees that could be considered and implemented by the credit union. The use of any fees, and their levels, should be documented in operational procedures.

Schedule 1.11
LIST OF SAMPLE LENDING FEES

For Mortgage and Consumer Loans

Application Fee - This fee covers the administration costs of establishing a loan. It is usually collected at the time the application is received. A portion of it may be refundable if the loan is not approved.

Appraisal Fee - This fee covers the cost of obtaining the report of a qualified real estate appraiser.

Legal Fees - These fees cover lawyer services to prepare loan and security documents plus out-of-pocket expenses covering title searches, registration and land transfer tax.

PPSA Registration Fees - These fees cover the cost of registering security under the Personal Property Security Act.

Member Pay Loan Insurance Fees - These fees cover the cost of member loan insurance which protects the credit union from loan default due to member death or disability.

For Commercial/Agricultural Loans

Application and Appraisal Fees - see above definitions.

Commitment Fee - This is an additional fee that is collected up front from a prospective borrower, which is not refundable if the borrower refuses the loan offer.

Fees for Letter of Credit or Guarantee - This fee (usually 1% to 3%) is applied to the face value of a letter of credit or a letter of guarantee issued by the credit union on behalf of a member.

Legal and PPSA Registration Fees - see above definitions.

Standby Fee - This fee is charged as a percentage of the unused portion of a credit facility which is available for drawing during a given period.

Account Maintenance Fee - This fee is charged monthly on the current account for services to commercial/ business clients, to compensate for administration and monitoring costs.

Marketing Plan

Marketing Tools

In order for a credit union to undertake effective marketing and increase its membership penetration, it must identify and analyze key marketplace factors. This process begins by profiling the market and the members. Once this has been completed, a long term marketing plan can be assembled.

Market Profile

The total market profile is evaluated by answering the following questions:

- What is the size of potential membership (assuming an open bond of association)? What is the market share for the credit union?
- Who is the competition and what are their success factors?
- What are the demographic characteristics of the market?
- Is the market growing or declining?
- Are other major changes expected in the marketplace? What and when?

In determining the size of the local market and the profile of competitors, the following participants should be considered: banks, trust companies, consumer finance companies, insurance companies, credit card companies and money market funds. Refer to Schedule 1.12 for a list of factors that should be researched on these competitors in order to determine their marketing advantages.

Schedule 1.12 *DATA FOR COMPETITOR PROFILE*	
• Size and image	• Hours of operations
• Financial condition	• Credit standards
• Location of main office and branches	• Quality of services
• Market segments served	• Price of services
• Market share	• Range of services
• Technology	• Advertising
• Automated teller machines	• Promotional efforts
• Telephone banking	• Major accounts
	• Debit cards

Member Profiling

Profiling the membership should begin by asking the following questions:

- How do we better serve our members?
- What services or products do our members needs?

In order to determine if and why members are taking any of their financial service requirements elsewhere, it is recommended that member surveys be conducted. Alternatively, professional marketing assistance may be obtained from leagues or other outside sources, to devise marketing surveys and provide objective analysis of results.

Market research should be conducted annually. Member surveys and/or focus group sessions are recommended in order for credit unions to stay in touch with their members and remain member driven. Where appropriate, promotional incentives should be offered to members to ensure completion of these surveys. Member profile by age, profession, income and other variables should also be obtained from these surveys, in order to assess demand for loans and cash management products by demographic group.

A significant marketing challenge for each credit union is to attract younger members who are net borrowers, while retaining members in the 50 and over age bracket who are net depositors. Marketing strategies should aim at promoting and advertising those services that are access points for younger members. The basic deposit and chequing accounts are important key access products. Recruitment/welcoming letters to young members and encouraging opportunities to participate on the credit union's committees is recommended. Additionally, support may be donated to local community youth activities.

Use of Membership Data

Information obtained through membership surveys, or collected through the credit union's management information system, can be used effectively for target marketing purposes. Refer to Schedule 1.13 for sample member data that could be reviewed for marketing applications

Schedule 1.13 ***SAMPLE MARKETING APPLICATIONS OF MEMBERSHIP DATA***	
Membership Data	**Possible Application**
Addresses of members that have a similar postal code	Indicates potential demand for new branch location
Members with savings over a certain dollar amount	Indicates potential opportunity for new investment instruments
Demographic data; i.e. age and income of members	Target product offerings: RRSP deposits, loan products (e.g. student loans) etc.

Marketing Strategies

After management has assessed the credit union's market and its members, appropriate strategies should be documented in a marketing plan that covers at minimum one year, but where possible greater time spans, such as three to five years. There are four major elements of a marketing strategy that should be addressed in the marketing plan: products, price, promotion and place.

As noted in the preceding Section, products should be analyzed in terms of their contribution margin before they are offered to members. The pricing of products should be competitive (i.e. in line with local pricing). If a product is economically viable, management should plan to promote it through advertising (billboards, radio, mail, telemarketing, etc.) or special promotional events (i.e. gifts, draws, etc.) as required. Promotional and advertising costs should be included in the product profit contribution analysis.

The place of business is a major concept in market planning. No longer limited to location of the branch, the place of business has been expanded through technology to include use and location of automated teller machines, telephone banking, the Internet and the acceptance of debit and credit cards by merchants. Management should therefore be guided by the memberships' requirements as to access of service and products. This can best be determined through the use of customer surveys, and a review of the technology presently available to financial institutions. If and when new technology is introduced to a credit union, it is recommended that members be informed in advance as to how these changes are in their best interest.

Post Marketing Strategies

In order to foster membership confidence and loyalty, it is recommended that marketing strategies be designed for more than just attracting members to buy a particular product or service. Marketing efforts should also provide for service and support to members beyond the point of sale. The following are some suggested practices for effective post marketing:

- Offer new member packages which contain basic information about the credit union and the movement in general. The welcoming package should explain the philosophical difference between banks and credit unions; i.e. the principles of economic democracy, accessible management and contribution to the local economy. The importance of membership capital and patron-age should be communicated.
- Arrange new member meetings which introduce staff and permit questions to be answered personally.
- Use telemarketing for follow up of new and/or existing members' needs.
- Mail congratulatory letters to members regarding a new product purchased.
- Circulate a regular newsletter which updates the member on new services/products, the outcome of member surveys, recent activities of the board and general members, including coverage of the annual meeting.
- Organize social and interest group meetings which may host a feature speaker on a relevant community or personal finance topic.
- Establish information display tables and suggestion boxes.
- Ensure there is an inviting social atmosphere for general meetings.
- Establish membership awards for years of patronage or committee contributions.

Human Resources Plan

Management should develop a plan to ensure the credit union has the necessary human resources to carry out its strategies identified in the strategic financial plan. The human resources plan will therefore need to do the following:

- Analyze the sufficiency of current human resources (see Schedule 1.14), and note any necessary changes.
- Summarizes human resource requirements, given the strategies and action plans developed by management and approved by the board.
- Based on the changes in human resource requirements, establish a human resources budget (the budget should provide detail about salaries, either by individual, or by department, and should also include other related costs, such as training, bonuses, benefits, etc.).
- If new staff is required, set dates and responsibilities for the recruiting of additional resources; arrange any necessary training.
- A specified date for the annual review of the general manager of the credit union.
- Where appropriate, a specified date for submission to the board of a report on the general quality, competency and experience of employees, by area of operational responsibility, to be prepared by the general manager.

Schedule 1.14 ***ASSESSING SUFFICIENCY OF CURRENT HUMAN RESOURCES***
• Are staffing/recruitment practices in line with the business needs of the credit union?
• How does the ratio of salaries to average assets compare for the peer group? For the industry?
• What is the turnover ratio of employees per annum?
• What is the absenteeism rate of employees per annum?
• What is the average education and experience level per employee within a job class?
• How many training hours per annum does the average employee receive?
• What comments have been received regarding service quality from member questionnaires?
• Is a succession plan in place for key staff members?

The human resources plan can also provide guidance in other areas, such as:

- committee appointments and committee member training;
- management training needs;
- succession planning (for staff, management, the board and committees).

Succession Planning

In order to ensure that appropriate expertise and knowledge is maintained, it is important to plan for an orderly development and transfer of necessary skills and knowledge of key employees.

Succession planning is a key element of human resource planning. The objectives of succession planning include:

- identifying and maintaining key skills and core competencies
- identifying potential succession candidates
- ensuring the orderly transfer of critical knowledge as a result of staff turnover

A succession plan should include consideration of such issues as:

- anticipated evolution of the business environment
- identified requirements established in the business plan
- key skills and competencies that need to be retained and expanded
- identification of additional skills and competencies that need to be developed
- demographics of staff including expected staff retirements
- Personal development plans for succession candidates

The succession plan should be completed annually in conjunction with the annual business planning process. A summary of the plan should be submitted to the board or designated boar committee.

Succession Planning: Emergency Situations

A succession plan should also be developed for emergency situations such as the unexpected unavailability of the general manager and other key personnel. The plan should address the process and actions, including the appointment or assignment of interim personnel, to be taken in defined circumstances.

Operational Budget

Preparation of the operational budget is the last step in the planning process. The operational budget is a one year document, which authorizes specific expenditures and projects in the upcoming fiscal period. The budget also outlines in detail the expected financial impact of planned activities, and should reflect the credit union's priorities and objectives, as expressed in the strategic financial plan prepared by management. The operational budget should be prepared by management for the board's review and approval one or two months before fiscal year end. The recommended components of the operational budget include:

- forecast balance sheet;
- forecast income statement;
- forecast schedule of reserves;
- forecast asset/liability matching (gap) report;
- monthly cash flow forecasts.

Monthly Forecasts

It is recommend that these components be forecast on a monthly basis, so that management and the board can compare actual results against the projected results on a monthly basis. The operational budget should also incorporate several sub-budgets, where applicable, including:

- the lending and deposits budget;
- the marketing budget;
- the personnel budget;
- the capital expenditures budget.

Larger Operations

Where applicable, the general manager/CEO should delegate preparation of the sub-budgets to the senior staff members responsible for lending, human resources, marketing and capital expenditures. These staff members should be briefed on the priorities and objectives, and strategic plans of the credit union. In order to ensure that various departments develop sub-budgets which adhere to the goals of the general budget, a preliminary master budget, or operational targets, may be presented by the general manager to the various departments to steer the detailed planning process. The preliminary master budget for example would reflect expected minimum growth in deposits or a desired gross interest margin, sufficient to cover operating costs and to build required reserves. Additionally, a specific return on assets figure may be targeted. This "bottom-up" process of planning revenues and expenses is recommended for all credit unions which must focus on earnings as a method of guaranteeing their economic viability. Normally, it is the general manager who would finalize and integrate the sub-budgets into the master budget. Where there are branch operations, each branch should submit a separate budget to the general manager for consolidation. Management must ensure that the general budget presented to the board is consistent with the objectives and strategic plans of the credit union, as far as practically possible. In order to achieve such consistency, a number of reviews and further revisions of the sub-budgets may be required.

Smaller Operations

For smaller or less complex credit unions which do not have senior staff to complete the sub-budgets, the general manager should prepare sufficiently detailed support schedules on planned lending/deposits, marketing, personnel and capital expenditures.

Board Approval

While it is management who prepares the business plan, it is the board who must approve it, after having an opportunity to discuss the business plan with management. The board should ensure that the business plan implements the objectives and strategic plans of the credit union, and that it is realistic in its assumptions.

When reviewing the business plan, the board should consider:

- the plan's compatibility to meeting the needs of the membership in services, interest rates, and equity;
- the plan's contribution to the credit union's longer term objectives (e.g. higher reserves, increased profitability, etc.);
- the realism of the business plan and the operational budget in light of the historical financial record of the credit union and the present economic climate.

Once the business plan has been approved by the board, it should be entered into the board's minutes.

Business Plan Revisions

Events during the year may necessitate the need for business plan revisions, or changes to specific elements, such as the operational budget. Significant amendment to either require:

- a comprehensive report detailing reasons for the change;
- revised estimates for the balance of the fiscal year for the areas affected;
- revised long-term plans if applicable;
- approval by the board of directors

Governance

(Code of Conduct)

Executive Summary

A Code of Conduct documents the rules and policies that govern the business and ethical conduct of directors, committee members and staff (i.e. officers and employees). The scope of a Code of Conduct includes the individual legal duties of each director, committee member and staff member, as well as identifying unlawful or prohibited conduct.

The Code forms part of the credit union's board level policy. Therefore, its form and content must be reviewed and approved by the board. All directors, committee members and staff must be familiar with the contents of the Code, and agree to abide by its terms (preferably in writing).

It is important that ethical and lawful conduct be evidenced in all credit union practices, in order to protect the reputation and credibility of the organization and preserve community trust. Establishing a proper Code of Conduct is the first step in demonstrating such conduct.

Elements of a Code of Conduct

A Code of Conduct should address all important ethical issues and legal duties with respect to the behavior and conduct of individual directors, volunteers and staff members of the credit union. It should therefore address the following issues:

- general standard of care of directors and officers;
- compliance with all applicable laws;
- confidentiality;
- conflicts of interest;
- restricted party transactions;
- unethical conduct.

These elements are each discussed below in the materials which follow. A sample Code of Conduct is attached as an appendix to these materials.

The Code of Conduct, whether developed by management, the credit union's lawyers, or simply adopted from the Sample Policies, must be approved by the board.

As well, it must be communicated to all directors, committee members, and staff of the credit union. This involves two recommended activities:

- Require all new directors, committee members and staff to review the Code of Conduct, and sign a declaration of ethical conduct acknowledging its contents.
- Annually, require all directors, committee members and staff to review the Code of Conduct, and sign a declaration acknowledging its contents.

By signing a declaration, directors, committee members and staff acknowledge that they have read the Code, understood its contents, and agree to abide by its terms. It is important that they also be given the opportunity to review the Code of Conduct prior to signing the declaration, and be given the opportunity to raise questions on its significance with either an officer or staff member in charge of implementing the Code.

General Standard of Care

The general duty of care required of directors, officers and committee members of credit unions, is expressed in section 144(1) of the Credit Unions and Caisses Populaires Act, 1994 (the Act), which states the following:

> *"Every director, officer, and member of a committee established under this Act shall exercise the powers and discharge the duties of his or her office honestly, in good faith and in the best interests of the credit union."*

The standard to which this duty is to be held, is set out in section 144(2) of the Act:

> *"The director, officer or committee member shall exercise the degree of care, diligence and skill that a reasonably prudent person would exercise in comparable circumstances."*

It is possible that an individual with specialized knowledge, education or work experience may be expected to fulfill the duties of his or her office in a particularly skilled manner in meeting this standard of care. For example, a director who is by profession a qualified lawyer may be held to a higher standard that reflects the additional qualifications which that director has, by virtue of his or her professional credentials.

In order to mitigate against the risk of legal liability, the following practices are recommended to individuals holding senior positions in a credit union:

- Fully understand the scope of statutory and assigned authority and do not act beyond this scope.
- Keep informed of changes to DICO by-laws and provincial legislation and object immediately to incidents of contravention.
- Ensure that each action performed is in the best interest of the credit union, and is not for personal gain.
- Co-operate fully with FSCO and DICO in responding to their concerns, particularly on matters of statutory compliance and institutional risk.
- Keep abreast of legal actions taken against the credit union.
- Ensure controversial decisions involving conflict of interest are carefully documented.
- Review on-site verification reports, league reports and external auditors' reports to identify and correct operational weaknesses.
- Ensure that officers/employees are bondable, and may be relied upon.
- Ensure that sufficient access to material and resources is available to management and the board so that sound business and financial decisions can be made.
- Develop a common organizational view prior to making a public comment regarding controversial issues that concern the credit union.
- Obtain director's liability insurance.
- Ensure that all significant policy matters have been approved by the board and implemented by management in compliance with DICO By-law No. 5 and the Act.

Duty to Comply

The Act and Regulations

Directors, committee members, officers and employees have a duty to comply with the Act and Regulation 76/95. In this regard, they should obtain sufficient understanding of relevant legal duties and prohibitions under the Act and Regulation 76/95.

The following schedule summarizes some of the sections under the Act which prescribe duties and responsibilities for directors, committee members, and staff. Readers should refer to the Act and Regulations for a complete description of their duties and obligations.

Schedule 2.1 *SUMMARY OF IMPORTANT CORPORATE GOVERNANCE LEGISLATION*		
	Act	**Regulation 76/95**
Restriction on dividends	s. 67	
Qualification of directors	ss. 91 and 92	
Powers and duties of the board	ss. 104 to 108	
Executive committees	s. 109	
Duties of the credit committee	ss. 121 to 124	ss. 24 and 25
Duties of the audit committee	ss. 137 to 139	s. 26
Duty of confidentiality	ss. 142 and 143	
Duty of care	s.144	
Duty to comply	s.145	
Liability of directors	ss. 152 and 153	
Business powers	Part VIII	
Restricted party transactions	Part IX	Part X
Offences	Part XVII	

Non-Compliance

Non-compliance with the Act can carry serious consequences for directors and officers, especially where it represents an offence under the Act. Any director, officer or agent of a credit union who commits an offence under the Act, authorized, or acquiesced to the offence, is liable to severe penalties. Penalties prescribed in the Act include a maximum fine of $100,000 or maximum imprisonment for two years for a first offence.

In certain instances, directors, committee members and staff can be held jointly and severally liable to their credit union for their unlawful actions. Specifically, directors will be held jointly and severally responsible for losses resulting from their voting or consenting to the following unlawful resolutions:

- The sale of shares by directors, committee members or staff for consideration other than cash, contrary to section 59(1) of the Act.
- The issue of subordinated indebtedness contrary to section 186, for a consideration other than money (see section 153(1)).

- Illegal payments contrary to the Act, such as the redemption of shares or payment of a dividend where the credit union is insolvent, or where the redemption or payment would cause its insolvency (see section 153(2) for a complete list).
- Transactions with restricted parties, contrary to the Act and Regulations (see section 153(2)).
- Failure to divest of illegal investments, or illegal loans, upon an order by the Superintendent of Financial Services (see sections 237 and 238).

Other Acts and Common Law

The credit union, and its directors, committee members and officers, have responsibilities and duties under other Acts, and under the common law as well, including:

- The **Ontario Human Rights Code**, which deals with discrimination in the treatment of employees and in hiring.
- The **Employers Health Tax Act**, which requires the credit union to remit health taxes.
- The **Income Tax Act, Canada Pension Plan** and **Employment Insurance Act**, which require the credit union to remit income taxes and Canada Pension Plan and Employment Insurance premiums.
- The **Pay Equity Act,** which ensures that staff and officers receive equitable compensation.
- The Consumer Protection Actwhich sets out the disclosure requirements for borrowing costs for all credit arrangements
- The **Consumer Reporting Act,** which ensures that proper information is communicated to members about the credit union's products and services.
- The **Employment Standards Act**, which ensures that the credit union meets standards of fair employment.
- The **Bankruptcy and Insolvency Act**, which requires the credit union to observe the rights of debtors and creditors in dealing with the assets of a bankrupt individual, and provincial creditor protection legislation.
- The **Ontario Health and Safety Act**, which sets out employers' duties regarding the health and safety of employees within the workplace.
- **Employment case law**, which governs cases such as wrongful dismissal, or the lack of a proper notice period.
- The **Personal Protection and Electronics Documents Act (PIPEDA)** which requires the credit union to observe privacy legislation surrounding the collection, use and disclosure of personal information of its members and employees and information obtained in the normal course of business.
- The **Proceeds of Crime (Money Laundering) and Terrorist Financing Act** which requires the credit union to implement a compliance regime for identifying and reporting large and suspicious transactions.

For a complete list of relevant laws, credit unions should contact their lawyer.

Confidentiality

Statutory Duty

Rules of confidentiality are prescribed in section 142 and 143 of the Act. These rules extend to every director, committee member and officer of a credit union. The following schedule summarizes the subject matter of each rule under the Act. Readers should refer to the Act for a complete description of their duties regarding confidentiality.

Schedule 2.2 *SUMMARY OF CONFIDENTIALITY LEGISLATION*	
	The Act
Duty to keep information confidential.	Section 142(1)
Prohibition against the use of confidential information for an individual's benefit or advantage.	Section 142(2)
Specific duty of confidentiality regarding members' transactions.	Section 143(1)
Exceptions where information may be disclosed.	Section 143(2)

Sound Practices

Sound business and financial practices require that individuals hold in strict confidence all organizational and member transactions except as permitted under the Act, the applicable by-laws, or by compulsion of the law. In addition to the rules under the Act, the following materials provide guidance regarding the use of confidential information.

Confidentiality Agreements

Prior to assuming duties which include the right of access to member records, directors, committee members and staff should be required to sign a confidentiality agreement. This agreement is a written pledge of an individual to hold private matters in strict confidence. Refer to Appendix 2.1 for a sample Declaration of Ethical Conduct, which includes the requirement for confidentiality.

Protection of Records

Each credit union should establish administrative and physical controls to ensure the protection of records from unauthorized access or disclosure, and from physical damage or destruction. The controls instituted should be related to the degree of sensitivity of the records but at a minimum would ensure that:

- records are protected from public view;
- the area in which the records are stored is supervised during all business hours to prevent unauthorized persons from entering the area or obtaining access to the records.

Conduct of Employees

The general manager of each credit union should be responsible for ensuring that employees subject to his/her supervision are advised of the serious-ness of maintaining confidentiality. Employees should be made aware of their responsibilities to protect the security of personal information, to ensure its accuracy, relevance, and completeness, and to avoid unauthorized disclosure either orally or in writing. With respect to each record maintained by the credit union, employees of the credit union should:

- collect no information of a personal nature form individual sunless authorized to collect it to achieve a function (i.e. marketing activities, membership surveys) or to carry our a responsibility of the credit union;
- collect information, wherever possible and appropriate, directly from the individual to whom it relates;
- abstain from disseminating information concerning an individual's religious or political beliefs or activities, or his/her membership in associations or organizations.

Violations of Confidentiality

Violations of confidentiality which should not be practiced include the following:

- Providing (selling, lending or otherwise making available) to persons unauthorized, copies of the Register of Members or the membership mailing list.
- Indiscriminate discussions (i.e. gossip) about the transactions of a member, or the business affairs of the credit union, to persons not entitled to the information.
- Selection of unsuitable locations for board or committee meetings or employee discussions of confidential matters, such as public places (i.e. restaurants or elevators).
- Mailing confidential information to the business office of the recipients when the intact delivery of the confidential information is not assured.
- Reviewing confidential information in a manner which, due to neglect, lack of control, or carelessness, results in unauthorized persons also seeing this information (i.e. reading in public places or leaving confidential material unattended).
- Employing volunteers to assist in clerical duties of the credit union without instructing them on the rules of confidentiality.

Exceptions to Rules of Confidentiality

The following individuals have the right of access to confidential information from the credit union:

- the Superintendent of Financial Services;
- DICO or its agents, and the stabilization authority of the credit union;
- an affiliated league for examination purposes;
- duly appointed auditors or lawyers of the credit union, or a duly appointed liquidator;
- a member inspecting his or her own account.

Confidentiality of information regarding members is also qualified by:

- compulsion of the law;
- public duty to disclose;
- the necessary defence of the credit union.

Although they are not legally obligated to do so, credit unions are permitted under section 143(2) to provide confidential information to:

- an affiliated league providing consultation services;
- another financial institution in the course of conducting business which involves the use of confidential information;
- a credit grantor or reporting agency, if the information is on the member's credit worthiness.

Conflicts of Interest Rules

Each and every director, committee member, officer or employee has an obligation of loyalty to the credit union and must subordinate their personal interests when they conflict with or threaten to conflict with the best interests of the credit union.

Directors and officers hold positions of respect within their organization, and have been given the unique opportunity to serve, to counsel and to lead. By acceptance of their respective positions, they have assumed fiduciary, legal and moral responsibilities to conduct the affairs of their credit union for the best interests of the members at large, and to avoid conflicts of interest, real or implied.

Conflicts of interest rules are set out in the Act (see sections 146 to 149). The Code of Conduct must acknowledge these rules, and should also incorporate policies to safeguard against violation of them.

Disclosure

Generally, individuals must disclose the nature and extent of the benefit or consideration which they will derive, directly or indirect-ly (i.e. through a relative or associated company) as a result of such contract or transaction, to the extent that such information is within their knowledge or control. The duty of disclosure requires that the conflict of interest be revealed at the earliest possible time. The following schedule summarizes the subject matter of each rule under the Act. Readers should refer to the Act for a complete description of their duties regarding conflicts of interest.

Schedule 2.3 SUMMARY OF CONFLICTS OF INTEREST LEGISLATION	
	The Act
Disclosure of conflicts of interest	Section 146
Restrictions on voting rights for an interested party	Section 147
Avoidance	Section 148
Acting for the credit union	Section 149
Restricted party transactions (see also Part X of the Regulation 76/95)	Sections 207 to 210

It is recommended that the detailed particulars of a conflict of interest disclosure be recorded in the board minutes, for the protection of all directors, together with a record of the concerned individual absenting himself or herself from the discussion of the transaction.

If a conflict of interest is not disclosed by the relevant party, the contract or transaction may be set aside by the courts, upon application by a member or the credit union. Additionally, failure to declare a conflict of interest constitutes sufficient grounds for removal from office.

Restricted Party Transactions

With respect to restricted party transactions, full disclosure of material transactions should be recorded in the board's minutes and should be transacted in accordance with legislated restrictions.

(See sections 207 to 210 of the Act, Part X of Regulation 76/95, and FSCO Interpretative and Administrative Bulletin 1/96 (page 4)).

Capacity of Director

Under the Act, a director is prohibited from being a member of the credit committee. Directors (and committee members) are also prohibited from receiving compensation for providing professional services, such as legal, auditing or management services (see section 149 of the Act).

This does not preclude directors from receiving a nominal fee (usually called an honorarium) for their work and contribution to the credit union. This practice is common in smaller credit unions that are unable to afford management staff.

Where a director provides management or consulting services on a volunteer basis to the credit union, care should be taken to limit the extent of those services offered. The board provides an independent check on the affairs of management; as a result, these two functions should be performed by independent persons.

Director and Staff Loans

The board of directors should establish a policy which regulates the conditions under which the credit union's directors, committee members, officers and employees may be granted preferential loans or services.

Notwithstanding the preferential terms, loan qualification for directors, committee members and staff should be based on the normal financial tests and other criteria applied to arm's length borrowers and lending decisions should be in adherence to sound lending practices prescribed in Chapter 5 on Credit Management.

Whenever a director, committee member or staff loan is being approved, the individual's cumulative borrowings from the credit union, and from other sources must be disclosed to those authorizing the loan, as should any loan arrears to the credit union. Each director, committee member or officer loan which exceeds, or if granted would exceed, that member's total shares and deposits must without exception be approved by the board and the credit committee of the credit union (see section 208 of the Act, and FSCO Administrative and Interpretive Bulletin 1/96)).

Preferential rate loans to staff, if any, should be treated as part of the overall compensation package offered to employees, and not as gratuitous benefits additional to salaries. Financial statement disclosure of preferential rate loans to staff (i.e. with respect to related party transactions) should be made whenever a material income differential is attributable to these loans.

Other Conflicts

The purpose of identifying conflict of interest situations is to prevent the credit union from placing the interests of a few members ahead of the interests of all members. This general rule should be used by directors and officers to identify other situations of conflict not specified in this section, and to develop policies which reduce the risk that such situations pose.

To avoid conflicts of interest, directors, committee members, officers, and employees must do more than merely act within the law. They must conduct their affairs in such a manner that their performance will at all times bear public scrutiny. The appearance of conflict of interest as well as the conflict itself must be avoided.

Unethical Conduct

Other forms of unethical or inappropriate conduct which should be prohibited either in policy or directly in the Code of Conduct include:

- abuse of the personal privileges of office;
- secret commissions;
- inappropriate gifts;
- acts of slander and libel;
- nepotism;
- employee discrimination and harassment;
- criminal acts;
- reporting of questionable and fraudulent acts.

These are each discussed in turn below. Additional situations of unethical conduct, not specified above, may arise, and should be addressed systematically by the credit union through board policy.

Abuse of the Personal Privileges of Office

Reasonable limits should be established regarding the personal privilege which a director or officer of a credit union may exercise. Land, buildings, equipment, supplies and other materials leased or owned by the credit union are in existence for the purpose of dispensing member services, promoting the credit union, and to aid the staff in the performance of their duties. The conditions under which an officer may be allowed to use, loan, or remove property and possessions of the credit union for his personal benefit should be regulated so that the protection of property and the rights of general members are not over-looked.

Secret Commissions

A secret commission is the unauthorized receipt of a reward, advantage or benefit of any kind by a director, officer, employee or committee member in return for favoured treatment by the credit union. Demanding, accepting, offering or agreeing to accept a secret commission is a criminal offence, punishable by imprisonment. The acceptance of a secret commission is also a violation of fiduciary obligations owed to the credit union, the breach of which may result in the loss of all sums wrongfully received and liability for punitive damages.

Credit unions should adopt a policy prohibiting the direct or indirect receipt of any reward, advantage or benefit by any employee, officer, director or committee member from suppliers or customers doing business with the credit union. Policy should require staff to notify their superior in writing if they have been offered a reward, advantage or benefit; the notification should be shared with the board of directors for consideration of further action to be taken.

Accepting Gifts

No director, committee member, officer, or employee should accept any gift, hospitality or favour offered or tendered by virtue of the official's position with the credit union, where the gift, hospitality or favour possesses any one of the following characteristics:

- is in the substance or form such that an impartial observer would construe it to be an improper incentive;
- places the official under an actual or implied obligation;

- has a value equivalent to or greater than a dollar amount established by the board (e.g. $100);
- is in the form of cash or cash equivalent.

Where it is deemed that small tokens of appreciation (e.g. a box of chocolates) may be given to employees by members/suppliers, as a gesture of goodwill, a dollar limit to these token gifts should be prescribed in the written policies of the credit union.

Public Officials

When dealing with public officials whose responsibilities include the business of credit unions, acts of hospitality should be of such a scale and nature so as to avoid compromising the integrity or reputation of either the public official or the credit union. Such acts of hospitality should be undertaken in the expectation that they could well become a matter of general knowledge and public record.

Acts of Slander and Libel

Any actions which resemble slander (spoken defamation) or libel (written defamation) of members or competitors of a credit union should be prohibited. Defamation consists of unjustified injury of reputation. Spoken statements reflecting adversely on a member or a competitor's honesty, solvency, ambition or concern for public welfare constitute slander. Similarly, written advertising statements which reflect negatively on the quality of a competitor's products or services constitute libel. No legal liability arises from "puffery", i.e. exaggerated statements such as "our product is best"; however, direct and unsubstantiated criticism launched against a competitor is a legal offence.

Nepotism

Nepotism and anti-nepotism, is defined as favouritism or prejudice shown to a relative, generally in connection with providing employment. Only objective criteria, such as skill and performance, should be used in hiring and advancement decisions. One approach to facilitating objectivity is the establishment of an interview panel consisting of one management representative and a minimum of two directors who are not related to the employment candidate. This same panel should interview all candidates competing for the same position. It is advisable that related persons (including those in a common law relationship) not be placed in a supervisory/subordinate reporting relationship.

Employee Discrimination and Harassment

In accordance with the Ontario Human Rights Code, a credit union must not engage in any employee discrimination on the basis of the following: race, ancestry, religion, place of origin, colour, ethnic origin, citizenship, creed, sex, sexual orientation, age, marital status, family status, or disability. The right to be free from discrimination in employment is not confined to the hiring stage, but extends to all aspects of the employment relationship, including employment testing, on-the-job training, working conditions, transfers and promotions. Only objective criteria, such as skill and performance, should be used when making hiring and advancement decisions regarding employees. Credit unions recruiting new employees should not include any questions on their employment application forms which seek to classify individuals according to any of the prohibited discriminatory categories.

Harassment in the workplace, whether it be sexual, racial, directed against the disabled, or on some other prohibited ground, should be a matter of concern for management. In most instances, an employer will be held liable for the harassment of his or her employees by other employees. In order to reduce the likelihood of harassment, a credit union should adopt a formal policy and publicize its contents to all employees. The policy should identify behaviour which constitutes harassment. A complaint procedure should be set out indicating where, harassment complaints should be addressed (usually a member of management), and the disciplinary action which will result if any employee is found to have harassed another person.

Criminal Acts

Criminal acts committed by directors, committee members or staff represent sufficient grounds for immediate termination; however, management should obtain legal advice or consult its league prior to confronting the suspect and seeking restitution. Criminal activity can includes acts such as secret commissions, extortion, embezzlement, fraud, false presence (e.g. cheque kiting), forgery or theft. All criminal acts must be reported to the police. It is recommended such acts also be reported to the audit committee, the Superintendent of Financial Services, and the appropriate bonding company, where that officer or staff member is bonded.

The Reporting of Questionable or Fraudulent Actions

It is the responsibility of directors, officers, employees and committee members to report their awareness of any situation which might adversely affect the reputation of the credit union. This would include any questionable, fraudulent or illegal events or material actions in violation of credit union policy which comes to their attention. If such events involve employees, the matter should be reported to the appropriate senior employee/officer, who in turn should report the matter to the audit committee. If the matter involves the general manager, directors or committee members, the matter should be reported to the audit committee. The audit committee should always be informed of questionable, fraudulent or criminal acts. The committee must report all such acts, as well as any violations of the Act, Regulation 76/95 and the by-laws to the Superintendent of Financial Services (see section 138 of the Act).

Every director, officer, employee or volunteer is expected to comply promptly with any request from internal and/or external auditors for assistance and to provide full disclosure of any situation under investigation.

Appendix 2.1: Sample Code of Conduct

Purpose

The purpose of this Code of Conduct is to establish the rules governing the business and ethical conduct of the directors, officers, employees and volunteers of ABC Credit Union Limited. It is important that ethical and lawful conduct be evidenced in all business practices, in order to protect the reputation of the organization and preserve community trust. The board has adopted this policy and the board shall review this policy annually.

General Duties of Care

Each director, officer, employee or volunteer of the credit union shall exercise the power and discharge the duties of his/her office honestly, in good faith, and in the best interests of the credit union, and shall comply with the applicable by-laws, guidelines, policies and procedures of ABC Credit Union Limited.

Directors, credit committee members and officers shall also comply with the Credit Unions and Caisses Populaires Act, 1994 (the Act), Regulation 76/95 prescribed therein, the by-laws of DICO and the terms and conditions set out in the policy of deposit insurance issued by DICO.

Confidentiality

Each director, officer, employee or volunteer must use utmost care and discretion in the handling of confidential information and other information not normally available to the public, generally coming to them by reason of their directorship, office or employment. Such information shall, subject to certain limited circumstances, not be disclosed to third parties and shall not be used for personal benefit or for the benefit of family, friends, or associates.

In respect of information regarding members' transactions with the credit union, a director, officer, employee or volunteer may disclose such information in the following circumstances, pursuant to section 143 of the Act:

(a) to a person acting in a confidential or professional relationship to the credit union including an employee of a league in which the credit union is a member;
(b) to a financial institution with which the credit union has transactions that may involve confidential matters;
(c) to a credit grantor or to a reporting agency, if the disclosure is for the purpose of determining the credit-worthiness of the member;
(d) to the Superintendent of Financial Institutions, deposit insurer and the stabilization authority for the credit union;
(e) to any other person entitled to the information by law.

Conflicts of Interest

Each and every director, officer, employee or volunteer has an obligation of loyalty to the credit union and should subordinate his/her personal interest when they conflict with or threaten to conflict with the best interests of the credit union.

Each and every director, officer, employee or volunteer of the credit union shall declare all actual or potential material conflicts that may arise between their duty to (i) the credit union and (ii) their personal obligations, other fiduciary duties or financial interests (direct or indirect). In the case of directors and officers, these conflicts shall be reported to the Chair, and in the case of employees and volunteers, to the person to whom they directly report.

A director, officer, employee or volunteer should not engage directly or indirectly, as a director, officer, employee, consultant, partner, agent or major shareholder in any business or undertaking that competes with, does business with or seeks to do business with the credit union. The only exception to this is where the express written approval is given by either the general manager (in the case of an employee) or by the chair of the board of directors (in the case of an officer or director). A major shareholder is defined as a person who owns (directly or indirectly) more than ten per cent of the issued and outstanding equity of a company.

With respect to restricted party transactions, full disclosure of material transactions shall be recorded in the board's minutes and will be transacted in accordance with legislated restrictions.

To avoid conflicts of interest, directors, officers, employees and volunteers must do more than merely act within the law. They must conduct their affairs in such a manner that their performance will at all times bear public scrutiny. The appearance of conflict of interest as well as the conflict itself must be avoided.

Accepting Gifts

No director, officer, employee or volunteer shall accept any gift, hospitality or favour offered or tendered by virtue of the official's position with ABC Credit Union Limited, where the gift, hospitality or favour possesses any one of the following characteristics:

(a) is in the substance or form such that an impartial observer would construe it to be an improper incentive;
(b) places the official under an actual or implied obligation;
(c) has a value equivalent to or greater than $100.00;
(d) is in the form of cash or cash equivalent.

When dealing with public officials whose responsibilities include the business of credit unions, acts of hospitality should be of such a scale and nature so as to avoid compromising the integrity or reputation of either the public official or the credit union. Such acts of hospitality should be undertaken in the expectation that they could well become a matter of general knowledge and public record.

Maintenance of Credit Union Records

Accounting, administrative and member records will be maintained in an accurate and timely fashion so as to present fairly and accurately the financial position of the credit union and of all member accounts for which it has responsibility. No undisclosed assets, liabilities or hidden funds of any sort are permitted.

The Reporting of Questionable or Fraudulent Actions

It is the responsibility of directors, officers, employees and volunteers to report to the credit union, their awareness of any situation which might adversely affect the reputation of the credit union. This would include any questionable, fraudulent or illegal events or material actions in violation of credit union policy which comes to their attention. If such events involve volunteers or employees, the matter should be reported to the appropriate senior employee/officer; if the matter involves the general manager, directors or committee members, the matter should be reported to the audit committee.

Every director, officer, employee or volunteer is expected to comply promptly with any request from internal and/or external auditors for assistance and to provide full disclosure of any situation under investigation.

ABC CREDIT UNION LIMITED
DECLARATION OF ETHICAL CONDUCT

I, [NAME], hereby acknowledge that I have carefully read and understood the credit union's Code of Conduct dated   . I agree to faithfully abide by the terms of the Code of Conduct and to discharge my duties honestly and in good faith and in the best interests of the credit union. I will promptly and fully disclose any fiduciary relationship, activity or personal financial interest that might impair or affect my judgment or influence my decisions. I understand that I will be in possession of sensitive information relating to the credit union and its members and I will treat such information as confidential and will not disclose it to third parties or use it for my own personal benefit or the benefit of any other person. I will use the utmost care and discretion in the handling of such confidential information.

Dated at______________this_________________day of __________,

___________________________   ________________________________

Declarant   Witness

Governance

(Human Resources)

Executive Summary

People provide the guidance, labour and expertise that are critical to the success of an institution. Consequently, it is important that the credit union set minimum standards for the quality of human resources, and undertake practices to ensure resources meet or exceed those standards.

The responsibility for the management of human resources rests initially with the board, which must ensure that the credit union is being managed by a qualified and competent general manager (or a chief executive officer, or a treasurer, depending upon the credit union). This can be achieved through a thorough recruiting process and an annual review of the general manager's performance. (For the remainder of this chapter, the term general manager will be used to denote the highest ranking officer of the credit union, whether it be a treasurer, chief executive officer, or the general manager).

The quality and competency of staff must also be managed. This function is normally delegated to the general manager, but should be supervised by the board.

Finally, to complete the process, the board should regularly assess its own performance, to ensure it is providing the credit union with the guidance and leadership necessary for it to prosper.

Quality of Management

The board of directors is responsible for ensuring that day to day operations of the credit union are in the care of qualified management. This involves appointing a qualified and competent general manager to run the credit union, and reviewing that person's performance annually.

Appointing a Qualified General Manager

The key to finding the right person for the job of general manager is understanding what the credit union needs. This can be facilitated through the preparation of a job description. A thoroughly prepared job description will clarify the:

- duties and responsibilities of the position;
- knowledge and experience, personal skills and attributes required for the position.

In selecting the appropriate candidate, it is important for the board to match the skill sets of the individual to the needs of the credit union. For instance, if the credit union has been suffering from chronic decreases in membership and deposits, then they may require a general manager with sales and marketing experience.

The assistance of leagues or other external organizations is recommended to assist in the process of recruiting a qualified, competent individual for the key position.

Reviewing the General Manager's Performance

A formal written review of the general manager's performance should be undertaken annually by the board. The performance evaluation should be written and objective. A review is most effective when it is based on criteria or goals established at the beginning of the year. These criteria, which should be agreed upon by both the board and the general manager, can include;

- achievement of priorities and objectives set out in the annual business plan;
- clear measures of performance, established at the beginning of the year;
- the general manager's compliance with regulatory requirements and board policy.

The review process may be enhanced through the use of a questionnaire, which incorporates the above factors as part of the assessment criteria. A rating system applied to each question, which can be easily tabulated and analyzed, will assist in the evaluation. Leagues may be consulted for standardized forms, if desired.

Either the board, or a sub committee of the board could be given responsibility for the general manager's evaluation. If a sub-committee is responsible, it must be required to report the results and recommendations to the board. In either case, the results of the review should be documented in a report, which should be approved by the board.

The results of the assessment should be shared with the general manager, in order to provide him or her with helpful feedback. The purpose of this should be to reinforce positive behaviour and/or change the general manager's behaviour and improve his or her performance. The review should be followed up with support, either in the form of coaching or training. (Refer to Schedule 3.1 on page 3-6 for a summary of management and staff training programs provided specifically for Ontario credit unions.)

Remuneration

The board should also annually review and approve the general manager's remuneration, preferably upon completion of the performance review. The salary level should be competitive and reflect both the manager's scope of responsibility in terms of the credit union's asset size as well as the general manager's success in meeting objective performance criteria mutually agreed upon by the board and the general manager.

Replacing Management

If the board becomes dissatisfied with the performance of the general manager, it should address the matter directly. Whenever the hiring of a new general manager is required due to questionable activity, (i.e. fraud is suspected, poor loan performance was experienced), the board should ensure that some type of exit audit is conducted on the departing general manager. The board should determine how best this may be performed (i.e. through external auditors or a league).

Staff Performance

The credit union should ensure that it employs people who are skilled and competent in their job function. While the ultimate responsibility for this rests with the board, it is practical to delegate this function to management, with the board retaining a supervisory role.

The following recommended activities can assist management in maintaining high quality and competency among staff:

- Set job descriptions for each position which can be used to establish expectations of staff, and as a basis for evaluating performance.
- Annually evaluate the performance of each staff member - based on the results of the review, the supervisor and staff member can prepare a development plan, aimed at improving skills and expertise.
- Establish minimum skills requirements for each position, to ensure that candidates have the necessary training to carry out functions. (Refer to Schedule 3.1 on the following page for more details regarding training).
- Establish fair and progressive human resources practices - actual and perceived equity in the workplace can improve performance, morale, and cooperation - practices are most effective when committed to written policies.

The general manager should provide an annual report to the board on the general quality and competency of senior management and/or staff where appropriate. The report should at minimum include;

- a breakdown of human resources, by functional or operational area;
- an assessment or opinion on the quality and competency of the staff within each functional or operational area;
- steps or actions to be taken by management, where the quality and competency in a functional or operational area is considered insufficient to carry out functions properly.

Management and Staff Training

Training is an effective tool for improving the skills and knowledge of both staff and management. Board policy or operational procedures should address access to training for staff and management. Accessibility should be based upon a balance between the need for training, and the availability of resources to provide training.

Schedule 3.1 below provides a summary of the management and staff training programs offered by organizations within the credit union system. Credit unions can also consider training programs or professional education outside the system.

Schedule 3.1 Management and Staff Training	
Association/Organization	**Program**
Credit Union Institute of Canada (CUIC)	Provides professional development programs in conjunction with Dalhousie University leading to accreditation. Consists of existing college/university courses, plus credit union specific courses at a university level.
The Credit Union Managers Association (CUMA)	An association of credit union managers formed to promote excellence in credit union management through training, information sharing and conferences. Hosts biannual forums on management skills and relevant issues.
Credit Union Central of Ontario	Offers a variety of programs for all levels of staff encompassing lending, sales, management, member relations, financial planning and more.
La Fédération des caisses populaires de l'Ontario	Offers various courses on topics of interest to directors, managers and staff. The "Répertoire et calendrier des activités de formation" is published semi-annually and serves as a complete reference tool.
Credit Union Professionals' Association (CUPA)	Hosts an annual forum on lending skills.

Board Performance

Board Self-Evaluations

The board of directors of a credit union shoulders the ultimate responsibility of ensuring that the institution is operated in a safe and sound manner. To accomplish this objective, the board's effectiveness must be evaluated on a regular basis so that identified weaknesses may be improved upon. It is suggested that this process be completed on an annual basis, as a part of the business planning process.

The board should evaluate its aggregate performance, in terms of:

- the performance of major board responsibilities (identified in DICO By-law No. 5, and outlined in schedule 3.2 below);
- the achievement of the goals and objectives set out in the annual business plan;
- the management relations and communications;
- the effectiveness of the board's structure (size, independence, committees) and process (effective meetings, conflict resolution).

Schedule 3.2   ***BOARD'S RESPONSIBILITIES***
• Review and approve, policies and the business plan on an annual basis.   • Ensure that qualified and competent management is appointed to implement appropriate risk measurement techniques and risk management procedures.   • Monitor performance to ensure adherence to the policies and the business plan.   • Oversee member and community relations.

There are different means of evaluating the performance of the board. In conducting a review, the following recommendations are suggested:

- The board, where feasible, obtains external expertise from their league or from human resource consultants to assist them with their review.
- A review of the board's performance is based on objective criteria (such as those identified above).
- The review is of the board's performance as a whole, and not on the performance of individual directors.
- The results of the review are used to effect change and improve performance.
- The results of the review are documented for future reference.

Director Self-Assessment

A board may consider evaluation of the performance of individual directors. Where such an assessment is undertaken, it should be for the specific purpose of obtaining positive feedback and improving individual skills. The review should also be based on a self-assessment by each individual director. Under such a review, it is highly recommended that external assistance be obtained, either through a league or a human resources professional.

Board Independence

An important element of the board's performance is its ability to act independently from management. This is necessary if boards are to be effective in the function of monitoring the performance of management, and in ensuring members' interests remain paramount. Independence of the board can be fostered through the following steps:

- the board does not get involved in the day-to-day operation of the credit union;
- the board ensures that management views are questioned and tested;
- the board can meet on a regular basis without management present.

Board Tenure

A system of rotation or tenure of directors involves limiting the number of consecutive years a member can serve on the board. This will ensure broader representation of credit union membership on the board. It is recommended that the maximum term for a director be set out in the board policy on Corporate Governance. The policy could also provide for a time period after which the director can seek reappointment.

Compensation for Directors

Depending on the policies of the credit union, directors may receive reasonable monetary compensation for their contributions; either by way of a year-end honorarium, or payment on a monthly basis for their board meeting attendance. Monthly compensation should not be paid in advance of meeting attendance. The amount of compensation to be dispensed to directors should be disclosed to the member-ship at the annual meeting and reported annually in accordance with the Income Tax Act.

Director Training

The board should encourage ongoing education and budget for directors' attendance at appropriate training seminars to ensure that a capable and effective board exists to direct the organization. Appropriate compensation should be made available if such training conflicts with the directors' working hours. Directors' educational expenses should be reviewed by the audit committee. Schedule 3.3 on the following page provides a summary of director training programs offered by the credit union system.

When new directors are elected, the board and management should arrange an orientation session for the new directors to be introduced to:

- roles and responsibilities of directors;
- the legislative framework for credit unions;
- the Standards of Sound Business and Financial Practice;
- the role of committees and management;
- an overview of credit union operations.

For further information on the roles and responsibilities of a credit union director, readers should refer to DICO's Handbook on Sound Business and Financial Practices for Ontario's Credit Unions and Caisses Populaires (the Director's Handbook).

Schedule 3.3 ***DIRECTOR TRAINING PROGRAMS***	
Association/Organization	**Programs**
The Credit Union Directors Achievement Program (CUDA)	A national program of education and orientation specifically designed for directors of credit unions. Training is sponsored by Ontario Central and CUSOURCE Credit Union Knowledge Network, the national learning organization for the credit union sector.
Credit Union Directors of Ontario (CUDO)	Organizes an annual Directors' Forum which focuses on current topics and issues specific to credit union directors. Usually held in November each year.
Credit Union Central of Ontario and Level Five Strategic Partners	Offer various courses designed for credit union directors and committee members. Topics include Roles and Responsibilities, Legislation, Financial Management and Analysis, Strategic Planning, Credit, Audit and many more.
La Fédération des caisses populaires de l'Ontario	Offers various courses on topics of interest to directors, managers and staff. The "Répertoire et calendrier des activités de formation" is published semi-annually and serves as a complete reference tool.
L'Alliance des caisses populaires de l'Ontario limitée	Offers a one day training session to all new board members to review the roles and responsibilities of directors and committee members.

Capital Management

Executive Summary

Capital represents the difference in value between a credit union's assets (such as its loans and fixed assets), and its liabilities (such as deposits by its members and debts owed to its creditors). Capital fills this gap, providing a buffer against losses, and provides room for growth.

The board of directors is responsible for determining the level of adequate capital for their credit union. The amount of capital needed by a credit union will vary with the degree of risk inherent in its assets and upon its environment; the riskier the underlying assets of a credit union, or the less stable an economic environment, then the greater need for capital. At a minimum, capital should meet the regulatory minimum set out in the Act and in Regulation 76/95.

In order to maintain or increase capital to adequate levels, a credit union can either build retained earnings, raise capital investment, or reduce the asset base. Capital investment can be raised by increasing the Membership share investment, restricting the redemption of existing shares, or issuing non-membership share capital.

Failure to maintain adequate capital can lead to intervention by FSCO or by DICO, or by both, and loss over control of the credit union by the board.

A credit union can meet standards of sound business and financial practices by ensuring it has developed and implemented capital policies, risk and performance measurement techniques, and risk management procedures comparable to those contained in this chapter. Policies, techniques and procedures should be appropriate for the size and complexity of the credit union's operation.

Legislative Summary

Capital related regulatory requirements are prescribed in Part VI of the Act, Part V of Regulation 76/95 and the FSCO's Capital Adequacy Guideline.

These regulatory requirements prescribe the minimum levels of capital required to be held, and the types of capital that can be held, by a credit union. They also describe the consequences of failing to meet the minimum regulatory capital requirements.

Provided below is a summary of the important regulatory restrictions pertaining to capital management. As only a summary is provided, readers should refer to the Act, Regulation 76/95 and FSCO Guidelines and Interpretative Bulletins for a complete description of a credit unions regulatory rights and obligations.

Schedule 4.1 ***RELEVANT CAPITAL RELATED LEGISLATION***		
	The Act	**Regulation 76/95**
Capital adequacy	84	12-15 *
Directors orders - additional capital requirements	85 - 88	
Report to director on capital	89	
Capital structure	Part V	5-11
*Also refer to FSCO's *Capital Adequacy Guideline*.		

Prescribed Types and Quality of Capital

Section 14 of Regulation 76/95, along with FSCO's Capital Adequacy Guideline, lists the different forms of capital and equity that qualify as regulatory capital for purposes of the Act. The Capital Adequacy Guideline categorizes these forms of capital into two distinct quality groupings, identified as Tier I capital ("core capital") and Tier II capital ("supplementary capital"). Examples of Tier I and Tier II are illustrated in Schedule 4.2.

Schedule 4.2 ***PRESCRIBED FORMS OF REGULATORY CAPITAL***	
Form of Capital	**Quality**
• membership shares	Tier I
• retained earnings	Tier I
• contributed surplus	Tier I
• non-membership shares (non-redeemable portion)	Tier I
• non-membership shares (redeemable portion)	Tier II
• subordinated debt	Tier II
• investments by a stabilization authority	Tier I & II
Refer to section 14 of the Act and the *Capital Adequacy Guideline* for a complete description of regulatory capital.	

Tier I capital comprises a higher quality of capital than Tier II capital because it has greater permanence and has a higher level of freedom from mandatory fixed charges (i.e. tier 1 capital is not subject to withdrawal by the member, and interest payments on them is at the discretion of the board).

Prescribed Levels of Regulatory Capital

Regulation 76/95 prescribes two different tests for capital adequacy; leverage ratio, and risk weighted assets ratio. Both ratios measure capital adequacy differently, and both must be met for a credit union to be in compliance. The two ratios for capital adequacy are prescribed in section 12 of Regulation 76/95, and are defined in sections 13 to 15.

Failure to Meet a Standard

Any credit union that is below the minimum capital to assets target, and therefore is not adequately capitalized, will require a variance order from the Superintendent in order to continue operations. A variation order will usually be subject to restrictive terms, such as prohibiting the payment of cash dividends to members, or requiring the credit union to raise additional capital.

DICO Depositor Protection Program

DICO also prescribes capital adequacy requirements with respect to its depositor protection programs. These requirements are described in DICO system releases. When a credit union fails to meet these requirements, DICO, in its role as a stabilization authority, may request FSCO to order a credit union into DICO's Supervision Program. (DICO is granted this authority under section 285 of the Act). Under Supervision, DICO works closely with the board of a credit union to correct specific operational problems which necessitate intervention.

If capital reaches low levels, such that it represents extreme risk to depositors, DICO also has the authority under section 294 of the Act to place a credit union under its Administration Program. Under Administration, DICO is required to undertake the direct management of a credit union with the objective of protecting depositors and minimizing the risk of any future loss to DICO's deposit insurance reserve fund.

Special Orders

In addition to compliance with Part V of Regulation 76/95 and FSCO's Capital Adequacy Guideline, a credit union may also be required to comply with a Superintendents orders (such as increasing capital or providing additional liquidity) in unusual circumstances. (Refer to section 85 of the Act). These circumstances may include a situation where the credit union has not been complying with sections of the Act or Regulations. It may also include a situation where the Superintendent feels such measures are necessary to protect the interests of the credit union's members.

Policy

It is recommended that the credit union adopt a policy that addresses:

- authorized types of capital;
- minimum capital levels;
- distribution of dividends and redemption of capital instruments to members
- compliance with regulatory requirements;
- frequency, form and content of board reports.

These recommended objectives of capital policy are discussed in greater depth in Sections 4201 to 4204. Adopting a capital policy will assist the credit union to manage risk and to comply with the Standards in DICO By-law No. 5.

These are minimum policy elements required by sound business and financial practices; the credit union may elect to establish other policy elements as appropriate.

Reference Materials

Examples of capital policy are available in the DICO publication Sample Policies, and are available to the industry for customization as appropriate. As well, the information provided in Sections 4201 to 4204 will also assist in establishing policies of capital management.

Regulatory Compliance

Capital policy must not conflict with regulatory requirements - specifically, the capital requirements prescribed in Part VI of the Act, Part V of Regulation 76/95, and FSCO's Capital Adequacy Guideline.

Capital Management Philosophy

Adopting a capital management philosophy is an important first step in drafting capital policy. The philosophy should set out the broad goals and objectives of the credit union's capital base, as established by the board of directors. This philosophy governs all capital policy constraints and helps address new situations where policy does not yet exist.

While goals and objectives will differ depending upon the circumstances and environment of the credit union, the principles of capital management should always address the importance of:

- maintaining a prudent cushion of equity to protect the credit union's economic viability and finance new growth opportunities;
- maintaining sufficient capital to meet regulatory requirements.

Forms of Capital

In the case of more complex operations, capital policy establishes the types of regulatory capital the credit union may issue. A variety of capital forms are permissible, each with unique advantages and disadvantages. The different forms of capital used by credit unions are listed in Schedule 4.2 (located in Section 4100). A description of the more common of these forms are provided in depth below.

Membership Shares

The minimum share capital investment required for membership, or "membership shares", are equity interests in a credit union held as a condition of membership. Membership shares provide the share holder with the right to receive dividends on those shares when declared by the board and the right to receive the remaining property of the credit union upon dissolution.

Members are required to hold a specified number of membership shares (as detailed in the by-laws of the credit union), and are given voting rights under section 35 of the Act. Credit union members have equal rights to vote (one member, one vote) and participate in decisions affecting the credit union, without regard to the amount of savings or deposits or the volume of business they conduct.

The cost of a membership share can have implications on the attractiveness of membership in the credit union. A high membership share price may be a barrier for new members, while a low membership share price may help to attract new members. When setting the price for membership shares, management should consider share prices for credit unions in the same peer group.

Member to any other individual or organization. However, membership shares are redeemable upon certain circumstances such as death, voluntary membership withdrawal or member expulsion. Redemptions can be indefinitely deferred, however, by the credit union in accordance with the Act whenever such requests jeopardize the viability of the organization. Given the general tendency for total membership to either increase or maintain itself, however, membership shares provide a perpetual form of financing. Membership shares are eligible to receive non-cumulative, variable rate dividends, related to earnings, which is treated as an interest expense.

Non-membership Shares

Under section 53 of the Act, credit unions may issues other shares than those required for membership, and which may be purchased by members on a voluntary basis. These "non-membership shares" are distinguished from membership shares in that a member does not hold them as a condition of membership, but for other purposes, such as a higher investment return. (Non-membership shares usually provide higher dividend income than membership shares.) .. Normally, these shares do not carry a maturity date, but have redemption features frequently anytime after five years. In some cases, redemption can even occur earlier than five years. As a result, they would be considered Tier II Capital due to their characteristics of less permanence. Sections 53 and 57 of the Act set out the possible rights and conditions these non-membership shares may have. These rights and conditions are briefly summarized in Schedule 4.3.

Non-membership shares are only transferable to other members of the credit union or to persons prescribed under the Act, which include DICO, a league or stabilization authority. It is not intended that non-membership shares be traded with speculative investors who do not already have a legitimate interest in the credit union system. Procedures for issuing non-membership shares are discussed in Section 4502 of this Reference Manual.

Schedule 4.3 ***CHARACTERISTICS AND FEATURES OF NON-MEMBERSHIP SHARES***	
Classes of shares:	The credit union may issue a number of different classes of non-membership shares, each one having different rights and conditions.
Series of shares:	The credit union may offer multiple series of non-membership shares within each class, each series having different rights and conditions (usually different issuing prices).
Proxy rights:	Proxy rights allow a shareholder to give another person the authority or power to exercise his or her voting rights.
Preemptive rights:	Preemptive rights gives the holders of a class of non-membership shares the right to purchase on a pro rata basis new issues of the same class of non-membership shares.
Rights:	A right or option attaches to a particular class of shares, and allows the shareholder the option to purchase more shares of that class at some future date.

Surplus

Retained Earning

Retained earnings represent the income earned by a credit union that has not been paid out to members in the form of dividends. Retained earnings are calculated as the accumulated net balance of income less losses arising from the operation of the business, after taking into account dividends and any refundable taxes.

Reserves

Reserves is an amount that has been appropriated from retained earnings or other surplus. The reserve may be established at the discretion of management for some future purpose, such as a reserve for a future branch expansion. A reserve may also be appropriated as a requirement of a statute or trust indenture (such as a sinking fund reserve set aside to pay off a debt).

Contributed Surplus

Contributed surplus usually represents an amount of capital invested by a member, but for which the member did not receive any shares in return, and usually arises in the context of gifts by a member to a credit union.

Other Forms of Capital

Subordinated Debt

Debt that is legally subordinated to the rights of depositors and other creditors of the credit union also represents a form of capital. Common forms of this include loans from a league or stabilization authority.

Minority Interests

The minority investment by a credit union in one of its subsidiaries is, under certain conditions, considered a form of capital, as it recognizes the equity interest the credit union has in that subsidiary.

Adequate Levels of Capital

Credit unions that are adequately capitalized maintain a measure of financial stability and are able to withstand an economic downturn, unfavourable rate mismatching, or unusually high loan costs. Adequate capital can also provide a competitive advantage, as a well capitalized credit union is better positioned to offer competitive loan and deposit rates, superior dividends, and to introduce valuable services or pursue growth opportunities. Most importantly, adequate capital protects members' deposits. Capital policy establishes the minimum levels of capital the credit union will maintain. Although minimum surplus and capital requirements are prescribed through the Act and Part V of Regulation 76/95 (i.e. capital ratios of five per cent of total assets and eight per cent of risk weighted assets), capital policy should encourage the pursuit of adequate levels of equity, which may be higher than the regulatory minimum, or even the credit union's current capital level.

It is the job of the board to determine the adequate level of capital to be maintained by the credit union, beyond the minimum required by regulation (prescribed in section 12 of Regulation 76/95). For every additional dollar of capital, the credit union is able to hold an additional 20 dollars of earning assets, thereby increasing the contribution to revenue. .The amount of equity needed by a credit union will generally vary with the degree of risk inherent in the credit union's operations, its assets, liability and its environment. Schedule 4.4 provides a list of some of the risks that should be considered in determining the appropriate level of capital for the credit union. The greater the risk, the greater the amount of capital that should be maintained. Finally, additional levels of capital need to be accumulated and maintained by credit unions to finance future growth opportunities and/or business mergers.

Capital policy may prescribe specified tiers of capital within the overall ratio of capital to assets that will be maintained. For example, given that retained earnings is an inexpensive form of capital funding, capital policy may stipulate that retained earnings comprise a large percentage of total capital (e.g. 70 per cent). Alternately, policy may specify that Tier I capital (which has more permanence than Tier II capital by definition) be maintained at 70 per cent of total capital. At a minimum, the amount of Tier I capital cannot fall below the amount of Tier II capital, in accordance with FSCO's Capital Adequacy Guideline. Boards should establish a balance Tier I and Tier II capital that is appropriate for the credit union.

Schedule 4.4 ***RISK ASSESSMENT: CAPITAL***
• The credit portfolio is generally exposed to higher levels of risk (e.g. character lending, unsecured lending). • The credit portfolio is exposed to a high level of concentration risk (i.e. concentration in either a particular locality, industry or product). • The credit union's loan limit represents a significant proportion of capital. • A significant proportion of the investment portfolio is in instruments whose principal is not guaranteed. • The credit union is exposed to significant interest rate risk. • The quality of internal controls or level of management expertise are not yet at a level satisfactory to the board. • The risk inherent in the credit union's bond of association.

Earnings Distributions - Dividends

Section 65 of the Act permits the board of directors of credit unions to declare, and the credit union to pay, dividends (both on membership shares and non-membership shares), subject to their own by-laws. Dividends may be paid in the form of money or property, or in the form of fully paid shares (also known as stock dividends).

Patronage Returns

Under section 66, the board may also declare patronage returns, subject to the credit union's by-laws. A patronage return is similar to a dividend, except that it is paid based on the amount of business done by each member with or through the credit union, and not on the amount of shares held. A patronage return rewards a member for using the services of the credit union. Patronage returns may be paid in the same form of dividends, as described above, but may also include a rebate of interest paid by members in respect of loans during the fiscal year.

Prohibition and Director's Liability

Section 67 of the Act prohibits the payment of any dividend or patronage return where there are reasonable grounds for believing that the credit union is, or the payment would cause it to be, in contravention of the capital adequacy and liquidity adequacy requirements (which are prescribed under Part V of Regulation 76/95). Directors are required by the Act not to declare prohibited dividends and will be held jointly and severally liable to the credit union for any illegal dividend paid (see section 153(2) of the Act).

Additionally, credit unions which do not meet the minimum legislated capital levels may become subject to intervention through one of DICO's Depositor Protection Programs (i.e., Supervision or Administration).

Planning

Annually, the management and board of directors of the credit union must develop an annual business plan, summarizing its goals and objectives for the coming year.

This annual business plan includes a strategic financial plan that addresses each area of risk management, including capital. As part of the strategic financial plan, management and the board must set financial targets and plans for capital management. The elements of a capital plan are set out in Chapter 1 on Planning, and should be referred to for planning purposes.

Risk Measurement and Board Reporting

It is recommended that the credit union measure the performance and risk level of the capital portfolio, and report these findings to the board.

Risk Measurement

The following are minimum risk and performance measures of capital, required by sound business and financial practices:

- periodic measurement of net income and total capital;
- periodic projection of year end capital levels;
- tracking of forthcoming capital maturities, where appropriate;
- comparison of capital levels to regulatory requirements, to ensure compliance;
- any other measurements of capital required by the Act or Regulations.

The credit union must also meet any capital measurement requirements set out in the Act and Regulations. The credit union may track other measures of capital as they see fit.

These measurements 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 goals. Management can also assess whether there are material variances from the plan which need to be addressed.

Comparison of these measurements against historical performance, where possible, can also identify significant trends which may need to be addressed by management.

Risk Management Techniques

Subsection 4403 provides techniques for measuring the adequacy of the credit union's capital position.

Board Reports

The above measurements should be reported to the board of directors, so that they can monitor capital management and ensure adherence to regulatory requirements and to the annual business plan. Material negative variances from plan, and their causes, as well as management's plan to correct the variance should also be included in the report.

Frequency

Management should provide the board with a report on capital for each board meeting.

Form

Schedule 4.5 illustrates a Sample Board Report on Capital, which can be used by management to track capital adequacy, ensure regulatory compliance and report findings to the board. The report compiles and compares all the volumes, targets and policy limits required to properly manage the credit union's capital position. This report can be adopted or amended for use by the credit union.

Information contained in the report can be expressed on a periodic basis (monthly, quarterly), or on a year-to-date, or both, depending upon the preferences of the board and the frequency of reporting.

The frequency, form and content for board reporting should be set out in capital policy.

Schedule 4.5
SAMPLE BOARD REPORT ON CAPITAL

Part I: Capital Adequacy

	Actual	**Per Plan**	**Minimum Per Policy**	**Statutory Requirement**	**Variance from Plan**
Net income (year to date) expressed in dollars ($):	$	$			%
Total capital expressed in dollars ($):	$	$	$		%
Leverage ratio (as a % of total assets) (see section 12 of Regs.)	%	%	%	%	%
Risk weighted ratio (as a % of risk weighted assets (see section 12 of Regs.)	%	%	%	%	%
Total tier I capital (as a % of total assets): (see FSCO *Capital Adequacy Guidelines*)	%	%	%	%	%
total tier II capital (as a % of total assets): (see FSCO *Capital Adequacy Guidelines*)	%	%	%	%	%

Variances should be calculated as a percentage of the corresponding figure stated in the business plan.

Part II: Tracking Capital Maturities

Provide details of any capital maturing within the next 12 months:

Form of Capital	**$ Amount**	**% of Assets**	**Maturity Date**

Part III: Corrective Action/Strategies for variances and maturing capital

Variance	**Corrective Action/Strategy**

Risk Measurement Techniques

Measuring Capital Levels and Capital Costs

For purposes of board reporting, capital levels should be segregated by their regulatory classification in accordance with FSCO's Capital Adequacy Guideline, e.g. Tier I capital, Tier II capital, non-qualifying Tier II capital (where applicable). Refer to Schedule 4.6 for a sample presentation of capital levels and associated costs. The capital measurement and reporting should segregate amounts relating to retained earnings, and unencumbered reserves. It should also confirm that capital ratios meet regulatory minimum requirements. The two ratios, leverage and risk weighted assets, are calculated as part of the illustration in Schedule 4.6.

Credit unions may raise more share capital than qualifies as regulatory capital. This may occur when some portion of non-membership shares or other instruments increase Tier II capital to a level that exceeds 100 per cent of Tier I capital. Under FSCO's Capital Adequacy Guideline, Tier II capital cannot exceed 100 per cent of Tier I capital. Therefore, such excess capital would not count for regulatory purposes. If a credit union is raising capital only to meet the regulatory minimum requirements, it would likely not be interested in acquiring capital that does not qualify as capital for regulatory purposes. However, many fully capitalized institutions which require financing to grow may need to issue non-regulatory capital and should measure its volume and cost.

Measuring Costs of Capital

The accrued or historical cost of each form of capital is useful information that can be calculated and disclosed. With respect to membership shares, for example, if dividends are not paid until year end, the planned rate of member share dividend should be accrued relative to year-to-date earnings and disclosed as the cost of this capital.

Schedule 4.6
SAMPLE BOARD REPORTING ON CAPITAL LEVELS AND CAPITAL COSTS

	In $000s	Average Cost
Tier I Capital:		
Membership Shares	200	4%
($50 per 4,000 members)		
Retained Earnings	1,340	0%
Total Tier I	1,560	
Tier II Capital:		
Fixed rate 5 year debenture	300[1]	5%
• face value of debenture is $500,000		
• 3 years until maturity - include 60%1		
Total Regulatory Capital	1,860	
Non-qualifying Capital Instruments	0	
(excess Tier II capital)[4]		
Total Capital	**1,860**	

Leverage Ratio = total capital divided by total assets
= 1,860 / 31,631[2] = 5.9%

Leverage Ratio of 5.9% exceeds 5% regulatory requirement

Risk Weighted Ratio = total capital divided by risk weighted assets
= 1,860 / 19,969[3] = 9.3%

Risk Weighted Ratio of 9.3% exceeds 8% regulatory requirement

1 Tier II capital amortized in accordance with FSCO's *Capital Adequacy Guideline.*

2 Total assets are $31,631,000.

3 Total risk weighted assets are $19,969. See calculation (in accordance with FSCO's *Capital Adequacy Guideline*) illustrated in Schedule 4.7.

4 Excess Tier II capital cannot be included as capital for regulatory purposes, but should be included as capital for accounting purposes. Excess Tier II capital is defined as:

max. (0, total Tier II capital - total Tier I capital)

Schedule 4.7 *SAMPLE SUMMARY CALCULATION OF RISK WEIGHTED ASSETS*				
Total Assets are $31,631,000		**$000's**	**Regulatory Risk Weight**	**Risk Adjusted Assets**
Cash	$ 663	x	0=	0
Liquid Assets (league deposits)	4,198	x	0=	0
Other Instruments (government securities)	1,273	x	0=	0
Fixed Assets	497	x	1=	497
*Loans:				
Personal Loans	14,909	x	0.8 =	11,927
Residential Mortgages	5,091	x	0.5 =	2,546
Commercial Mortgages	2,500	x	1 =	2,500
Other Commercial Loans	2,500	x	1 =	2,500
Total Risk Adjusted Assets				**$19,969**
*Assume for illustration, none of the above loans have government guarantees/ security which would reduce risk weightings. Readers should refer to section 15 of Regulation 76/95 for further details.				

Profitability Analysis and Projected Year End Capital

Key measures of capital management include profitability and annual growth in retained earnings after dividend pay-outs on all classes of shares. The capital measures when analyzed against plan and historical performance will identify areas requiring remedial follow up. Calculation of a projected year end capital position is useful whenever interim profit targets are below plan and there is a possibility that minimum regulatory requirements cannot be met by year end.

Schedule 4.8 illustrates a list of the key financial variables affecting profitability. These measures should be routinely calculated and the explanations of performance trends should be documented for periodic review by management and the board.

Schedule 4.8
FINANCIAL VARIABLES AFFECTING PROFITABILITY

Financial Margin	Other Income
• Loan Interest Income • Investment Income • Interest Expense on Deposits • Interest Expense on Borrowings • Loan Costs: Provisions For Impaired Loans	• Fees and Commissions
Operating Expenses	**Other Factors**
• Salaries and benefits • Occupancy • Computer, office & other equipment • Advertising & communications • Member security • Administration	• Non-recurring gains/losses • Extraordinary gains/losses • Income Taxes/Recovery • Capital Taxes/Recovery • Dividends

Accrued Dividends

Net profit earnings reported should include all dividends payable on credit union shares; these are considered to be a form of current period interest expense that should be included in the calculation of financial margin and net profit when declared.

Monitoring Capital Maturities

In cases where a credit union has issued non membership shares or debentures to finance its operations, it should diarize the maturity of these instruments and analyze whether, at the date of these maturities, new capital instruments are required.

Risk Management

An important activity in the effective management of risk is management's timely response to unauthorized risk or poor performance developments. As a follow up to the capital risk measurements taken by the credit union (and discussed in the previous section), management should investigate all significant performance variances relative to the annual business plan and to historical performance. Corrective action should by taken by management to respond to unacceptable variances. Management must similarly respond to any contravention of board policy or regulatory requirements, or other unauthorized risk.

Given that the principal policy objective relating to capital management is maintaining appropriate levels of capital, Sections 4501 to 4502 discuss procedures for correcting and improving capital levels, which include:

- methods for raising new sources of capital or preserving existing capital;
- procedures for issuing non-membership capital.

Raising New Sources of Capital

In order to raise new capital (or preserve existing capital levels), a number of alternative methods or procedures may be selected. These are summarized in Schedule 4.9, and discussed in depth below.

Schedule 4.8 ***IMPROVING THE CAPITAL POSITION***	
Mechanism	**Strategies**
Build Retained Earnings	• Improve profitability. • Limit cash dividends
Increase Share Capital	• Raise minimum share investment. • Issue a second tier of non voting shares (e.g. voluntary share capital)
Downsize Assets	• Sell assets. • Lower deposit interest rates

Build Retained Earnings

Retained Earnings (or surplus) is an inexpensive form of capital for the credit union, as it does not require the payment of dividends, or carry the contingency of having to redeem membership shares on demand.

Retained earnings can be built-up in two ways. The first approach is through improved profitability. Credit unions can review their profitability by examining the elements that contribute to profit, including financial, operational, and human resource performance factors.

Another method for building retained earnings is to reduce cash dividends to members. While reducing cash dividends may not be popular with members, it may be necessary to prevent capital reserves from dropping below regulatory or policy minimums. In fact, it is a contravention of the Act for a credit union to declare or pay out dividends that would put capital or liquidity adequacy ratios below regulatory minimums (see section 67 of the Act).

Alternatively, a credit union may choose to temporarily reduce cash dividends to allow capital to grow to a level sufficient to finance a new project, such as an investment in new technology.

In either case, the key to successfully reducing cash dividends is by achieving consensus (or at least understanding) from the membership. This can be achieved through effective communication with the membership, and by educating or informing them of the importance of increasing (or preserving) capital levels.

Raise Minimum Share Investment

Another method of increasing capital is to increase the amount of share capital invested in the credit union by its members. This is done by increasing the dollar amount of the minimum share investment required by members. This would be especially effective in credit unions where the current minimum share investment has remained at nominal values for some time (e.g. $10 or $20). The minimum investment in membership shares could be increased so that share financing will represent a significant amount of capital (e.g. $50 per member).

The board should be careful not to set the minimum required investment level too high, and unintentionally discourage new membership, or lose existing membership. The board should consider conducting a member survey to determine the amount of an increase members are willing to bear. As with dividend reductions, the key to success is effective communication with the membership, to promote understanding and consensus.

A by-law amendment is needed for an increase in minimum share investment. (Although the board can approve them, by-laws are not effective until confirmed by two-thirds of the credit union membership at a general meeting. For more information on passing by-laws, see section 105 of the Act).

Issue Non-membership Shares

Section 53 of the Act allows a credit union to provide for additional classes of shares beyond the traditional membership shares. These shares are generically referred to in the Act as non-membership shares (also referred to as participation shares of voluntary capital). Non membership shares are distinguished from membership shares in that a member does not hold them as a condition of membership, but for other purposes; mainly, to support the credit union, and to receive a competitive return on investment.

Depending upon the level of management experience, member wealth and loyalty, and other factors (discussed later), non-membership share issues can raise significant amounts of capital for the credit union. Several successful large issues were undertaken by Ontario credit unions in 1997. Non-membership share issues are discussed in more depth in Section 4502 of this Reference Manual.

Downsize Assets

By reducing its asset base, a credit union can increase its ratio of regulatory capital to assets (and to weighted assets) and improve its capital position. A credit union may adopt such a strategy when it is concerned it may soon fall below regulatory capital adequacy requirements.

Possible strategies for reducing the asset base include:

- reduce interest rates on deposits to discourage new business;
- sell off part of the loan portfolio, while continuing to administer it, and reduce deposits by a corresponding amount;
- contact large depositors directly and request they place their deposits elsewhere.

It is important to be aware, however, of the negative impact these strategies may have on the credit union's reputation among existing members and potential customers.

Issuing Non-Membership Capital

Before a credit union begins to undertake a non-membership share offering (also known as a voluntary share offering or participating share offering), it is essential to establish a business case for the offering. There must be a clear need for increased capitalization to meet regulatory requirements, to expand or open a new branch, or to invest in improvements in the credit union's technology. Other less expensive methods of raising capital should have been exhausted (such as those discussed in the Section 4501). Furthermore, it must be feasible for the credit union to undertake the offering. The credit union must have the resources, the membership must have sufficient wealth to purchase the offering, and management should have the required expertise to carry out the offering (although some assistance can be obtained from external counsel, financial advisors, the league and FSCO).

It is best that a share offering be controlled internally, by one officer or by a steering committee. It is important that these projects have an internal champion, someone to foster and promote internal support. This person can also ensure that the offering statement process never loses sight of the financial needs of the credit union. Where projects are undertaken mainly by external advisors, there is the possibility that the objectives of the project are lost sight of, and not carried through.

Ontario Securities Act

Generally, under Ontario law, when any person (individual or corporation) offers securities for sale, they must comply with the Ontario Securities Act.

Section 75(1)(a) is a special exemption from the requirements of the Ontario Securities Act established specifically for credit unions. A credit union is exempted from the additional requirements of the Securities Act, as long as it meets certain conditions under that Act. In order to qualify for this exemption when issuing non-membership shares, the credit union must prepare an offering statement, and must obtain a receipt from FSCO for that offering statement.[1]

Offering Statements

An offering statement is a comprehensive document which summarizes the details of a credit union's non-membership share issue. The document includes the price of the security, rights and conditions of the class of shares, as well as providing "full, true and plain disclosure" of the credit union's operations. An offering statement must be prepared, issued a receipt by FSCO, and made available to members and prospective purchasers before a credit union may offer non-membership shares to its members.

A credit union's offering statement must comply with the requirements set out in the Act, Regulation 76/95, and FSCO's Guideline on Offering Statements. Although less complex than a prospectus, the preparation of an offering statement will require significant time and effort, as well as the assistance of legal counsel and accounting experts. The offering statement must be in a form approved by FSCO, and must meet a high standard of disclosure and accuracy. Finally, the offering statement must be accompanied by a disclosure certificate signed by the credit union's chief executive officer, chief financial officer and chairperson of the board.

[1] This exemption is not relevant to the issuance of membership shares, dividend shares and patronage shares. These are automatically exempt from the Securities Act, even without the preparation of an offering statement (see section 75(2) of the Ontario Securities Act.)

FSCO has the discretion to refuse to grant a receipt where the offering statement (or any documents accompanying it) fail to comply in any substantial respect with the requirements set out in the Act, Regulations, FSCO's Guideline on Offerings Statements, or if it contains a false, deceptive or misleading statement or promise, or if it conceals or omits any material facts. Other reasons for refusal of a receipt are listed in section 78.

Once the receipt is issued, the securities may be sold by directors, officers and employees of the issuing credit union (or of the issuing league), and/or by a person registered under the Ontario Securities Act as a securities dealer, investment dealer or broker.

Key Success Factors

Membership Support

A key factor for success in non-membership share offerings is member loyalty. Where a credit union has a strong bond of association, members are often eager to support such ventures of the credit union. The stronger the bond and loyalty, the greater the support that can be expected from the membership. This loyalty factor can be maximized by associating a particular need to the offering; for instance, communicating to the membership that an offering will be made to finance a new branch, or an infusion of capital to improve the technological base of the credit union and improve service.

It is equally important to understand which segment of the membership will support the offering. Historic experience with credit union share offerings has indicated that the primary market for any credit union tends to be higher income net savers; those members that hold term deposits or RRSP's. Usually, these members have portfolios large enough so that a $5,000 investment in non-membership shares would not represent a significant portion of their investment portfolio. These investors are also relatively sophisticated, and are aware of other investment options in the financial market.

Membership studies may assist in identifying this segment, and the size of it within the membership. Focus group studies (with small groups of members) can also provide information as to investment needs and preferences, and assist in pricing an offering. A very supportive membership may be willing to assume a somewhat lower rate than comparable investments in order to assist the credit union.

Pricing the Offering

The pricing of the share offering is a critical element in the success of any offering; pricing mainly refers to the return, or dividends, offered by the shares. Return is usually the primary consideration when making an investment. Therefore, it must be carefully selected. When pricing such an investment, it is important to scan the financial environment to see the return offered by investments of similar term and similar risk, such as five year GIC rates, and five and ten year bond rates of companies with equivalent bond ratings (this may require management to estimate what bond rating they might be given from a bond rating service).

The denomination of shares is an important factor, and should reflect the purchasing power of the target investors. A $1,000 minimum purchase is generally an appropriate denomination, as it is competitive with denominations for GIC's and Bankers Acceptance Notes.

Dividends

As well, the structure of the return can be an important factor in meeting investors' expectations. Returns can be fixed, or can be tied to some external benchmark such as the prime rate, or market indices. The former might appeal to an investor who wants a guaranteed rate or return, the latter to an investor who is speculating interest rates will rise. A greater perception of fairness may be created when dividends are tied to an outside index or instrument (as opposed to an internal instrument rate), since the credit union would then be unable to manipulate the dividend rate.

Where the credit union can benefit from Tier II capital, cumulative dividends can be offered, thereby giving the investor greater assurance that they will receive their dividend, if not in the current year, then when the credit union has sufficient funds.

Investors may be attracted by a bonus, such as a one year interest bonus (i.e. a higher rate of interest for the first year) or a share bonus (i.e. a member is issued an extra 100 shares for every 1,000 shares purchased). Bonuses, however, should not be too generous, otherwise they may have the potential of draining retained earnings in favor of raising new capital. This could in turn be prejudicial to existing members who did not participate in the share offering. Generally, bonuses should be limited to one year.

Timing

Timing is another critical factor in a share offering. When a share offering is made in a period of low interest rates, the shares dividend rate will accordingly be low; the overall cost of the funds to the credit union would be significantly less than if the offering was made during a period of high interest rates. Examine the maturity profile of the deposit portfolio for the credit union; a share offering would be more successful if launched during a period where many term deposits are coming due.

Sales Force

The preparation of front-line staff is an important final step to a successful offering. They should be provided with all the details of the share offering (return, term, structure, incentives, etc.), as well as with the profile of the target market (so that they know which customers to promote the product to). Certain details of the offering cannot be provided to members until the offering statement has been approved, and a receipt issued, by FSCO. (Refer to section 8.1 of Regulation 76/95 for details regarding the type of which may be given to members prior to the issuance of a receipt by FSCO).

For further information on non-membership share offerings, credit unions should contact their leagues and their legal counsel.

Redemption

It is important that the redemption and maturity of non-membership or investment shares is appropriately addressed in capital management policy. Considerations should include the impact on capital from projected redemptions and maturities.

Credit Risk Management

Executive Summary

Sound credit management is a prerequisite for a financial institution's stability and continuing profitability, while deteriorating credit quality is the most frequent cause of poor financial performance and condition. The prudent management of credit risk can minimize operational risk while securing reasonable returns.

Ensuring lending staff comply with the credit union's lending licence and by-laws is the first step in managing risk. The second step is to ensure board approved policies exist to limit or manage other areas of credit risk, such as syndicated and brokered loans, and the concentration of lending to individuals and their connected parties (companies, partnerships or relatives).

The board and management should also set goals or targets for their loan portfolio mix, as part of their annual planning process. The loan portfolio should be monitored on an ongoing basis, to determine if performance meets the board's expectations, and the level of risk remains within acceptable limits.

Standardized lending procedures should be adopted to reduce risk of transactional error, and ensure compliance with regulatory requirements and board policy. Approval and disbursements, documentation, lending staff and loan security are just some of the procedures recommended in this chapter.

A credit union can meet standards of sound business and financial practices by ensuring it has developed and implemented credit policies, risk and performance measurement techniques, and risk management procedures comparable to those contained in this chapter. Policies, measurement techniques and procedures should be appropriate for the size

Legislative Summary

Management and lending staff should be apprised of the comprehensive lending legislation set out in the Act and Regulation 76/95, as well as relevant legislation in other Acts. Members of the board should also be familiar with the major aspects of lending legislation. Referring to or repeating lending legislation in board policy and operational procedures is an effective means to ensure compliance.

The following is a summary of important lending legislation which defines lending powers, limits and restrictions, both in the Act and Regulations, as well as in other relevant statutes and bodies of law.

Lending Powers

A credit union's lending powers are formally defined by its lending licence, which it obtains either by designation under the Act, or through an application to FSCO.

Credit union by-laws also impact lending powers. A by-law is required to request a change to the credit union's lending licence, and determines membership eligibility for the credit union, thereby impacting who can borrow from the organization.

The Act additionally prescribes lending powers, restrictions and limits. Refer to Schedule 5.1 for a summary of important lending legislation. For actual text, refer to the appropriate sections of the Act and Regulation 76/95. Violations of the Act will cause manager/director liability, and may lead to penalties or economic damages.

Lending Licences

Under section 196(5) of the Act, a grandfathering provision effective March 1, 1995 established for each credit union a deemed lending licence comparable to the lending powers prescribed by the credit union's then existing by-laws.

The legislation proclaimed in 1995 introduces different classes of loans, each associated with a different class of lending licence, which are as follows: agricultural, commercial, institutional, personal, residential mortgage and bridge loan, syndication and unincorporated association lending. The loan classes are defined in sections 51 to 57 of Regulation 76/95.

Schedule 5.1 *RELEVANT LENDING RELATED LEGISLATION*		
	The Act	**Regulation 76/95**
Adherence to lending policies and procedures	190	
Establishment of written lending policies and procedures	191	50
Loans to be made in accordance with lending license and the Act	193	59
Loans to members only	194(1)	
Loans to unincorporated associations	194(2)	194(3)
Lending limits and variations	195	
Lending licences	196	
Loan classes		51
Definition of loan classes		52-57
Classes of lending licences		58
Syndicated loans		60
Individual and aggregate lending limits and lending matrices		61, 62
Aggregate limits on commercial and agricultural loans		63
General restrictions on security for loans		64, 65
Advertising regarding credit products and services	100	76

In order to make a loan of a particular class, the credit union must have the appropriate lending licence. A credit union may only make an agricultural loan if it has an agricultural lending licence. It may only make a commercial loan if it has a commercial lending licence.

A credit union must apply to the Superintendent of Financial Services (the Superintendent) for a new lending licence if it wishes to expand into a new class of loans, or to expand lending limits for a particular class. When considering expanding the line of loan products, it is recommended that an adequate study of required liquidity, equity and qualified, experienced staff resources be made prior to such a request.

Licence Non-Compliance

The Superintendent may revoke or amend a lending licence at any time, should the credit union fail to comply with its licence or with a provision of the Act or Regulation 76/95.

An amendment might include the addition of conditions or restrictions, or the reduction of a lending limit on a particular class of loans. Revoking a lending licence is considered a last resort by the Superintendent, and would most likely only follow should other remedial measures (conditions or restrictions, or a reduction in lending limits) prove ineffective.

Lending Limits and Lending Limit Matrices

Lending licences can carry lending limits that are either set at fixed amounts, or determined under growth matrices set out in sections 61 and 62 of Regulation 76/95. Where a lending licence has a limit fixed in the licence, the credit union will have to apply to the Superintendent any time it wants to increase the limit due to increased loan demand or increased asset size and lending expertise.

However, where the lending licence utilizes lending limit matrices, lending limits will automatically adjust with growth in the credit union (growth being measured by total regulatory capital and deposits as per annual audited financial statements). There are two separate lending limit matrices. The first matrix, authorized under section 61 of Regulation 76/95, details three sets of graduated limits on the amount of personal, residential mortgage and bridge loans, that can be made to an individual. (Loan limit matrices do not exist for commercial or agricultural lending) The second matrix, prescribed by section 62, provides graduated limits on the amount of total loans (any number of loans of any type) that a credit union can make to a particular person and his/her connected persons.

Not every credit union will automatically qualify for the use of lending limit matrices. A credit union must specifically request the use of a lending limit matrix through a lending licence amendment, and must provide the Superintendent with a rationale for the use of the graduated lending limit matrix.

Illegal Credit Transactions

Any loans in excess of a credit union's lending limits, as defined by the organization's lending licence and by-laws, are illegal. Additionally, a credit union may only offer those loan classes authorized in its lending licence (e.g. personal loans, mortgages, commercial, agricultural, etc.) to authorized members, otherwise it is lending illegally.

Authorizing illegal loans is a contravention of the Act and is considered an offence under section 322 of the Act. Any director, officer or agent of a credit union who commits such an offence, authorized, or acquiesced to the offence, is liable. (Penalties prescribed in the Act include a maximum fine of $100,000 or maximum imprisonment for two years). Therefore, it is recommended that directors, officers and credit committee members object to the existence of illegal loans known to them, and advise the Superintendent in writing of any loans which violate the Act, the lending licence, or the by-laws.

In order to assist the credit committee and staff in their responsibilities to grant proper loans, board policy should define what constitutes a legal and an acceptable loan. Additionally, senior management, the credit committee and the board should monitor for illegal loans and large loans that approach regulatory limits.

Syndicated Loans

Should a credit union find that periodically it must decline borrowers for loans exceeding its legal lending limits, the credit union can seek to syndicate loans with its league or another financial institution. Before a credit union can syndicate a loan on behalf of one of its members, it must possess a syndication lending licence. If it does not have one, it must apply for one from the Superintendent.

A credit union does not require a syndication lending licence to participate in a syndicated loan where it is not acting as the syndicating credit union (i.e. the credit union is not organizing the deal on behalf of one of its members, but is participating in a syndicated loan organized by another credit union). Further restrictions and conditions of loan syndication can be found in section 60 of Regulation 76/95. The credit union, for example, can underwrite a portion of a syndicated loan only if it is within an applicable loan category and the limits of its own lending licence.

Other Lending Statutes and Common Law Obligations

In addition to ensuring compliance with the Act, Regulation 76/95 and its own lending licence and by-laws, the credit union must comply with other lending statutes, and should be aware of its lending liability under contract and tort law. Schedule 5.2 summarizes the major common law obligations of a lender. Schedule 5.3 highlights the content of specific statutes to which Ontario lenders should adhere. More detailed information on any of the statutes summarized below should be obtained, as required, from legal counsel. It is recommended that loan personnel be broadly informed of all relevant legislation affecting their loan portfolio.

Schedule 5.2
SUMMARY OF LENDER LIABILITY

Major Obligations of a Lender under Contract and Tort Law

- Duty to perform in accordance with the terms of a loan contract.
- Duty to honour oral representations, especially to the extent they alter the terms of written agreements.
- Implied duty to exercise reasonable care and skill in carrying out banking business.
- Implied duty of confidentiality on a member's transactions.
- Duty to avoid misrepresenting an existing state of facts to a member.
- Duty to avoid slanderous or libelous treatment of a member.
- Duty to avoid offering financial investment advice which can cause economic damage to a borrower.

Schedule 5.3 ***KEY LENDING LEGISLATION IN ONTARIO***	
Act	**Content**
Absconding Debtors Act	Provides remedies against debtors who attempt to avoid creditors.
Assignments and Preferences Act	Prevents debtors giving unjust preference to one creditor over another.
Bankruptcy and Insolvency Act (Canada)	Permits debtors to legally nullify creditor liabilities through realization and distribution of their assets.
Bulk Sales Act	Protects unsecured creditors in the event of a sale of all or most of business's assets.
Companies' Creditors Arrangement Act	Facilitates compromises and arrangements between financially distressed companies and their creditors.
Construction Lien Act	Provides supplier of services and materials with a lien against property under construction.
Creditors' Relief Act	Gives all creditors right to share in proceeds of a debtor's assets, where debtor has been successfully sued by one creditor.
Criminal Code (Canada)	Limits the amount of interest or fees chargeable on loans.
Debt Collectors Act	Governs and restricts methods of debt collection.
Environmental Protection Act	Prohibits any person from discharging contaminants into the natural environment in excess of prescribed levels. The act empowers the Government to issue administrative clean-up orders on persons with management or legal control of a contaminated property, which could include, in certain circumstances, credit unions in their capacity as mortgagees. Any such order is binding upon the successor or assignee of the property.
Execution Act	Establishes a procedure for enforcing court judgments against a debtor's property.
Family Law Act	Governs the rights to property between spouses that arise upon marriage, separation and divorce.
Farm Debt Mediation Act (Canada)	Provides protection to a farmer facing insolvency, including possible delays in the realization of security.
Farm Improvement Loans Act (Canada)	Facilitates and encourages the provision of intermediate and short term credit to farmers for the improvement and development of farms.
Fraudulent Conveyances Act	Prohibits debtors from conveying property to others with the intent of defeating, hindering, delaying or defrauding creditors.

Schedule 5.3 (continued) *KEY LENDING LEGISLATION IN ONTARIO*	
Act	**Content**
Interest Act (Canada)	Prescribes the manner in which interest costs are disclosed by a lender to a borrower. In certain circumstances, it also limits the amount of interest which can be charged on loans.
Land Titles Act and Registry Act	Provide for a system of registration of interests in real property. The registration systems provide notice to third parties of the interest being registered.
Landlord and Tenant Act	Deals with rights between tenants and landlords. Under this Act, a landlord is entitled to seize property of a tenant, including property pledged to a financial institution as security whenever rent is in arrears.
Limitations Act	Denies creditors a right of action for damages for breach of contract after a lapse of a specified time (generally 6 years).
Mortgages Act	Provides for two remedies for the mortgagee upon default by the mortgagor: power of sale and foreclosure.
Personal Property Security Act	Governs the taking of security against personal property in Ontario. The Act also establishes a registry whereby priorities in rights to security are established and notice to third parties of security interests in a debtors assets is given.
Wages Act	Governs the assignment of wages to settle debts, fixing the maximum assignment to 20 per cent of wages, without a court order.

Policy

It is recommended that the credit union adopt a credit policy that addresses:

- authorized credit instruments;
- limits or prohibitions on credit exposures including concentration;
- connected, restricted party and staff loans;
- lender approval limits;
- major lending criteria;
- securing loans;
- loan process;
- conditions for rewritten and restructured loans;
- frequency, form and content of board reporting.

These recommended objectives of credit policy are discussed in greater depth in Sections 5201 to 5211. Adopting a credit policy will assist the credit union to manage risk and to comply with the Standards in DICO By-law No. 5. The board's credit policy must be sufficiently flexible to allow for managerial scope and the application of professional lending judgment without being so general that effectiveness is lost. The specifics of managerial scope in lending as much as possible should be documented in operational procedures. For recommended operational procedures, refer to Section 5500.

Reference Materials

Examples of credit policy are available in the DICO publication Sample Policies, and are available to the industry for customization as appropriate. As well, the information provided in Sections 5201 to 5211 will also assist in establishing policies of credit management.

Regulatory Policy Requirements

Section 191(2) of the Act also requires credit unions to establish credit policies and procedures. FSCO has published Guidelines for Prudent Investment and Lending Policies and Procedures, which sets out guidelines for establishing lending policies and procedures. When establishing credit policies and procedures, management and the board should ensure they meet FSCO requirements as well as By-law No. 5 requirements. In addition to By-law No. 5 criteria and FSCO policy, credit unions may elect to establish other credit policies as they see fit.

Regulatory Compliance

Credit policies must not conflict with requirements prescribed by the Act, Regulation 76/95 and any interpretative bulletins or guidelines issued by FSCO. It is optimal for key regulatory requirements to be repeated in lending policies for greater lender clarity and ease of reference.

Credit Management Philosophy

Adopting a credit management philosophy is an important first step in drafting credit policy. The philosophy should set out the broad goals and objectives of a credit union’s lending activities, as established by the board of directors. Developing a credit granting philosophy provides the board with an opportunity to express their vision for the credit union's lending program. This vision should govern all lending policy constraints and help address new situations where policy does not yet exist.

Credit management philosophies will vary amongst credit unions, reflecting the differences between members needs, and the credit union's goals and objectives. Some aspects of credit philosophy, however, should be the same for every credit union, such as first and foremost, protecting the safety of members' deposits.

Other possible considerations or principals that can form part of the credit management philosophy include the following:

- Lending is the credit union's core business. All loans must be considered in the context of providing creditworthy members with borrowing opportunities, at a reasonable rate of return for the credit union, while safeguarding the overall assets of the credit union.
- The credit union may return a portion of the income derived from lending to eligible borrowing members in the form of a loan interest rebate.
- The loan portfolio will be, as much as possible, diversified with the objective of spreading risk.
- Borrowers will be provided with a full explanation of the terms and conditions of loans before loan agreements are signed.
- Loan agreements and security documents will contain clear statements of terms and conditions, including fees and penalties, to the degree that is legally possible.

Authorized Credit Instruments

An important lending parameter that must be established by board policy is a list of authorized credit instruments. This section summarizes some of the more common credit instruments. Credit policy should state for each credit instrument the following: the maximum loan amortization period, credit offering circumstances (i.e. eligible loan purpose) and where applicable, special types of authorized products (e.g. various types of mortgages).

Schedule 5.4
SAMPLE CREDIT PRODUCTS

Loan Class	Credit Instruments	Credit Purposes
Agricultural Loans	• Mortgage • Term Loan • Line of Credit	Farm home, crop production, equipment, land, working capital
Bridge Loans	• Bridge Loan	Provide transitional financing for new home purchase.
Commercial Loans	• Mortgage • Term Loan • Line of Credit • Leases • Letter of Credit	Operating requirements, rental income properties, business premises, equipment purchases, capital
Institutional Loans	• Term Loan • Line of Credit	A loan made to a government body or agency, a municipal body or agency, or a school board.
Personal Loans	• Demand Loan • Term Loan • Line of Credit (secured and unsecured) • Automobile Lease • Overdraft Protection	Vehicle purchase, investments, RRSP purchase, education, vacation, gifts, home improvements, home construction, consolidation of loans
Residential Mortgage Loans	• First Mortgage • High Ratio Mortgage • Second Mortgage • Bridge Loans • Reverse Mortgage • Construction Mortgage	Principal residence, vacation home, non-profit use properties

Over time, as a credit union gains further experience and expertise in new lending areas, it may be able to expand the lending instruments offered within its lending classes. Product diversification is an important strategy which should be considered by management and the board. Refer to Schedule 5.4 for a sample list of credit products by loan class. Selection of a diversified mix should be based on the availability of demand and the internal resources required to offer these loan products.

Personal Credit Instruments

Schedule 5.5 outlines a number of credit instruments that are available for personal lending. These are summarized along with a list of common forms of security that are taken by credit unions for personal credit, not all of which are equally effective.

Schedule 5.5
PERSONAL CREDIT INSTRUMENTS AND SECURITY

Instruments	Security
Term Loan	Personal Property Lien
Demand Loan	Collateral Mortgage
Personal Line of Credit	Assignment of Securities
Credit Card	Pledge of shares and deposits
Financial Leases*	Assignment of moneys receivable**
Conditional Sales Agreements	Personal Guarantee**
	Wage Assignment**
	Lodgment of Title**

* For financial leases, security is not required as the credit union obtains ownership of the personal property upon execution of the agreement.

** A personal guarantee, a wage assignment or assignment of moneys receivable are viewed as supplemental forms of security which should be attributed a no dollar security value. A lodgment of title is generally viewed as a sub-optimal form of security. Refer to the following paragraphs for additional information.

Credit Management - Authorized Credit Instruments

Term and demand loans have historically been the most common forms of credit offered to members; these loans are for a fixed amount and are normally secured by major assets that are being financed. Recent consumer trends, however, have increased demand for personal lines of credit. These loans provide the borrower with a revolving sum of money up to a maximum limit, that can be used repeatedly, and is frequently unsecured. Whenever a personal line of credit is offered to a member, its availability should not be for an unlimited period of time, but rather, it should be subject to scheduled review and renewal, and where appropriate, collateralized. Lines of credit should be periodically monitored for the usage of these credit facilities and confirmation of upward and downward fluctuations.

A personal line of credit should be offered to all credit worthy members who might otherwise experience overdrafts in their chequing accounts. Under section 181 of the Act, overdrafts are prohibited, unless provided for, to a specified amount, in an overdraft protection agreement. For those credit unions that issue their own credit cards and hold the associated receivables, credit policies of the credit union should also require a line of credit to be approved for all members requesting credit cards.

Types of Residential Mortgage Instruments

There are several types of residential mortgages that may be offered by credit unions. Three of the more common types include:

- conventional first mortgages;
- high ratio, insured mortgages;
- conventional, second mortgages.

These credit facilities can be used for the purchase or construction of a home. (Construction mortgages are discussed later in this chapter).

Conventional First Mortgage

The conventional first mortgage is the instrument most commonly used to finance a home purchase. It entitles the lender to have first claim of the property in the event of a borrower default. In accordance with section 57 of Regulation 76/95, the principal amount for this kind of mortgage must not exceed 75 per cent of the value of the property when the loan is made. The value of the property should be determined by the property's appraised value or purchase price, whichever is the lesser amount.

High Ratio Mortgage

A high ratio mortgage is one in which the loan to property value ratio exceeds 75 per cent. These loans must be insured by a government agency (e.g. the Canada Mortgage and Housing Corporation created under the National Housing Act) or some private insurance company approved by the Superintendent. High ratio mortgage insurance protects the credit union against default and is required for compliance with section 57 of Regulation 76/95, although it is the borrower who pays the insurance premiums. It is technically possible to finance a property up to 95 per cent of its value if mortgage insurance is obtained.

Second Mortgage

Another type of residential mortgage is the second mortgage. A second mortgage is one in which the lender, in case of default, is behind the first mortgage in claim against the security (property). As this type of mortgage is higher risk, it should command a higher rate of return. Section 57 of Regulation 76/95 permits credit unions to offer second mortgages, as long as the total of the first and second mortgages on a property does not exceed 75 per cent of the property value, or unless mortgage insurance is obtained. When underwriting second mortgages, credit unions should consider the:

- maturity date of the existing first mortgage;
- size and interest rate of the first mortgage;
- ability of the proposed borrower to service both mortgage payments;
- potential depreciation or appreciation of the secured property.

Bridge Loans

All credit unions which have a mortgage lending licence can offer bridge loans. Bridge loans provide interim financing to a member for a property purchase with a closing date prior to that of an existing property being sold by the same member. Terms of up to 90 days are generally applicable. Repayment of the principal is not required until the closing date of the sale of the member's property. The following steps should be required by policy before advancing bridge loans:

- Executed unconditional agreement of purchase/sale for both the property being purchased and the property being sold.
- Irrevocable, acknowledged, letter of direction, from a lawyer stating that the funds from the sale of the property will be remitted to the credit union to extinguish the bridge loan.
- Written statements of mortgages outstanding from all mortgagees (other than the credit union) to determine the net equity in the property being sold after all deductions (i.e. real estate commissions, legal fees, etc.). This net equity must be equal to or greater than the amount of the bridge loan.
- Bridge loans may not exceed the limits prescribed in the by-laws/lending licence and compliance with regular lending policy.
- Sub-search for other registered liens, outstanding taxes, work orders, clouds on title, etc.

Reverse Mortgage Line of Credit

The reverse mortgage line of credit is a unique type of credit facility which requires adherence to special lending criteria. Like a conventional mortgage, the reverse mortgage involves the conveyance of an interest in land (real property) as security for debt, in particular a line of credit permitting demand drawings. As a result, a sound knowledge of mortgages is required before offering this product. A reverse mortgage differs principally from a conventional mortgage, in that there are no loan payments until maturity, at which time the original principal advanced plus all compounded interest must be repaid.

The reverse mortgage product is beneficial for two types of borrowers:

- Seniors who need additional cash to finance their needs but are unable to borrow due to income limitations.
- Individuals who are temporarily unemployed due to the pursuit of a higher level of education or persons taking a leave of absence from work for family, health or travel reasons.

The product generally offers two amortization options:

- Fixed Term (e.g. three years): for individuals who will re-enter the work force and resume normal mortgage payments or who plan to eventually sell their home and move to other accommodations.
- Life Tenure (approximated): for elderly individuals who wish to have the loan balance repaid from the eventual proceeds of their estate.

For a lender, reverse mortgages pose a number of risks including: term or credit risk, collateral risk, liquidity risk and interest rate risk. The following caveats are recommended to mitigate against these risks:

- The conditions of the reverse mortgage should be discussed in detail with the member so that he/she comprehends and fully accepts the credit costs and conditions of the program (e.g. settlement of the debt is expected when the homeowner dies or moves and sells the home). Members should be required to discuss their decision with their lawyer (members must receive independent legal advice) and a financial planner as appropriate. Powers of attorney and estate issues should be discussed.

- The credit history of the borrower should be confirmed as being satisfactory, and the original level of equity in the home should be significant. A conservative lending policy would set a loan to value ratio of 50 per cent at maturity; a moderate scenario might show the loan to value ratio at 60-70 per cent; under no circumstances should the loan to value ratio be expected to exceed 75 per cent at maturity.
- The arrangement should require a renewal every five years with a maximum program limit of 15 years. For life tenure reverse mortgages, actuarial tables must be consulted to estimate life expectancy since age is the critical determinant in calculating the credit limit. It is strongly recommended that a time cushion (e.g. an extra two to four years) be applied in order to reduce term uncertainty.
- Collateral risk should be minimized by selecting homes in neighbourhoods with proven capital appreciation rates. Annual reviews should be conducted to investigate the member's financial needs, to check collateral and recalculate the credit limit. A qualified property appraisal should be obtained at least every five years.
- Liquidity risk should be managed by establishing annual withdrawal limits, taking into account the loan term and the credit limit. Additionally, a portfolio limit for aggregate reverse mortgages should be approved, closely monitored and reported to the board annually.
- Interest rate risk should be managed by obtaining appropriate term funding. For life tenure reverse mortgages, the credit union should stipulate that renewals every five years are subject to interest re-pricing.

In summary, the reverse mortgage is an innovative instrument that may be very useful for certain members who are experiencing a shortage of cash and cannot borrow using conventional debt. The credit union, where applicable, can therefore provide a significant new service and in doing so be rewarded; reverse mortgages normally generate an extra 50 to 200 basis points over the conventional mortgage rate to cover associated risks. Credit unions should be aware that specialized personnel training is required to offer this product, and ensure that the member obtains independent legal advice.

Automobile Leases

Due to the increasing cost of new automobiles, automobile leasing has become an increasingly popular method of vehicle financing. For credit unions that have sufficient financial and other resources to offer leasing services to their members the following benefits can be pursued: improved servicing of member needs, increased loan penetration, increased member retention rate, and increased revenues.

Benefits

The benefits to members of automobile leasing include the following: up-front security payment is usually lower than a down payment on a conventional car purchase; monthly payments are smaller than on a conventional car loan and maintenance costs are usually lower (because most customers dispose of their vehicle long before any major repairs are needed).

Disadvantages

Automobile leases, however, also have disadvantages. From the member's perspective, leasing usually carries higher financing rates and charges than a conventional car loan, and it may not be economical for a consumer to purchase the vehicle at the end of the lease. From the credit union's perspective, the two major disadvantages include the liability insurance required for leased vehicles and the expertise and financial risk associated with the disposal of previously leased cars.

A credit union may meet market demand for leasing services either directly or through a subsidiary. For credit unions investigating automobile leasing, a number of factors must be considered, some of which are as follows:

- Under a car leasing arrangement, the credit union does not need to take chattel security as it owns the lease vehicle.
- In order to sell leased automobiles other than to the lessor, the credit union will need to obtain an automobile broker's licence.
- In order to protect itself from accident liability which is attached to the ownership of a vehicle, special insurance must be obtained, and appropriate documentation created for lessees to also acknowledge liability.

Given the above factors which expand legal liability for credit unions, it is recommended that leasing, where possible, be arranged through a limited liability subsidiary, or alternative car loans should be considered (discussed later in this chapter).

Before entering into the provision of lease products, a credit union which does not already have the necessary experience in leasing can contact a league, other credit unions with leasing experience, the Credit Union Central of Canada or the Caisse Centrale Desjardins.

Commercial Credit Instruments

Three fundamental instruments can be extended for commercial credits:

- commercial mortgages;
- commercial term loans;
- operating lines of credit.

A general overview of the three types of commercial credit is described below.

Commercial Mortgages

Commercial mortgages are defined as mortgage loans for business use, properties or multi-residential buildings. Commercial mortgages normally finance apartment complexes, retail and office buildings, or industrial properties providing warehousing and manufacturing facilities. (Under Regulation 76/95, mortgage rental properties in excess of four units, regardless of whether a building is owner occupied, constitute commercial loans. These can only be underwritten where a commercial lending licence permits.)

Construction Mortgages

Commercial construction mortgages and/or interim financing offered to construction companies and real estate developers for the building of new properties is a highly specialized type of lending which is not addressed in this reference manual. Cost overruns, structural defects, labour shortages, property liens under the Construction Lien Act and volatile real estate markets are risks which can lead to large potential losses for businesses in this industry. In order to engage in this type of lending, it is recommended that the credit union have significant real estate expertise and lend only on a strictly controlled basis to credit worthy contractors. Highly developed internal policies and specialized criteria for credit granting to real estate and construction companies are recommended.

Commercial Term Loan

A commercial term loan is a credit facility generally obtained to finance the fixed assets of a business (e.g. equipment, vehicles). Advances may be drawn down and are to be repaid over a fixed term according to a formula or schedule agreed upon by the credit union and the borrower. The amortization period of a commercial loan offered by a credit union must not exceed the economic life of the asset. Balloon payments (if any) at the end of the term loan should be restricted in size by lending policy and not exceed the value of the asset at the time of the balloon payment.

Operating Line of Credit

A commercial operating loan (also referred to as a line of credit) is a loan which supplements the day-to-day cash requirements of a business. Caution should be exercised when approving operating loans as they may represent higher credit risk than commercial mortgages or business term loans due to the nature of the security taken (e.g. inventory and receivables) and the lack of a definite draw down and repayment schedule. Additionally, operating loans utilize more resources of the credit union as extra manpower is required to monitor advances and security on a daily basis, and extra liquidity is needed by the credit union to accommodate potentially large fluctuations in loan demand.

Letters of Credit and Letters of Guarantee

A letter of credit is a promise of payment made by a financial institution on behalf of a member and for the benefit of a third party. Letters of credit are payable by the financial institution when stipulated conditions are met. A letter of guarantee is a similar undertaking by the credit union on behalf of a member, to a third party, which ensures compensation for non-performance of a contractual obligation (e.g. bid bond or performance guarantee). The purpose of a letter of credit or letter of guarantee is to substantiate a member's commitment to a contract with a third party.

The Act and Regulation 76/95 contain restrictions on letters of credit and letters of guarantee. Under subsection 178(1) of the Act, letters of credit and letters of guarantee must be (i) for a fixed sum of money and (ii) must require that the recipient has an unqualified obligation to reimburse the credit union for the full amount of the letter of credit or letter of guarantee. Under section 45 of Regulation 76/95, a letter of credit or letter of guarantee must have a fixed term and the credit union must have security at least equal to the amount of the obligation guaranteed.

When advanced for business purposes and for an amount greater than $25,000, a letter of credit or letter of guarantee constitutes a business loan for the purposes of the Act. As a result, the credit union must have a commercial lending licence (or deemed commercial lending licence under subsection 196(5) of the Act) before offering these instruments.

Letters of credit which are required by individuals, for purposes of court proceedings, should be classified as personal credit, and would be covered under the personal loan lending licence (or deemed lending licence) and the personal loan lending limits set out in section 61 of Regulation 76/95. (Refer to Section 5101 for more on lending licences and loan limits).

Limits

Apart from the lending licence restrictions, subsection 178(4) of the Act and section 46 of Regulation 76/95 prescribe a cap on the aggregate value of letters of credit and letters of guarantee that can be made by a credit union and its subsidiaries. This limit is prescribed in Regulation 76/95 as 10 per cent of regulatory capital and deposits of the credit union. (However, a credit union may petition the Superintendent for exemption from this limit under certain circumstances.)

Letters of credit and letters of guarantee provide financing to a member. As a consequence, these instruments require credit approval in the same manner as any other type of borrowing.

Documentation

A promissory note and a signed indemnification agreement (which may be combined in one document) must be obtained from the member, once the letter of credit or letter of guarantee has been duly approved. Standard forms for indemnification should be obtained from a league or a lawyer. The indemnification agreement should authorize the collection of a fee for this service, generally one per cent to three per cent per annum of the face value of the instrument. Letters of credit and letters of guarantee must be fully securitized in the same prudent manner as all other loans. Generally, these instruments note an expiry date. Where they are open (e.g. subject to the third party's cancellation) a condition of the credit facility must be that they must be renewed annually. Letters of credit should be recorded separately in the books of account and disclosed in the monthly loan report approved by the board, and reported in the notes to the annual financial statements.

Loan Volumes, Portfolio Mix and Industry Classification

Credit policy must limit the overall volume and mix of credit risk to be included in the loan portfolio. Credit policies should specify prudent limits on concentration of risk as follows:

- for each loan class, specify aggregate loan limits (as a percentage of capital and deposits) and individual loan limits (e.g. maximum dollar amount for individuals and their connected parties) - it may be prudent for these to be lower than what is allotted in the lending licence;
- establish prudent limits (either as a percentage of total loans or of total assets) and/or prohibitions on higher risk loan categories, including syndication loans, brokered loans, and loan concentrations within certain industries (refer Industry Classification below) , or riskier categories of loans within authorized lending classes such as personal loans for commercial purposes, social conscience loans, consolidation loans etc;
- establish limits on connected and restricted party loans (which may be lower than what is required by statute) as well as any policy restrictions or conditions for the approval of such loans.

Although authorized lending classes are clearly set out in the credit union's lending licence, it is nevertheless a prudent practice to acknowledge these lending classes in lending policy for easy reference by board and staff. Policy should state that the credit union must comply with its lending licence, and should set out those areas where policy restricts lending below the licence limit.

Industry Classification

To faciliate measuring and monitoring loans conectrated within certain industries, is is recommended that all commercial loans are classified using the North American Industry Code Standards (NAICS).

For simplicity, only the primary industry codes need to be used except for agricultural, contruction and real estate loans. Loans in these sectors require further segregation and should be classified by the use of appropraite industry sub codes.

Additional NAICS codes are available for use where required internally and where further classification is appropriate. These can be obtained through the NAICS website at – http://www.census.gov/epcd/naics

A listing of minimum industry codes is provided in Shedule 5.5.1 below.

Schedule 5.5.1 *NAICS INDUSTRY CODES*			
Primary Code	**Primary Category**	**Sub-Code**	**Sub-Group**
11	Agiriculture	111	Crop Production
		112	Animal Production
		113	Forestry
		114	Fish/Hunting/Trap
		115	Support Activities
21	Mining/Oil/Gas Explorartion		
22	Utilities		
23	Construction	231	Prime Cntracting
		232	Trade Contracting
33	Manufacturing		
41	Wholesale		
44	Retail		
45	Retail		
48	Transportation		
49	Warehousing		
51	Information/Cultural		
52	Finance/Insurance		
53	Real Estate	531	Real Estate
		532	Rental/Leasing
54	*Professional/Scientific/* Technical		
55	Management		
56	Administration		
61	Education		
62	Health Care		
71	*Arts/Recreation/* Entertainment		
72	*Accomodation/* Food Servics		
81	Other Services		
91	*Public Administration/* Government		

Volume Restrictions on High Risk Loans

In addition to specifying areas in which it will lend, it is also prudent for a credit union to specify in its credit policy those high risk categories in which it will not lend, or which it will lend to a relatively limited extent. Such categories of high risk may include:

- high risk industries with which the credit union is not familiar, or lacks the required lending expertise;
- specialized areas of lending, including brokered loans, syndicated loans, and any other area of lending the credit union is not comfortable lending to, or lacks the required lending expertise.

For instance, a credit union may choose not to lend to gas stations, due to environmental risk, even though they are able to under their commercial lending licence. Similarly, a credit union may choose not to provide mortgages on vacant land, although they are permitted under their residential mortgage lending licence. Such restrictions should be clearly stated in credit policy, and communicated to all lending staff.

The following schedule summarizes areas of lending that often represent high risk to some credit unions, either because of the lack of staff expertise in those particular areas, or because of certain environmental factors.

Schedule 5.6 ***AREAS OF HIGH RISK LENDING***
• consolidation loans • student lending • loans to gas stations • loans to restaurants • mortgages on vacant land • investments loans

Connected, Restricted Party and Staff Loans

Credit unions are required under the Act to limit the amounts of loans to individuals and their connected persons, and to restricted parties that may have undue influence over the credit union. The credit union should establish policies and procedures which address these requirements.

Connected Party Loans

All loans to connected parties must be approved in accordance with the lending licence limit set for such loans. Two members will be "connected" when one of the following relationships exist (members can be corporations, businesses or partnerships):

- The two members are related companies.
- One member belongs to a partnerships which is also a member.
- One member has guaranteed repayment of another member's loan to the credit union.
- One member is a dependent dwelling with the other member (refer further to FSCO's Interpretation Bulletin 1/96 for more detailed related person criteria).
- Any of the other relationships listed under section 73 of Regulation 76/95.

When approving loans in accordance with credit policies, the total lending limit of a borrower should be calculated to include loans to "connected persons" in accordance with section 62 of Regulation 76/95.

Restricted Party loans

Restricted parties include all directors, officers and committee members. Policy should require that director, officer and committee member loans be granted based on the normal financial tests and other criteria applied to arm's length borrowers as described in this Reference Manual. Each officer, director or committee member loan which exceeds that member's total shares and deposits must without exception be approved by the board and the credit committee of the credit union (see section 208 of the Act, and FSCO Administrative and Interpretive Bulletin 1/96).

Credit policy should also deal with staff loans, although under statute, staff are not considered to be restricted parties. For conflict of interest purposes, however, any person, (including directors, staff or a committee member), whose loan or that of a business associate, spouse, relative or related corporation is being considered, should not participate in any part of the loan approval process and shall absent himself/herself from any meeting or discussion about such loans. The credit union may choose to have a policy which provides loan benefits to staff, officers and directors, at preferred rates. These practices should be determined relative to other forms of compensation being offered. The practices should be well documented and strictly applied.

Reference should be made to Schedule 5.7 below, which sets out legislative restrictions on restricted party loans. Policy should recognize and reflect these restrictions, and provide for even tighter restrictions where it is felt necessary.

Schedule 5.7 *RESTRICTED PARTY LOANS*	
(R denotes Regulation 76/95; subsections noted)	
R. 82	"Restricted Party" is defined to include a director, officer, committee member, a spouse or relative of a director, officer or committee member, an auditor (if an individual), a corporation if 10 per cent is owned by a director, officer or committee member, and an affiliate of the credit union. (“Officer” is defined in section 1 of the Act. Relative” is defined in FSCO's *Interpretation Bulletin 1/96.*)
R. 208	Loans to officers, committee members or directors may be made in excess of the deposits of these persons, if so approved by the board and the credit committee (if any), before the loan is advanced.
R. 86.7	A residential mortgage loan in favour of a restricted party is permitted, if it is approved by two-thirds of the members of the board of the credit union.
R. 86.8	A personal loan in favour of a restricted party is permitted, if it is approved by two-thirds of the members of the board of the credit union.
R. 86(4)	Residential mortgage loans, personal loans and other loans made to directors, officers, committee members or employees may be made where two-thirds of the members of the board have approved in advance the terms of the loan and the policies and procedures governing them. Where the loan is a residential mortgage or personal, it may be made on terms more favourable than those offered to its members.

Lender Approval Limits

Maximum dollar limits for the authorization of individual loans by credit category and the authorization of total loans to any one member should be assigned to every lender in the credit union based on that lender's credit experience. Schedule 5.8 highlights the various categories of lenders which should be considered in the policy on lending limits.

Schedule 5.8 ***SAMPLE LENDER CATEGORIES***	
Lender Categories	**Lender Limits**
Apprentice Lender	No lending authority
Junior Lender	Up to $5,000 in personal loans
Intermediate Lender Senior Lender Senior lender and credit committee and/or board	Credit policy must determine lender limits per loan category and individual borrower in accordance with by-law limits

Lending approval limits may also vary depending on the nature of security received.

As discussed earlier in this Reference Manual, where possible, the co-existence of a credit committee and a lending department is recommended for joint approval of large loans. Where there is no credit committee, the board should co-review and approve large loans at or approaching the credit union's regulatory limits that have undergone the normal credit approval process. The size of loan requiring board approval will therefore vary depending on the asset size of the credit union. A definition of large loans requiring board approval should be documented in credit policies.

Lending Criteria

It is important for credit policy to document key lending criteria and required credit investigations. Policy should set general requirements to evaluate a borrower's character, cashflow, capital and collateral security, mandate special investigations relating to environmental risk, commercial and agricultural credits. Operational procedures should detail the minimum terms and conditions for different loan classes. Operational procedures are covered in section 5500 of this chapter.

Required Credit Information

It is prudent for a credit union to establish a policy outlining the minimum required credit information necessary for loan processing by loan category. For larger credit unions these details may be set out in operational procedures which are periodically reviewed by the board. Recommended detail on required credit applications, investigations and security requirements, by loan category, can also be found in Sections 5503, 5504 and 5505 of this chapter.

Required Credit Evaluation

Policy should mandate a formal credit evaluation of each loan being considered. Policy exceptions may be possible in this regard with respect to social conscience loans which provide community assistance and are limited to a prescribed percentage of the total loan portfolio.

Prescribed lending criteria must always include two general factors for evaluating a borrower's credit worthiness: (i) the ability and (ii) the willingness to repay the debt. The first consideration is a matter of financial background, while the second is a matter of character background. These considerations are often summed up in the expression "Know Your Borrower", which is essential for prudent lending.

The financial background of a borrower is basically assessed in terms of a member's cashflow capacity and existing capital (i.e. net worth) base. Character is assessed from personal information relating to the borrower's residential and employment history, in addition to his/her credit bureau rating. For further details and procedures on application of credit criteria and credit evaluation, refer to Section 5504 of this chapter.

Loan Process

Board approved policies on credit management must mandate a consistent lending process and related internal controls. Policies should provide for the following elements of a properly functioning loan approval process:

- loans decisions are made and approved by appropriate staff, with the appropriate authorization and accountability;
- lenders should be delegated formal lending limits in accordance with their lender credentials/experience;
- loans follow a pre-established loan processing flow, which sets out the proper movement of loan applications within the credit union;
- loan information and credit analysis are properly documented on standardized forms;
- loan applications are analyzed against established credit criteria;
- loan funds are disbursed through proper channels, with proper safeguards against theft or fraud;
- generally, loan renewals are subject to the same criteria and credit evaluation process as when first approved.

While the scope for these processes and controls must be documented in policy, the actual detail or content do not. Due to the level of detail, and the need for flexibility, this detail can be documented in operational procedures. Recommendations on the content of the above procedures and controls are covered in more detail in section 5500 of this chapter.

Securing Loans

Policy should establish the minimum prescribed types and amounts of security required for various classes and categories of loans. Details of such requirements, if lengthy, may be delegated to operational procedures. Policy and procedure requirements should be compatible with lending licence and by-law restrictions.

Security should be obtained before funds are advanced, with the notable exception of mortgage funds, which may be advanced in trust through a lawyer. Due to the significance of security as a legal remedy for collecting delinquent loans, credit management policies should require all security documents be physically safeguarded by the credit union. For a detailed discussion on the procedures for registering and/or protecting security, refer to Section 5505 of this chapter.

Board approved policies should document the maximum amount of unsecured loans allowed under regulatory limits, and under the credit union's lending licence and by-laws, as applicable. Generally, unsecured loans should only be considered for short-term loans and for members with the highest credit rating who have a previous and satisfactory borrowing history at the credit union.

While an evaluation of the financial history and future prospects of a potential borrower are crucial in determining whether a loan is sound, the taking of collateral or security is a method of ensuring that the loan is also safe. Unforeseen, adverse developments can affect the earnings of any borrower; as a result, security should be taken in order that a secondary, or back up, source of loan repayment is available to the lender. The taking of collateral should never be viewed as the rationale for making an unsound loan or a loan for which no credit investigations have been conducted since security realization often results in losses due to asset impairment or liquidation costs. The objective of successful lending is for every loan to be equally safe and sound.

Delinquent and Impaired Loans

A loan is delinquent if any of its scheduled payments are in arrears by a period greater than one day. A loan generally becomes impaired where, as a result of deterioration in credit quality, the lender no longer has a reasonable assurance of timely collection of the full amount of the principal and interest. Where this is the case, the carrying amount of the loan should be reduced, through the use of a loan loss allowance.

Policy on Delinquent and Impaired Loans

Loans which are in arrears or are considered to be a potential problem for the credit union should be actively managed with the intent of avoiding loss, or mitigating it to the greatest extent possible. The credit union should establish a process whereby loans in this category are effectively dealt with in a timely way. Refer to Section 5211 on Loan Rewrites and Restructuring. Refer to Section 5507 for procedures on the Collection of Delinquent Loans.

Management must make allowances for impaired loans on a monthly basis, in accordance with the requirements of DICO By-law No. 6, section 90 of the Act, and section 22 of Regulation 76/95. (Refer to the discussion of By-law No. 6 below). All write-offs of a loan in whole or in part must the approval of the board of directors.

The board of directors should receive reports no less frequently than monthly on the status of delinquent and impaired loans (see section 24 of the Act and Section 5400 on Risk Measurement and Board Reporting).

DICO By-law No. 6

In order to simplify compliance with the accounting principles on impaired loans in Section 3025 of the Canadian Institute of Chartered Accountants (CICA) Accountant's Handbook, DICO, in co-operation with the CICA, developed an interpretation standard for use by Ontario's credit union system. The resulting interpretation standard developed by DICO is prescribed in By-law No. 6. This interpretation standard prescribes specific guidelines as to when a loan should be considered impaired.

DICO By-law No. 6 is accompanied by an Application Guide, published by DICO, which is an instruction manual created to assist management with the implementation and application of the By-law. Reference to the actual text of the By-law and the Application Guide is recommended when accounting for impaired loans.

Loan Rewrites and Restructures

Policy should address conditions for authorizing loan rewrite, loan postponements, and formally restructured loans.

Loan Rewrites

A loan rewrite involves changing any of several conditions of the loan, such as the maturity date, the amount of the monthly payments, or the security taken. For example, the credit union may wish to reduce the size of monthly payments to accommodate a permanent decline in the borrower's cashflow (e.g. borrower has taken a part-time job at a lower salary), thereby lengthening the loan's repayment period.

The rewrite of a loan provides an opportunity for the restoration of the lender/borrower relationship and an opportunity to review, or where possible, increase security values. All rewritten loans, for which ultimate collection is not in doubt (regardless of previous delinquency or impairment), should be considered for accounting purposes to be new loans. As long as the rewritten loan does not significantly defer full payment of principal and interest (e.g. as might result from repeated loan rewrites) and as long as the rewritten loan does not permit any forgiveness of principal (or interest), such loan is not considered to be impaired.

Loan Postponements

A loan postponement, or loan extension, is a specific type of loan rewrite, in which the original maturity date of a loan is extended, generally by one or two payment dates, without changing any other loan conditions. A credit union may wish to postpone the maturity date of a loan if the cause of the borrower's delinquency is temporary (e.g. strikes or sickness). A loan postponement/extension may only be granted upon the written request of a borrower.

Policy Considerations

Policy should emphasize that a loan postponement or loan rewrite should only be considered in the event that the financial circumstances of the borrower have changed, but ultimate repayment of the loan is not in doubt. Under no circumstances should either a loan postponement or loan rewrite be used to hide loan delinquency. (Once a loan has become “impaired”, it must remain “impaired” until brought up to date or formally restructured in accordance with DICO By-law No. 6.) The following factors should exist before offering a member a rewritten loan (which would include any loan extensions):

- A reasonable explanation exists for rewriting or postponing the loan (e.g. sickness, parental leave, temporary loss of employment, i.e. strike, major unscheduled expense).
- The member has a current and verified source of income which is sufficient to meet the payments of the loan or has retained employment status with an employer (e.g. despite being on strike or on parental leave).
- The collateral which has been pledged has been reviewed by the loan officer, and the present security value is deter-mined to be adequate.
- The member has demonstrated a strong willingness to ultimately repay the debt. The member has shown co-operation to the loan officer in terms of discussing the problem promptly, sharing future cashflow information and agreeing to increased security requirements for the loan, where applicable.

Where the above conditions are met, a credit union may consider postponing or rewriting a loan. A loan should not be rewritten more than once a year; if it is, it would generally be considered impaired. Ongoing rewrites would also be an indication of loan impairment.

Authority for Rewrites

The decision to make a loan postponement or loan rewrite should be made either by the credit committee, or where there is no credit committee, by a designated loan officer, and should be initiated upon a written request from the member filed with the credit union. Upon arranging a loan postponement or rewritten loan for a member, management should consider charging an administration fee for this service.

Where the amortization period of a rewritten loan is extended, credit risk increases, particularly where the new amortization period exceeds the useful economic life of the pledged security. Due to the change in credit risk of a rewritten loan, it is necessary that the same or higher approval level apply to the rewritten loan as to the original loan.

Whenever a loan rewrite or postponement is granted, the borrower should be required to sign a confirmation of the details of the new arrangement.

Monitoring

Initially, rewritten loans should be monitored closely to ensure they perform according to their new terms. Management should track the volume of loans rewritten throughout the year and summarize these for the board. (Refer to Section 5400 on Risk Measurement and Board Reporting and Section 5406 on Loan Monitoring).

Policy on Commercial Loan Rewrites

Where applicable, credit policy should separately address loan rewrites for large commercial loans. In these cases, cashflow projections for the business over the remaining term of the loan on a "best case", "worst case", "likely case" basis, in light of industry activity, should be required prior to any loan rewrite. Where it is assessed that the future cashflows of the company can be restored to support the repayment of the debt over an extended term, a loan rewrite should be considered.

Where significant changes to the business operations of a commercial borrower are required in order to generate sufficient cashflow for loan repayment, the credit union should be assured of the following additional conditions before consideration of a loan renegotiation:

- establishment of detailed workout strategies to improve cashflow;
- borrower's undertaking to co-operate in the loan workout and the consent of any guarantors to new loan terms and conditions;
- establishment of comprehensive reporting requirements to the loan officer on key performance measures of the business;
- agreement on the immediate actions required to initiate the loan workout.

Commercial lenders should take care not to control or manage the operations of a borrower in a workout situation as this may expose the credit union to claims for economic damages not only by the borrower but potentially from the borrower's other creditors as well.

Policy on Formally Restructured Loans

In some cases, when a credit union is dealing with a delinquent borrower (often a commercial borrower) who is near bankrupt or who seeks an out-of-court settlement of his debt, the credit union may elect to negotiate a compromise loan agreement, as a last resort collection strategy. The compromise loan settlement will result in some principal or interest being written off in exchange for the borrower's full co-operation to repay the residual debt without further collection efforts.

These types of loans are referred to as formally restructured. The recorded values of all formally restructured loans must be written down to their compromised value, and such write-downs charged to income, in accordance with DICO By-law No. 6 on Impaired Loans (refer to Section 5210 on Delinquent and Impaired Loans). Credit policy should require senior management and board approval of all restructured loans.

Ongoing monitoring of these loans is recommended (refer to Section 5406 on Loan Monitoring), although once restructured, these loans, for accounting purposes, can no longer be considered delinquent or impaired.

Planning

Management and the board of directors must develop an annual business plan, summarizing the credit union's goals and objectives for the coming year.

This annual business plan includes a strategic financial plan that addresses each area of risk management, including credit. As part of the strategic financial plan, management and the board must set financial targets and plans for credit management. The elements of a credit plan are set out in Chapter 1 on Planning, and should be referred to for planning purposes.

Risk Measurement and Board Reporting

It is recommended that the credit union measure the performance and risk level of the credit portfolio and report these findings to the board.

Risk Measurement

The following are minimum risk and performance measures of credit, required by sound business and financial practices:

- Compliance with the board approved credit policy, and with regulatory requirements.
- Loan portfolio volumes and portfolio mix by credit category (e.g. term versus demand, or by varying loan purposes) and credit yields, compared to historical and planned volumes.
- Any overdrafts or loans exceeding by-law limits or author-ized credits.
- Volume of rewritten loans and formally restructured loans.
- Volume of delinquent and impaired loans by loan class, in accordance with DICO By-law No. 6, and related collection efforts.
- Identification and volume of large loans (as defined in board policy).
- The identification and volume of loans to restricted parties.
- The identification and monitoring of rewritten, consolidated and formally restructured loans for a probationary period.
- Other reporting requirements to be compiled by the credit committee as set out in section 24 of Regulation 76/95, and summarized below.

The credit union must also meet credit measurement requirements set out in the Act and Regulations. Under section 24(1) of Regulation 76/95, the credit committee is also required to provide the board with a report on credit management. The contents of the section 24(1) report are listed below, under the heading Statutory Reporting Requirements. The credit union may track any other measures of the loan portfolio as it sees fit.

These measurements 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 goals. Management can also assess whether there are material variances from the plan which need to be addressed.

Comparison of these measurements against historical performance, where possible, can also identify significant trends which may need to be addressed by management.

Risk Measurement Techniques

Sections 5401 to 5406 provide techniques for measuring the risk inherent in the credit union's loan portfolio.

Board Reports

The above measurements should be reported to the board of directors, so that the board can also monitor credit management and ensure adherence to regulatory requirements and to the annual business plan. Material variances from plan, and their causes, as well as management's plan to correct the variance should also be included in the report. Management should also provide the board with a summary on compliance with credit policy and regulatory requirements.

Frequency

Management should provide the board with a report on credit monthly.

Form

Schedule 5.10 on the following pages illustrates a Sample Board Report on Credit Management, which can be used by the management to monitor the loan portfolio, ensure regulatory compliance and report findings to the board. The report compiles and compares all the volumes, targets and policy limits required to properly manage the risk of the credit union's loan portfolio. This report can be adopted or amended for use by the credit union.

Information contained in the report can be expressed on a periodic basis (monthly, quarterly), or on a year-to-date, or both, depending upon the preferences of the board and the frequency of reporting.

Statutory Reporting Requirements

The credit committee must also provide the board with a report containing the information specified under section 24(1) of Regulation 76/95, and which include the following:

- The number of loan applications received by the credit union.
- The number, type and aggregate value of loans that were granted.
- The number of loan applications that were denied.
- The security obtained for each loan of an amount greater than that specified by the credit union's lending policies and procedures.
- The number and status of delinquent loans and the details of each loan that is more than 90 days in arrears.
- The number of and status of loans, (i) for which the due date was postponed for all or part of a payment of interest or a repayment of any principal, (ii) for which any security was substituted or released, or (iii) that were re-negotiated because of a change in the borrower's circumstances.

The frequency, form and content for board reports on credit management should be set out in credit policy.

Schedule 5.10 *SAMPLE BOARD REPORT ON CREDIT MANAGEMENT*					
Part I: Loan Volume and Portfolio Mix					
	Loan Volume($)	**Portfolio Mix (%)**	**Average Yield (%)**	**Policy Limits (%)**	**Previous Period (%)**
Sample Loan Categories **Personal Loans** Unsecured Leases Secured					
Category Total					
Residential Mortgages Residential Bridge Insured (e.g. CMHC)					
Category Total					
Commercial Loans Term loans Commercial mortgages Lines of credit					
Category Total					
Unincorporated Association Loans					
Agricultural Loans					
Institutional Loans					
Unincorporated Association Loans					
Agricultural Loans					
Letters of Credit					
TOTAL					

Part II: Loan Delinquency and Impairment			
	Volume of Delinquent Loans ($)	**Volume of Impaired Loans ($)**	**Summary of collection efforts:**
Personal Loans	$	$	
Residential Mortgages	$	$	
Commercial Loans	$	$	
Institutional Loans	$	$	
Unincorporated Loans	$	$	
Agricultural Loans	$	$	
TOTAL			

Schedule 5.10 (continued)
SAMPLE BOARD REPORT ON CREDIT MANAGEMENT

Part III: Summary of Loan Exception Reports

$ volume of accounts in overdraft________________ # of accounts in overdraft ________________ ________

$ volume of loans exceeding by-law limits________________ # of loans exceeding by-law limits ______________________

$ volume of loans re-written ________________ # of loans re-written________________

(Re-written loans can include postponed loans but not loans which have been formally restructured whereby some principal or interest has been forgiven. Restructured loans are recorded below.)

$ volume of loans formally restructured ________________ # of loans formally restructured __________________

$ volume of large loans ________________ # of large loans ________________

(Large loans are defined in policy.) ________

$ volume of loans to restricted parties ________________ # of loan to restricted parties ________________

Part IV: New Loans

# of loan applications received ________________ # of loan applications denied ________________ ________

# of loan applications approved ________________ $ volume of loans applications approved ________________

Type of loans approved	**Volume of loans approved**	**Type of loans approved**	**Volume of loans approved**
Personal Loans		**Unincorporated association loans**	
Residential Mortgages		**Agricultural Loans**	
Commercial Loans		**Letters of Credit**	
Institutional Loans		**TOTAL**	

Security Obtained for Large Loans (as defined in policy):

Loan # ________________ Security ________________ ____

____

Loan # ________________ Security ________________

Part V: Corrective Action/Strategies

Variance	**Corrective Action/Strategy**

Portfolio Mix, Volume and Yields

Management must measure its loan portfolio mix, volume and yields by loan category. Measuring by loan category requires that the total loan portfolio be broken down into all loan classes (i.e. personal loans, residential mortgages, commercial loans, etc.) and where applicable into further classifications which relate to higher risk loans (e.g. construction loans, consolidation loans, personal loans for small business purposes, etc.). Additionally, management should measure the distribution of its loans by term to maturity categories. This measurement is needed for asset/liability management purposes.

Loan mix, volumes and yields should be compared to historical and planned measurements. Where information is reported monthly, this requires comparison to the previous month, and the corresponding one month period from the previous year. Where information is reported quarterly, then volumes should be compared to volumes from the previous quarter, and from the same quarter from the previous year.

It is important to monitor for variances from the business plan in the volume of loans and the loan portfolio mix, as this could have serious effects on net financial margin. Different types of loan categories will provide different yields. Measurement of the loan portfolio mix can alert management to declining margins caused by an unfavourable shift towards lower yielding loans. Different loan categories also represent different levels of loan risk (e.g. consolidation loans tend to represent higher risk than a mortgage), and therefore an unplanned change in the loan portfolio mix may mean increased portfolio risk. Where possible, management can control this risk by adjusting the portfolio mix through new business.

Loan volumes should be compared to plan and historical volumes to assess the extent and rationale for loan growth. Stagnant loan growth should be analyzed in terms of the competitiveness of the institution's pricing and marketing, membership demographics and new product needs, as well as lending staff capabilities. Confirmed causes of low loan growth should be addressed immediately given that this situation is often the cause of declining credit union viability. Loan volume should also be monitored relative to aggregate regulatory limits and the credit union's lending licence.

Average yields should be periodically measured by loan category and compared to budget and to average industry yields to determine if pricing is both competitive and operationally adequate.

Refer to Schedule 5.11 for sample reporting on monthly new loan volume, which can be used to report loan portfolio volumes and mix.

Schedule 5.11 *SCHEDULE OF NEW LOAN VOLUME* *FOR THE MONTH OF ______________*					
# of loan applications received _____# of loan applications approved _____ **# of loans re-written*_______________$ of loans re-written* ______**					
Loan Category	**New Fixed Loans**	**New Variable Loans**	**New Loans**	**Total Portfolio**	**Mix**
Personal Loans					
Unsecured					
Leases					
Secured					
Category Total					
Mortgages					
Residential					
Bridge					
Insured					
(e.g. CMHC)					
Category Total					
Commercial					
Term Loans					
Commercial Mortgages					
Lines of Credit					
Leases					
Category Total					
Agricultural Loans					
Letters of Credit					
Grand Total					
* Re-written loans can include postponed loans but not loans which have been formally restructured whereby some principal or interest has been forgiven.					

Credit Risk Ratings and Watchlist

One recommended risk measurement and monitoring technique to be used for loans other than personal and mortgage loans, is the technique of credit risk ratings. Risk rating involves the categorization of individual loans, based on credit analysis and local market conditions, into a series of graduated categories of increasing risk. Risk ratings are most commonly applied to all loans other than personal and residential mortgage/bridge loans.

Risk ratings should be conducted:

- at the time of application for all new or increased loan facilities
- as part of the annual review process
- in situations where new information is considered that may materially affect the credit risk of the loan

A primary function of a risk rating model is to assist in the underwriting of new loans. As well, risk rating assists management in predicting changes to portfolio quality and the subsequent financial impact of such changes. Risk rating can also lead to earlier responses to potential portfolio problems, providing management with a wider choice of corrective options and decreased exposure to unexpected credit losses. Finally, risk ratings are useful for pricing loans and regulating the commercial portfolio exposure to maximum levels of risk. Board policy should optimally set the maximum credit risk allowable by credit classes and aggregate maximum portfolio credit risk. The extent of gradation (number of categories) of a risk rating system should be reflective of the size and complexity of the credit union's commercial and agricultural loan portfolio. Generally, a larger and more extensive a credit portfolio may require a more sophisticated risk rating system including a greater graduation of risk ratings.

In many situations, however, a system comprised of six risk levels of increasing credit risk is appropriate. Under this system, the lowest risk rating (1) is assigned to undoubted borrowers with vitually no risk. The highest risk rating (6) is assigned to borrowers where there is little or no likelihood of repayment. Loans should only be granted for risk ratings of 1, 2 (low risk) or 3 (normal risk). Ratings of 4, 5 and 6 are reserved for existing loans where the risk rating has deteriorated from the time of the original approval. Risk rating 4 is a "cautionary" rating assigned to higher risk loans. Loans in this category should be placed on a "watch list" for increased monitoring. (Further information on the watch list process is provided on page 5-47.2). Risk rating 5 is for "unsatisfactory" loans that are impaired in accordance with DICO By-law No. 6.

Schedule 5.12 below provides a more detailed overview of a risk rating model which has six risk rating categories combined with risk rating trends. The table also includes the types of assessment criteria or considerations which should be used to determine risk ratings. Compliance with the risk rating requirement as outlined in Schedule 5.12 satisfies the "credit rating band" requirement found in FSCO's Lending and Investment Guideline and meets DICO's expectations for an appropriate risk rating model.

Schedule 5.12 ***Sample Risk Rating Model***			
Risk Rating		**Attributes**	
1	**Undoubted**	• Virtually no risk • Government borrower	• Full cash security • Strongly capitalized • Outstanding management
2	**Low**	• Minimal risk of any loss • Strong security/capitalization position	• Excellent financial history/trends • Strong management • Stable/strong industry
3	**Moderate**	• Good security margin/LTV • Demonstrable debt service capacity	• Sound management • Steady financial trends • Moderate capital level
4	**Cautionary**	• Deteriorating/lack of financials • Covenant breaches	• Potential security shortfalls • Potential debt service shortfalls • Significant adverse developments
5	**Unsatisfactory**	• Need for immediate action indicated • Security shortfall/capital crisis	• Cessation of operations • Adverse management change • Interest/principle arrears
6	**Unacceptable**	• Receivership or bankruptcy • Definite loss evident	• Disappearing assets/security • Fraud
Risk Rating Trend		**Attributes**	
I		Increasing risk	
S		Stable or Steady risk	
D		Decreasing risk	
Risk Component		**Assessment Criteria/Considerations**	
Financial		• Debt Service • Debt to Equity	• Quality of Financial Reporting • Working Capital • Financial Trends
Security		• Cash conversion • Quality of evaluation	• Asset coverage
Management		• Skill and tenure • Commitment • Infrastructure and support	• Succession planning • Quality and frequency of information
Environmental		• Issues, evaluation and insurance	• Industry risk • Competition

Delinquent, Impaired and Formally Restructured Loans

Monthly, management must measure the volume of delinquent loans, impaired loans and loans formally restructured in accordance with DICO By-law No. 6. These loan accounts should be uniquely coded in order to track their existence for ongoing reporting purposes. Coding of impaired and delinquent accounts should be updated to reflect their status. Reports must also be generated showing the progress of all delinquent loans, and the status of legal actions related to those loans. The concept of Impaired Loans and Formally Restructured Loans are prescribed in DICO By-law No. 6, but are discussed below for purposes of Risk Measurement Techniques.

According to section 3025.03 of the Accountants' Handbook issued by the Canadian Institute of Chartered Accountants, a loan becomes impaired where there is a deterioration in the credit quality to the extent that the lender no longer has reasonable assurance of timely collection of the full amount of principal and interest. By-law No. 6 sets out the following common circumstances under which a loan must be classified as impaired, despite any other evidence (other circumstances could arise which could cause the loan to be impaired):

- payment on a not fully secured loan, or a restructured loan, is 90 days in arrears;
- payment is 180 days in arrears regardless of security;
- loan is with a collection agency or part of a bankruptcy proceeding/creditor proposal or the debtor has absconded;
- loan has been unrealistically postponed so that the recovery of principal is significantly deferred beyond the loan's original term.

Loan impairment should be recognized sooner than the conditions as noted above if assurance of timely and full collection of principal and interest is in doubt. Loan impairment is discussed fully in DICO By-law No. 6 and in DICO's Application Guide to By-law No. 6.

Connected, Restricted Party and Large Loans

Management should measure the volume of loans held by connected parties, directors, committee members and staff, and other restricted parties, by credit class. Monthly monitoring of these loans should ensure they do not exceed the limits set out in the credit union's lending licence, or as set out in board policy. Refer to Section 5205 of this Reference Manual for definitions of connected and restricted party loans. Also refer to section 199 and Part IX of the Act and section 73 and Part X of Regulation 76/95.

Connected party and restricted party loans which exceed prescribed limits have historically been a significant cause of credit union failure. Careful review of these loans by the external and/or internal auditors should be encouraged in addition to monthly board reviews of this information. Computer tracking of connected and restricted party loans is recommended, where possible.

Management should also monitor the existence of large loans. Large loans should be defined in either board policy or operational procedures and monitored to ensure they do not exceed policy limits. Refer to Schedule 5.13 which is a sample report on large loans.

Schedule 5.13
SCHEDULE OF LARGE LOANS*

For the month of ____________________

(prepare for cumulative borrower credits over $________)

Account #/ Name Of Borrower**	New Advances This Month:		Total Advances	Purpose & Term	Security	Operating Within Credit Terms?
	Amount	Rate				
Page Total						

* Large loans should be defined relative to the credit union's by-law limits or by policy and will vary among organizations.

** Borrower is defined to include any group of connected parties.

Rewritten, Restructured and Consolidated Loans

For a probationary period of two or three months, management should monitor all of its rewritten, consolidated and restructured loans, to ensure they are operating within their terms and conditions.

Loan Rewrites

A loan rewrite involves changing any of several conditions of the loan, such as the maturity date, the amount of the monthly payments, or the security taken. A loan postponement is a specific form of loan rewrite, whereby the original maturity date of a loan is extended, generally by one or two payment dates, without changing any other loan conditions. Loan rewrites are discussed in Section 5211 of this chapter.

Formally Restructured Loan

A formally restructured loan is a loan rewrite where a portion of the principal or interest being written off in exchange for the borrower's full co-operation to repay the residual debt without further collection haggling. Formally restructured loans are discussed in Section 5212 of this chapter.

Consolidation Loan

A consolidation loan is defined as a loan to assist a member who has overextended his/her use of credit facilities and needs to rearrange his/her debts as a prudent measure to avoid insolvency. Generally, a consolidation loan allows a member to consolidate existing credit facilities (usually credit cards) under one loan agreement, over a manageable amortization period. Additionally, it enables a member to simplify his/her borrowing arrangements and to reduce borrowing costs, as a result of a lower interest rate relative to card credit.

Consolidation loans are an area of high risk lending, given that most borrowers requiring a consolidation loan have not managed their credit prudently in the past. Additionally, some borrowers utilize consolidation loans to further increase credit limits, because they are experiencing continued financial difficulty. Consolidation loans should therefore be carefully evaluate and monitored.

Loan Monitoring

A number of activities are recommended to effectively monitor the loan portfolio on an ongoing basis. The purpose of loan monitoring is to detect problem accounts early and to mitigate against probable losses either through loan restructuring or the termination of poor quality loans. Loan monitoring is a comprehensive process, which includes:

- routine review of borrowers' accounts (including lines of credit) to detect unusual activity;
- annual and interim review of commercial loans;
- interim review of problem mortgages;
- Use of exception reports recording loan irregularities;
- internal audit or league reviews of loan portfolio.

Each of these activities will be discussed in further detail below.

Routine Reviews

A certain percentage of loans in every loan portfolio will become delinquent due to unexpected adverse changes in the financial condition of certain borrowers. The credit union should be alert to, and investigate, any warning signals which indicate unusual borrower behaviour that could result in loan delinquency. Initial warnings of loan repayment difficulties by a borrower should result in that borrower being risk ranked accordingly as a watchlist loan and subject to ongoing monitoring by the credit union. Late or missed payments are generally the first sign of a potential problem; however, other early warning signs are common for individual borrowers. Refer to Schedule 5.14 in this regard. Credit unions can assist members experiencing loan repayment difficulties by referring them to, or offering, credit counselling.

Commercial Loan Reviews

For commercial accounts, an annual loan review should be under-taken three to six months after the date of the borrower's year end. Where updated financial information cannot be obtained, credit should not be renewed. All annual reviews of business loans should include a visit to client premises to confirm that business operations and security are intact. The annual review of loans should be explained to members as an important method for the credit union to reacquaint itself with the needs of its borrowers. An annual review provides an opportunity to market new products and broaden member services.

Schedule 5.14 *COMMON WARNING SIGNS OF INDIVIDUAL BORROWER FINANCIAL DISTRESS*
• Liabilities exceed assets • Escalating debt • High level of unsecured debt • Overdrafts • Urgent requests for loans • Repeated requests for higher credit limits • Late payments and requests for maturity extensions • Returned cheques (as indicated in the overdraft report) • Returned mail to credit union or telephone disconnected • Inquiries from other creditors on member's credit worthiness • Loss of employment (e.g. strike, local plant closure) • Borrowings from lenders of last resort (e.g. finance companies)

Loans which are subject to an annual review (e.g. this should represent the entire loan portfolio excluding mortgage and personal term loans that are in good standing) should be logged by the credit union according to the month that they are due to be reviewed. A senior officer should monitor and document the completion of these loan reviews. Where an annual review is more than 30 days overdue, this should be diarized in an exception report to the general manager, with valid explanations for the delay and a revised annual review date documented.

Certain commercial loans which are higher risk than average may necessitate financial review more frequently than annually. Conditions of a business credit may stipulate that the loan is subject to quarterly reviews because of the volatility of the business conditions or recent credit violations. Interim loan reviews should additionally be performed given the following circumstances:

- Member requests additional borrowings.
- Member experiences an adverse economic event.

Exception Reporting

In order to assist lending personnel in their loan monitoring function, routine exception reports should be generated (a separate report for each branch location, if applicable).

The following loan exception reports are recommended. Irregularities in the loan portfolio should be summarized on a particular date of each month on a lender by lender basis before compilation into the following reports:

- List of Delinquent and Impaired loans (based on system generated report);
- List of Loan Advances in excess of member's authorized credit (e.g. unauthorized overdrafts or off margin lending for commercial borrowers);
- List of Overdue Annual Reviews;
- List of Security Documents to obtain or register;
- List of Member Reporting Deficiencies (e.g. late interim financial information or receivables/inventory listings).

Some or all of these reports could be compiled in to one loan exception report, where appropriate.

The above reports should be reviewed and signed by the senior loan officer and the general manager. Reasonable explanations for deficiencies should be recorded on these reports by the individual lenders responsible, with the expected date for problem correction documented. Where a serious deficiency continues for a lengthy or indefinite period of time, an allowance for the loan should be established (refer to Delinquent and Impaired Loans in Section 5210 of this Reference Manual) and the loan categorized as an unsatisfactory credit risk. A significant number of unexplainable and sustained loan irregularities is evidence of a poorly managed loan portfolio.

System Generated Reports

System generated reports prepared by the accounting staff can provide additional useful information on borrower activity and staff compliance with the credit union's authorized loan processing flow. In larger credit unions, the following reports should be prepared daily (unless otherwise noted) reviewed daily by the senior loan officer, signed and dated. The general manager should randomly spot check these reports for evidence of exception follow up. In smaller credit unions, where the manager directly reviews the reports, the credit committee, the board or a sub-committee of the board should conduct random spot checks on the following loan reports (original computer printouts should be reviewed):

- Loan Disbursements Report should list all new loans issued by amount and borrower name.
- Report on Loans exceeding Authorized Limits should list all loans in excess of the credit union's policies and lending limits, and all unauthorized over-drafts.
- Large Debit Report should list deposit withdrawals over a certain size (size to be specified by management, to track member activities).
- Loan status report should list all adjustments to member accounts, both non-financial and financial fields (this report should be reviewed to detect account fraud).
- Delinquent and Impaired Loans Report should list all loans with overdue payments.
- Accrued Interest Report should list uncollected interest revenue (this report should be reviewed monthly for reasonableness based on total loans outstanding).
- Improperly Authorized Loan Advances Report should list those funds which were released without two appropriate authorizing signatures (this report must be prepared manually).
- Summary of all daily or weekly reports produced to ensure that exception reports have been reviewed (and not destroyed).

Credit Administration Diary

An important procedure in managing a loan portfolio and its accompanying security is the use of a Credit Administration Diary System. A Credit Administration Diary is an information system which keeps track of dates which are significant in the credit monitoring process (e.g. loan renewal and review dates, fire insurance expiry dates, etc.). These systems can be quite sophisticated (computerized), or can be simplistic (card catalogue), depending on the needs and size of the loan portfolio.

The Credit Administration Diary system can also be broken down into numerous diary systems (e.g. mortgage diary, insurance diary, security diary), again, depending upon the needs and the dynamics of the lending department. Where duties are segregated among staff, the Diary system may be divided in the same manner.

The following is a non-exhaustive list of important dates which could be monitored using a diary system:

- PPSA expiry dates;
- loan expiry dates;
- mortgage expiry dates
- credit facility annual review dates;
- fire insurance expiry dates;
- chattel insurance, non-filing insurance, expiry dates, etc.;
- loan collection follow-up dates;
- probationary periods for ongoing monitoring of rewritten and restructured loans;
- real estate tax arrears dates;
- inventory valuation review dates.

Security Diary

A registered security interest that is taken against a member's property must be renewed periodically to remain legally enforceable. If a credit union's registered first lien is allowed to lapse, a second lender can become first lien holder. Both of these risks can be mitigated through the use of a security dairy. A security diary is a monthly list of security documents in the loan portfolio requiring registration renewal.

As soon as a security document is registered, the borrower's name, account number, security instrument, and the security's renewal date should be diarized in the security diary for future renewals. In order to account for processing delays in registration, it is recommended that the diary page for the following month be reviewed 30 days in advance to initiate required renewals.

Due to the many technical requirements and continual revisions to Ontario's security legislation, it is recommended that the credit union contact its league and/or its lawyer to provide information updates on changes to this legislation.

Audit of the Loan Portfolio

The final component of an ongoing loan monitoring system includes the examination of a portion of the loan portfolio by persons independent of the credit granting process. For credit unions which do not have an internal audit department a number of alternatives may be considered. Loan reviews, for example, may be performed by a subcommittee of the audit committee, the league, the stabilization authority, DICO as part of their on-site verification process, or external accountants as part of a periodic review of annual business practices. The objective of a loan review is to obtain an independent opinion on the quality of a number of randomly selected loans. The following details should be examined for each loan:

- Compliance with the credit union's policies, by-laws, lending licence, lending limits, the Act and Regulation 76/95 (e.g. lender approval limits not contravened).
- Existence of valid and sufficient security (e.g. proof of PPSA registration).
- Existence of adequate documentation, including sufficient credit analysis and investigation which supports the credit decision.
- Evidence of a well performing loan (e.g. operating according to terms).

Risk Management

Corrective Action

An important activity in the effective management of risk is management's timely response to an-authorized risk or poor performance developments. As a follow up to the credit risk measurements taken by the credit union (discussed in Section 5400), management should investigate all significant performance variances relative to the annual business plan and to historical performance, and respond by taking action to correct these variances. Management must similarly respond to any contravention of board policy or regulatory requirements, or other unauthorized risk.

Operational Procedures

Procedures can assist management to monitor the loan portfolio, to monitor compliance with regulatory and policy limits, and to monitor loan delinquency. It is recommended that the credit union have the following documented procedures in place:

- Reliance on qualified and competent lenders
- Loan approval and disbursement process
- Loan documentation
- Credit Investigation and Analysis
- Loan security
- Loan renewals
- Collection of delinquent loans
- Use of real estate appraisers
- Use of lawyers for mortgage transactions

These procedures are discussed in Sections 5501 to 5509. **To assist in implementation, procedures should be both appropriate and cost effective given the size of the credit union's operations.**

It is a sound business and financial practice for credit unions to document procedures. Written procedures result in higher staff productivity and better control over resources.

Qualified and Competent Lenders

Each credit union must ensure that qualified and competent persons control credit management activities and that there are procedures in place to ensure credit authority is both appropriately delegated and implemented. Under DICO By-law No. 5, the board must be advised annually of the general quality and competence of human resources.

This objective can be partially met by the development and implementation of detailed job procedures and human resource systems which set out the qualifications for lending staff or volunteers (e.g. credit committee members), as well as measure their job performance relative to plan and policy expectations. (For more information on this, refer to Chapter 3 on Human Resources and Performance Appraisal.)

The board needs to ensure that members of the credit committee have adequate lending skills and/or obtain adequate training. Refer to the subsections below for recommended qualifications and training for lending staff and the credit committee.

Under the Act, the duties of the credit committee can be entirely or partially delegated to a loan officer. This common arrangement is also discussed below.

The Credit Committee

The duties and authority of the credit committee are prescribed in sections 110 to 124 of the Act. The Committee must be comprised of at least three persons who have been elected by the members of the credit union. The term of office for credit committee members should be set out in the by-laws. Officers, directors or members of the audit committee may not serve on the credit committee.

The credit committee must meet at least monthly to consider all applications for loans, and to make prudent lending decisions within the lending limits provided in the credit union's lending licence or by-laws or policies if they are more restrictive. Members of the credit committee may be liable for deficiencies on loans that violate the by-laws or the Act: section 238(3).

Loan Officers

Under sections 122 and 123 of the Act, authority to approve loans may be transferred from the credit committee to individual loan officers in two ways: (i) a by-law may be passed whereby loan officers are appointed to assume all duties of the credit committee, resulting in the elimination of the Committee, (ii) the credit committee may retain its advisory capacity, but delegate its lending authority and responsibilities to individual loan officers.

When delegating lending authority to officers, the continued existence of a credit committee for the purpose of periodic loan review results in an effective method of retaining control over the lending function. The co-existence of the credit committee and loan officers is also appropriate for providing joint approval of large loans that exceed certain dollar amounts.

It is important to note, that under section 124 of the Act, the board of directors in its monitoring activities cannot overturn a decision of the credit committee or of the loans officer to reject a loan application, as long as policy and regulatory requirements have been followed.

Credit Committee Qualifications and Training

For credit unions where loans are authorized by a credit committee, rather than a lending officer, the following recommendations for qualification and training apply:

- Well qualified individuals should be recruited for the credit committee and recommended for election by a nominating committee that has researched member qualifications. A person should be nominated to the credit committee because of his/her ability and willingness to fill the position and for no other reason.
- Members who are nominated to the credit committee should be able to demonstrate that they have a sufficient understanding of financial matters (e.g. through previous work and voluntary experience, or educational background).
- New members should attend a mandatory orientation program which instructs them on the credit policies of the credit union (e.g. required credit investigation/analysis policies and lending by-law limits).
- Each member of the credit committee must receive ongoing training on security legislation and/or credit risk evaluation. Reliance on league or other training programs which teach credit granting and financial analysis is recommended.

Lending Staff Qualifications and Training

In the case of lending officers, effective recruitment practices, supplemented by appropriate training and development, will contribute to the quality of the lending team, and in turn, the quality of the loan portfolio. Different lending positions demand different qualifications which management should consider when allocating staff to job posts. Commercial and agricultural lending, for example, require staff with special lending expertise.

In order to be an effective lender, an employee must have both an adequate educational background and the appropriate job training. Schedule 5.16 outlines sample employee qualifications recommended for various lending positions in a credit union. It is recognized that some individuals may require more or less job training experience to become qualified than what is recommended in this Reference Manual because of certain mitigating factors (e.g. previous work history, the complexity of their present assignment and personal aptitude).

Until such time as the necessary qualifications are met, employees should not be given lending authority. When lending authority is assigned to an employee, he/she should be required to sign a "Statement of Lending Authority" on which the following is acknowledged:

- The lending licence and lending policy limits (or, if applicable, internal by-law limits) of the credit union for each type of loan.
- The loan approval limits which have been specifically assigned to him/her unilaterally, and/or in conjunction with other senior lenders.

It is recommended, where this is possible, that credit unions adopt a team approach to training, as an effective method of staff development. An apprenticeship period of 12 to 36 months is recommended for novice lenders depending on the nature of their lending assignment and their individual aptitude. New lenders should receive close supervision for their initial period on the job (e.g. first six months). While the extent of such supervision would diminish over time, the requirement for ongoing monitoring and feedback by an experienced lender should continue for the full term of training. The experienced lender on whose team the novice lender is apprenticing should delegate job assignments with increasing difficulty and monitor employee progress frequently, recording and sharing performance observations with the employee. It is also recommended that the employee have his/her knowledge of products, lending policies and procedures tested on a formal basis through written or oral examinations, conducted by an experienced lender.

Schedule 5.16 ***RECOMMENDED QUALIFICATIONS FOR LENDING PERSONNEL***	
Type of Lender	**Suggested Qualifications**
Personal Lender	• Appropriate knowledge of products, personal lending policies and procedures. • Appropriate knowledge of the relevant lending legislation and lending licence restrictions. • Enrollment in consumer lending and mortgage course. • Instruction on security evaluation and registration. • Months of monitoring under an experienced lender.
Mortgage Lender	• Good understanding of products, mortgage lending policies and procedures. • Appropriate knowledge of the relevant lending legislation and lending licence restrictions. • Completion of consumer lending and mortgage course. • Knowledge of mortgage appraisals, documentation and registration. • Months of monitoring under an experienced mortgage lender.
Commercial Lender	• Adequate knowledge of products, commercial lending policies and procedures. • Appropriate knowledge of the relevant lending legislation and lending licence restrictions. • Satisfactory previous lending experience in personal loans or mortgages. • Months of monitoring under an experienced commercial lender. • College level accounting, business law course. • Financial statement training. • Completion of an advanced lending course (e.g. CUIC, or courses offered through a league).

For smaller credit unions where the team approach to training is not an option, the general manager should be held accountable for supervising new lending staff. This situation may require the hiring of part-time staff to relieve the manager of other administrative duties until the training of lending staff is completed. Alternatively, larger credit unions in the vicinity should be contacted and arrangements investigated for smaller credit unions to participate in neighbouring training courses.

When the manager or the assigned senior lender is sufficiently satisfied with the progress of the novice, a recommendation should be forwarded to the board and/or senior management that the lender is indeed qualified to receive a lending limit. Subsequently, the credit committee, the audit committee and/or senior management should continue to monitor the lending activities of the lending officers. Routine investigation of delinquent loans will assist in determining competence of a lender by determining the underlying causes of failed loans. (See Loan Monitoring, section 5406). Evidence of negligence or poor credit granting skills should be recorded on the employment record of the lender and taken into consideration when assigning him/her with additional lending responsibilities.

Lending personnel must receive ongoing training regarding new products, lending policies, and changes to security legislation. Where a credit union wishes to expand its lending services (e.g. into commercial lending) but does not have sufficiently qualified staff to offer these services, it is recommended that new personnel be recruited with the appropriate experience. Recruitment of new lending staff should be carefully conducted with satisfactory references received from the applicant's previous employer confirming that he/she holds appropriate qualifications for the job. Recruitment assistance from the league should be considered whenever job vacancies occur at the credit union.

When developing individuals for the credit granting function, it is important to train them as lending "counsellors". Professional lenders owe a duty of care to prospective borrowers to ensure these individuals do not overextend themselves in debt, jeopardizing their financial stability. Refusing a member's request for credit, where there is insufficient means of debt repayment or security, should be viewed as a natural and expected part of the lender's function. Consideration of loan requests must be based on factual information obtained and not in any way influenced by a member's standing in the credit union or in the community.

Loan Approvals and Disbursements Process

The loan approval process comprises of processing and evaluating loan applications, documenting loan decisions and distributing loan funds. It is important that management establish a loan approval process which includes controls over lending authority and accountability.

A properly functioning loan approval process requires the following:

- loans follow a pre-established loan processing flow, which sets out the proper movement of loan applications within the credit union;
- borrower information and credit analysis are properly documented against established credit criteria;
- loans decisions are made and approved by appropriate staff, with the appropriate authorization and accountability;
- loan funds are disbursed, after applicable security is in place, through proper channels, with proper safeguards against theft or fraud.

Loan Processing Flow

Every credit union should establish a standardized loan processing flow, and document this process in operational procedures. The following are the general steps in the loan process:

- The loan process begins with a lender establishing credit for a member in accordance with board policy.
- A security custodian would then register and file the security.
- A disbursements officer should advance the funds and the accounting staff should record the transaction. Two signatures should appear on the journal voucher sent to the disbursements clerk who advances funds to the member. The originating loan officer and either the general manager, or his designate (e.g. assistant manager) should authorize the journal voucher, after examining the supporting file.
- Advances should be totalled on a daily basis by accounting. The sum of the advances should be compared by senior management to the value of promissory notes or other evidence of indebtedness. Any discrepancies should be followed up immediately.
- Before a loan file is stored, it is recommended that it be reviewed against an accompanying loan checklist by senior management and initialled as evidence of such review.
- Finally, senior management and the credit committee, should receive detailed loan disbursements summaries on a monthly basis (where it exists).

Schedule 5.17 provides an illustration of this process.

Schedule 5.17* *RECOMMENDED LOAN PROCESSING FLOW FOR LARGER CREDIT UNIONS	
Procedure	**Responsibility**
1) Loan application	Loan officer
2) Credit investigation, verification, analysis and security valuation	Loan officer
3) Loan recommendation	Loan officer
4) Credit approval per loan limits	General manager (or designate)
5) Receipt of security documents and promissory note from member	Loan officer
6) Registration of security documents	Security custodian
7) Review of security registration and completion of debit journal voucher	Loan officer
8) Filing of security documents	Security custodian
9) Review and cosigning of debit journal voucher	General manager (or designate)
10) Loan advanced per debit journal	Loan clerk
11) Loan recorded in accounting records and in report on new advances	Accounting
12) Comparison of report on new advances and promissory notes received	Security custodian
13) Final review of loan checklist and file documents	General manager (or designate)

Limited Staff Resources

Where there is insufficient staff in a credit union for a complete segregation of duties, the following minimum recommendations apply:

- The credit approval and disbursements functions should be performed by two separate individuals.
- The accounting and disbursements functions should be performed by two independent individuals (this may necessitate the active involvement of committee or board members in the disbursements function). Total funds advanced should be balanced against the accounting records daily.

Loan Disbursements

In addition to the requirement for loan approval controls, there is a need to closely monitor the loan disbursement function. Individuals who have lending authority (including the general manager) must not be assigned unilateral disbursement authority by the board, the credit committee, or management, due to the conflict of interest this situation may create. It is generally recommended that an independent employee act as funds disbursement officer, empowered to release funds upon evidence of at least two other authorizing signatures. The disbursement of loan funds should not be authorized until all required security is in place.

Loan Documentation

Proper assessment of credit risk, loan monitoring and delinquency control begin with well documented member files. Maintaining orderly and adequately documented loan files is an important element of credit risk management. Proper documentation provides the following major benefits:

- It constitutes evidence of the terms and conditions of a member's indebtedness.
- It creates valid security which can be realized if it is in compliance with legal requirements.
- It provides an audit trail of the loan decision (e.g. that the loan was authorized in accordance with policy and good lending judgment).
- It allows easy and efficient follow up of problem situations (e.g. skip tracing) or routine member inquiries.
- It establishes a member's credit history for future lending decisions.

Ideally, it is recommended that security documentation be maintained physically separated from the loan application and credit investigation information. Alternatively, credit and security files should be stored together in a fire-proof environment. Negotiable security should be subject to the dual control of a security custodian and a designated senior management person. All files should be purged on a regular and periodic basis by the appropriate lending officer to ensure their continuing validity.

Schedule 5.18 outlines the recommended contents of both the credit and security files for various loan categories. For commercial borrowers, current account documentation will include additional data which supports credit transactions; refer to the Schedule 5.19.

It is recommended that in each credit file, a loan checklist be included, summarizing the various steps that have been taken to properly establish a new loan. This loan checklist should be completed by the lending officer responsible for the loan or by a designated credit committee member, where applicable. It should be reviewed and initialled by the loans supervisor/manager to ensure the credit and security files are in order before these files are stored.

Schedule 5.18 ***RECOMMENDED FILE DOCUMENTATION***	
Credit File	**Security File**
For Personal Credit: • Loan checklist • Approved loan application • Credit investigation • Credit analysis • Life and disability insurance application or waiver • Copy of bill of sale for chattel purchased • Member correspondence • Record of telephone conversations	• Chattel mortgage or other security documents • Promissory note • Payroll deduction authorization (if applicable) • Insurance endorsement (if applicable) • PPSA search • PPSA registration
For Mortgages: • Loan checklist • Approved loan application • Credit investigation • Credit analysis • Member correspondence • CMHC application (if applicable) • Record of telephone conversations	• Mortgage document • Lawyer's letter of final report and opinion with supporting documentation • Pledge of fire insurance Independent legal advice certificate (if applicable) • CMHC approval (if applicable) • Qualified appraisal report • Commitment letter/mortgage loan offer • Instructions to lawyer • Certificate of title insurance
For Commercial Credit: • Loan checklist • Approved commercial loan application • Borrower's financial statements • Supporting financial sum-maries (e.g. budgets and/or aged listings of receivables, payables, inventory and fixed assets) • Credit investigation • Credit analysis • Member correspondence • Record of telephone conversations	• Loan agreement and/or loan commitment letter • Promissory note • General security agreement and/or other security documents • PPSA search • PPSA registration • Assignment of fire/life insurance • Independent legal advice certificate (if applicable) • Any applicable guarantees • Lawyer's opinion letter

In the event of litigation, the contents of a credit file may be required to be disclosed to a member or another party. It is strongly recommended that a credit file not include any information (for example, in the form of notes, correspondence or memoranda) concerning matters not relevant to the loan decision and the maintenance of the loan.

Schedule 5.19 *COMMERCIAL LENDING REQUIRED ACCOUNT DOCUMENTATION*		
Sole Proprietor	**Partnership**	**Corporation**
Certified copy of registration of commercial name Photocopy of birth Certificate of proprietor Current account agreement	Certified copy of the registration agreement or declaration of persons operating under a trade name Photocopy of birth certificates of partners Partnership agreement which should include certified copy of borrowing and pledging resolution Current account agreement	Articles of incorporation Declaration of company operating under a trade name Certificate of corporate status Certification as to officers and directors of company Certified copy of borrowing and pledging resolutions/by-laws Resolution appointing signing officers per title Current account agreement

Personal/Mortgage Loan Application Forms

Personal loan or mortgage loan applicants should complete standardized loan application forms. The following information fields must be fully documented on these forms:

- Borrower's legal name
- Loan class
- Purpose of the loan and source of repayment
- Amount of loan
- Loan maturity
- Loan price (variable/fixed interest rate and fees)
- Terms and conditions of the loan
- Security (nature, value and ownership)
- Financial details of borrower (e.g. earnings, assets, liabilities, net worth)
- Credit investigation
- Credit analysis
- Rationale/recommendation for credit approval

Credit unions should consult their league for a sample loan application form.

Commercial Loan Application Forms

Whenever a commercial loan application is completed, it is recommended that a complete loan package accompany the business loan summary form. A complete loan package should include financial statements, cash flow statements and budgets, credit risk analysis, history of the business and qualifications of the principals (including credit history), description of assets/liabilities and security, as well as industry and market analysis. Application forms may be obtained from a league or developed independently. Forms which are developed internally by the credit union should be approved by legal counsel and reviewed periodically to ensure their comprehensiveness.

In each commercial loan application or loan summary form, the lender should document clearly and concisely the credit rationale supporting his/her recommendation for credit approval. The rationale should explain how the loan represents a satisfactory (or better) credit risk, referencing briefly the applicant's character, capacity to repay, capital base in addition to the value of loan collateral. The credit rationale (e.g. investigator's remarks) should summarize, generally in a few sentences, the basis for the credit decision; it should not ignore or unduly rationalize shortcomings of the applicant but should consider the facts of the credit and provide a conclusion which is consistent with the facts. The credit rationale must leave the reader fully convinced that the credit risk is acceptable within parameters established in policy and therefore should be approved, or that it is unacceptable and should be declined.

Loan Agreements

With the exception of the financial highlights of the borrower and the credit analysis/rationale, all details of the credit facility should be communicated to the borrower by way of a loan agreement. For consumer loans, a variety of forms may constitute the loan agreement per Schedule 5.20.

Schedule 5.20 ***SAMPLE CONSUMER LOAN AGREEMENT DOCUMENTATION***	
Loan Type	**Sample Documentation**
Fixed rate loan	Promissory note
Variable rate loan	Variable rate loan agreement
Home equity line of credit	Loan agreement for line of credit

For residential mortgages, the standard mortgage document will constitute the loan agreement. For commercial loans, all the important information summarized in a commercial loan commitment (or offer) letter should be set out in greater detail in a document called a commercial loan agreement. The loan agreement, for example, should state the financial statement reporting requirements and general conditions of credit (e.g. a required working capital ratio, assignment of insurance, etc.).

Credit Investigation and Analysis

Regardless of the types of loans offered to members, standardized processes, credit investigation and analysis should be conducted. Credit analysis should examine three basic types of information:

- borrower identity;
- employment and income information;
- financial details of the borrower (e.g. earnings, assets, liabilities, net worth).

The above information comprises what is often called the "3 C's" of lending analysis: Character, Cashflow and Capital. Often called the fourth C, "Collateral" should be considered subsequently by the credit union when structuring the terms of a loan. (Note that the C's of lending can be organized in a number of different manners, utilizing varying types of groupings; up to eight in some methodologies, depending upon the breadth of definition used. For example, some methodologies give separate credence to "Credit Bureau"; however, under the "3 C's" methodology this is covered under "Character").

The major objective of obtaining information on a member is to ascertain whether the person may be considered responsible and reliable. Income information is required to give the lender needed data on the cashflow capacity of the borrower. A borrower's ability to repay can usually be determined through an analysis of annual earnings against fixed expenditures and proposed new debt servicing commitments.

Finally, financial information on a member should be obtained to establish the borrower's net worth. A balance sheet is required, recording the value of major assets, and detail all liabilities, by individual creditor name, the balances owing and the debt payments due each month.

Credit Investigation for Personal Loans

It is important that a member applying for a loan, authorize, by signature on the loan application form, the credit union's right to verify all information provided.

A personal credit investigation requires the review of a member's personal background. The results of this investigation should be documented in the member's file. The following procedures are recommended:

- Length of membership in the credit union should be investigated and his/her previous borrowing history. Where the member is relatively new to the credit union, a credit inquiry to the member's previous financial institution should be made, and/or other personal references on the member should be obtained.
- A credit bureau report should be obtained (unless a recent report was filed in the past six months). The report should contain the credit rating of the individual, balances owing and payment history of major creditors, age, address, employer and record of legal judgements. Any negative information or undeclared borrowings should be verified and discussed with the member.
- Residential status should be investigated. If the member is a home owner, the mortgage holder should be contacted and the amount of the mortgage verified. Where the member is a tenant, his/her landlord may be contacted to verify that the applicant is a responsible tenant and makes timely rent payments.

- Verification of employment status should be undertaken (e.g. a telephone inquiry to the personnel department of the member's workplace to confirm position, salary and prospects for continued employment there).
- The size and reliability of other income (spousal or investment income) should be verified, if required for making the borrower eligible for the loan, (e.g. review of spousal employment pay stubs or tax returns).

Operational procedures should set out the minimum financial tests and conditions which must be met to obtain a loan. See Schedule 5.21 for a list of common ratios calculated, and some sample target conditions which an eligible borrower would be expected to achieve for total existing and proposed debt obligations. Whenever a credit union experiences increasing loan losses, particularly during a recessionary period, it should review and tighten its policies governing the minimum financial tests and conditions which must be met in order to grant credit. The maximum acceptable gross debt service ratio and the maximum acceptable total debt service ratio should be reduced, for example, under these circumstances, and whenever a particular borrower's net worth or the loan security available is not strong.

Schedule 5.21
RECOMMENDED FINANCIAL TESTS FOR EVALUATING A BORROWER'S DEBT CAPACITY

	Sample Maximum Condition
Gross debt service ratio: Monthly rent/mortgage, heating and taxes divided by monthly gross income	25% to 30%
Total debt service ratio: Total monthly debt payments divided by monthly gross income	35% to 40%

In calculating the total debt service ratio, it is recommended that the following items be included in total monthly debt payments: personal accommodation expenses (including average utility monthly bills), monthly vehicle leasing costs, alimony and other support payments, garnisheed wage commitments, and required monthly payments on the proposed new loan and other loan commitments (including five per cent of the balances of all lines of credit arrangements and credit cards).

When investigating a borrower's credit card history, it may be appropriate, where it is found that a borrower has large outstanding balances on several cards, for the credit union to calculate the debt service ratios using five per cent of all of the borrower's authorized credit card limits. This more conservative approach to calculate the total debt service ratio is warranted only in cases where the prospective borrower has relatively high unpaid credit card balances, and is therefore a likely candidate to utilize his/her full authorized limits.

With respect to including the spouse's income in the denominator of the debt ratios, this is entirely appropriate if the spouse co-signs or co-guarantees the loan (a spouse as co-signer or co-guarantor is discussed in Section 5505, under the heading "Loan Guarantees"). If this is done, however, the spouse's relevant loan commitments should also be included in the numerator of the ratio. This is necessary because the lender is relying on two separate parties to service the total new debt load. Finally, the extent of the borrower's equity or net worth should be evaluated, as an indicator of fiscal responsibility (e.g. commitment to savings and ownership), and available loan security. In this instance, a numerical chart is not practical since an individual's personal equity is normally expected to increase with age. Generally, the more equity an applicant has, the greater assurance of an individual's credit worthiness, assuming the applicant has satisfactory cashflow capacity and character.

Required Credit Investigations for Residential Mortgages

Verification and documentation of a potential mortgagor's personal employment income and financial information should be executed in a like manner as was recommended above regarding personal loans. It is recommended, however, that a written letter confirming a member's salary position, length of time on the job and probability of continued employment, be obtained from the employer in the case of a mortgage. Additional verification on the quality of property mortgaged should also be taken prior to granting credit approval. The loan officer must arrange for a real estate appraisal and review the purchase and sale agreement. Additional steps, which must be taken prior to funds disbursement are listed in Schedule 5.22 below and must be undertaken by a licensed real estate lawyer.

Schedule 5.22
REQUIRED PROPERTY INFORMATION AND VERIFICATION FOR RESIDENTIAL MORTGAGES

Property Information from Member	Property Verification
Legal address and property particulars: • detached home • basement, garage, • number of stories • exterior materials	• Confirm title and legal description of the property, from Land Registry or Land Titles office or from property tax assessment notices. • Obtain surveyor's certificate confirming that the house is within property boundaries. • Check with Tax Assessment Office as to status of property taxes. • Request a search on the property for existing charges registered against it. • Required Credit Analysis for Residential Mortgages

Required Credit Analysis for Residential Mortgages

Once all the information on an applicant and subject property has been compiled and verified, the credit evaluation should begin. Credit approval can be granted if the borrower meets three minimum borrower ratio tests. Like personal credit analysis, the two debt service tests of Gross Debt Service Ratio and Total Debt Service Ratio must first be met. Finally, the minimum equity test applicable to residential mortgages (e.g. five per cent to 25 per cent equity depending on whether the loan is conventional or high ratio mortgage) must be achieved. Ideally, the borrower should provide the full equity from his/her own resources; however, funds provided by parents or other relatives of the borrower which have no definite repayment term can be considered as coming from the borrower's own resources. The existence of secondary financing for conventional mortgages only (e.g. a second mortgage obtained elsewhere) can be considered acceptable to the credit union, provided the total debt service ratios are within the acceptable range.

Required Credit Investigations for Commercial Loans

For a commercial account, it is recommended the following credit verification/investigation work be performed (written consent for credit investigation must be obtained from any borrower which is not incorporated.):

- Obtain the commercial borrower's financial statements for the past three to five years and credit report from previous bankers.
- Obtain copy of business incorporation document (if applicable) and resolutions from the borrower's board of directors regarding signing officers and borrowing powers.
- Analyze available credit reports (e.g. Commercial Credit Bureau or Dun & Bradstreet reports) on the business (and its principals if the business is a sole proprietorship) to determine if credit history is satisfactory.
- Follow up employment record of key management players to assess adequacy of technical, marketing and financial management expertise.
- Substantiate net worth statements of principals whenever personal guarantees are taken; (these should be a requirement of all commercial loans) and investigate assignment of "key man" life insurance.
- Investigate major creditor/bank references for the business entity by telephone inquiry.
- Ensure the business has adequate insurance coverage (fire, property and casualty, equipment insurance).

The amount of required credit investigation will vary depending on the size and amount of the commercial account. For larger commercial enterprises, more research should be conducted on the quality of management strategies and plans.

Verifying Accuracy

In order to verify the accuracy of the financial statements, an audit opinion or "Review Engagement Report" should accompany the financial statements delivered to the credit union. A public accountant's association with the financial statements, either by audit or review engagement, confirms to some degree, the reliability of the financial statements, in addition to their compliance with GAAP (generally accepted accounting principles). Typically, a small business (e.g. revenues under five million dollars) would not be able to afford the accounting fees for a full scale audit, so the requirement for a review engagement should suffice.

For certain businesses, the financial statements may only have a "Notice to Reader" attached to them indicating that a public accountant has prepared the financial statements (usually for tax purposes) but did not attempt to verify the accuracy or completeness of the information or its consistency with GAAP. Users of these statements receive no assurance that these financial statements are reliable. As a result, a credit union relying on such statements should solicit further evidence of financial soundness, such as evidence of property title, confirmation of bank balances, etc. Alternatively, the credit union may insist that a Review Engagement be performed.

Required Credit Analysis for Commercial Mortgages

Credit analysis of commercial mortgages for income earning properties (i.e. those properties which generate income from rentals) can generally be considered on an individually financed basis. This means that the loan's cashflow assessment can be based on property revenues only. Assessment of commercial mortgages for properties which are categorized as non-earning or special-use property (e.g. head office, warehouse), however, must involve a broader analysis of the borrower's total cashflows.

Required Credit Analysis for Other Commercial Loans

Commercial credit analysis must focus on evaluating the debt servicing capability of a business (e.g. its cashflow and earnings) and its supporting capital base (e.g. working capital and investor capital). Trend analysis should first be conducted on the earnings and cashflow statements for a three to five year period. Additionally, the current year's budget and cashflow statements should be compared to current year's actual results, and the next year's forecasts to assess the reasonableness of the projections, the quality of management's planning and material performance variations. The following schedule summarizes factors that should be considered in the credit analysis of a commercial loan.

Schedule 5.23 ***CREDIT ANALYSIS FOR COMMERCIAL LOANS***	
Revenue Trend	Is there steady growth in sales (after allowing for inflation)? Determine reasons for a declining or erratic sales volume. Will these factors disappear? Consider the outlook for the industry in general; is it positive or negative? Is this consistent with budget forecasts for the business?
Gross Profit Trend	Explain any unusual fluctuations in the gross profit margins; a decline in the margins could mean that the business is facing tougher competition and finding it difficult to pass on increases in inventory costs. Compare gross profit to industry statistics to assess production efficiencies and pricing strategies.
Operating Expenses Trend	Each major expense item should be calculated as a percentage of sales, and any unusual fluctuations should be examined and explained. Are fixed costs relatively large, resulting in high operating risk?
Net Profit After Taxes Trend	The net profit amount should be examined to ensure that it does not include any non-recurring or extraordinary item such as a gain on the sale of a fixed asset. Calculate net profit as a percentage of sales, and explain trends; compare to industry statistics.
Operating Funds Trend	Determine operating funds as a measure of cashflow. Operating Funds are defined as net profits after tax plus non-cash outlays (non-cash outlays include depreciation, depletion allowance, special amortizations, etc.) plus deferred income tax. Operating funds, which measure cashflow, should be sufficient to cover the interest and principal portion of term debt payments, plus any investment in fixed assets required to maintain normal operations. Determine what the business' forthcoming capital expenditure requirements will be.

Calculate Key Income and Cashflow Ratios

See Schedule 5.24 below for a summary of two key ratios which measure debt servicing capacity. These ratios should be calculated on combined existing and proposed debt levels.

The credit union's commercial lending policy should recommend acceptable targets for the above ratios. The first ratio, for example, should generally not exceed 80 per cent, since this would indicate possible future loan defaults due to insufficient operating cashflows.

Schedule 5.24 *KEY CASHFLOW RATIOS*	
Ratio	**Calculation**
Debt Service Ratio	Sum of annual principal and interest payments divided by annual operating funds
Times Interest Ratio	Sum of annual operating funds and interest payments and taxes paid divided by interest payments

Generally, with respect to the second ratio, the higher the value of the ratio, the better the applicant's credit risk since a bigger earnings cushion exists for interest payments. However, the ratio should also be examined in the context of the industry in which the borrower is operating. Borrowers in high risk industries with more volatile earnings should have a higher interest coverage to permit a greater margin of safety. It may also be useful to compare the ratio of the borrower against other companies in the same industry.

Borrower ratios should be compared to Dun & Bradstreet industry ratios or Robert Morris industry ratios to determine their reasonableness. (The Robert Morris Ratio Report is an annual publication which records financial ratios by industry and asset size and can be found in most business libraries.)

Where key cashflow ratios are marginal, the reliability of cashflows needs to be investigated (e.g. are revenues by contract?). Both ratios should be calculated over a three to five year period with apparent trends explained as either positively or negatively impacting credit risk.

Review of Liquidity

Once the trend analysis has been completed on the income statement, trend analysis should be conducted on the balance sheet, in particular on the adequacy of business liquidity (e.g. working capital indicators). Working capital reflects the ability of the business to meet its obligations as they come due and is vital for the immediate survival of the business, particularly if business has a rapidly growing sales base. It is additionally important because elements of working capital may be taken as loan security.

In a review of key liquidity ratios, the lender should examine closely the level of aged payables to ensure the applicant is satisfying his/her creditors on a timely basis. The level of aged receivables should be examined to ensure the business is not suffering from a collection problem. Inventory turnover should be reviewed to determine the likelihood of inventory obsolescence.

Review of Equity

Besides a careful review of working capital indicators, the extent of investor capital, or equity, in the business must be assessed on the balance sheet to determine the credit worthiness of a borrower. A reasonable cushion of owner's equity is required to insulate the business against unforeseen setbacks, and also permit access to additional financing in the event of need.

Policy or operational procedures should set reasonable debt to equity limits for potential borrowers, which ensure that the credit union doesn't extend credit to a company already heavily leveraged. Debt to equity limits will vary depending on the nature and risk inherent in the borrower's business, and on the risk adversity of the credit union.

When calculating equity, assets of the borrower should be measured for their realizable or market value, as book value does not reflect the true value of the underlying assets. Lenders may also measure the disposable value of the underlying assets of the business, in order to obtain a more conservative estimation of the value of the borrower's equity.

In the loan agreement, the credit union should consider incorporating certain conditions which will mitigate against the withdrawal of equity, including the specification of minimum debt to equity conditions. The following additional measures are recommended:

- Postponement of claim on shareholders' loans.
- Undertaking not to redeem shares or shareholders' loans.
- Undertaking to restrict dividend payments.
- Restrictions on management salaries or partner's/ proprietor's drawings.
- No loans to others or guarantees on behalf of others.

If the equity position of a borrower is presently weak, the owners should be requested to increase the equity position before a loan is granted. Where the business is growing rapidly, ongoing equity investments should be made regularly by the principals to sustain growth.

Environmental Liability

Credit analysis for commercial loans should also include an assessment of the environmental risks that are assumed by the commercial enterprise. Lenders should avoid the risk of security devaluation of a contaminated commercial property and/or the cost of required pollution cleanup. This can involve an investigation of the historical land use of the premises of a prospective commercial borrower, by visiting the premises of all prospective commercial borrowers, particularly those enterprises engaged in farming, manufacturing and fuel distribution, and, if necessary, by commissioning an environmental audit of the property. Lenders should inspect premises for environmental risk indicators, including:

- damaged vegetation, stained soil odours;
- site that is adjacent to landfill site or an industrial facility;
- above or under ground storage tanks, drums or piping systems;
- remnants of old buildings;
- waste disposal areas including waste water ponds;
- significant on-site use of PCBs, pesticides or other hazardous chemicals (consult leagues for detailed

Where future environmental risk cannot be ruled out, the following safeguards should be considered for inclusion in the loan agreement:

- member covenants to have an environmental audit performed periodically;
- member covenants to provide management certification of statutory environmental good standing;
- member covenants to indemnify and hold harmless the lender from expense, loss or liability arising out of environmental damage resulting from the member's activities.

Required Credit Investigation/Analysis for Agricultural Loans

The credit analysis for a farm loan should be similar in form to the credit analysis conducted on any other type of commercial with special consideration paid to the following factors:

- Does the farm operation generate enough revenues to pay all operating expenses, mortgage debt plus provide sufficient living income to the farmer and his family?
- Is the borrower adequately knowledgeable in farming? Does the farm have good quality crops and/or livestock? Does productivity approximate the industry average? (Refer to industry statistics published annually by the Ministry of Agriculture and Food.)
- Does the business enjoy a stable market and adequate prices for its product? Is there a marketing agency or other government programs supporting the farmer?
- How does legislative change impact farm risk (e.g. free trade)?
- Is the farm well equipped with up-to-date equipment and are farm buildings in good repair? Is there good marketability of property?
- Does the farm have adequate insurance coverage (e.g. fire and wind insurance for buildings, livestock or crop insurance, and equipment insurance)?

Where the above factors are investigated and determined to be satisfactory, the credit union may consider extending credit to the prospective farm borrower. For farm land and/or buildings, mortgage loans should be granted only after a qualified appraisal has been obtained which substantiates the security value of the farm.

Loan Security

The extent of a borrower's net worth, an applicant's annual cashflow and the required term of the prospective loan should determine the nature of loan security requested. Where credit risk is high, for example, due to marginally achieved debt service ratios, unstable applicant work history or other risks, a maximum amount of security should be obtained, preferably "hard" security on specific chattels, and guarantees from individuals that have positive net worth and cash flow. Where credit risk is low (e.g. the loan is short-term), there is adequate net worth, and debt service ratios are easily achievable, supplemental forms of security (e.g. wage assignment) or no security may be considered (within authorized limits).

It is recommended that a personal property security search always be conducted on borrowers from whom collateral will be requested, in order to determine whether assets are already pledged. In order to conduct the search effectively, credit unions should obtain birth certificates, marriage certificates or Canadian passports confirming the borrower's current legal name. Once the borrower has authorized the taking of security, the security should be registered under the Personal Property Security Act (PPSA). Refer to following paragraphs for further recommendations on security searches, documentation and registration.

Extra-provincial Security

While an Ontario credit union would not be permitted to engage in the business of lending in another province, unless a reciprocity agreement is in place, there is no statutory prohibition on the taking of security in another province or country to secure a loan made in this province. Consideration, however, should be given to any restrictions on security realization that may arise under the laws of other jurisdictions.

Before taking security in a real or personal property in another province or country, it would be advisable to obtain a legal opinion as to any restrictions or requirements necessary to register and enforce security in that jurisdiction.

Security for Personal Loans

Chattel Security Interests

When a personal loan is extended for a car, boat or some other fixed asset purchase, it is recommended that a security interest be obtained on the item purchased. The amortization period of the term loan should not exceed the useful life of the chattel which is being pledged, in the event that the loan defaults and the security must be realized. Evidence of the market value, or realizable value, of the asset must be ascertained by the credit union to ensure that the value of the chattel exceeds the principal amount of the loan.

Recently dated purchase invoices recording the price of a new asset would generally suffice, unless the item purchased is personal property whose value might fluctuate significantly (e.g. art work, antiques); additional appraisals for these items should be requested. For currently owned property, reference should be made to published price lists on used goods. Depending on the credit quality of the borrower, where the market value of the security pledged marginally exceeds the principal amount of the loan, additional security (e.g. a general security agreement covering all personal assets of the borrower) should be considered.

Collateral Mortgage

A collateral mortgage may also be used as security for personal loans. A collateral mortgage is a real property mortgage that is taken as security for a loan; the mortgage security is in effect only for the term of the personal loan, and is often in the form of a second mortgage. Collateral mortgages are generally used for multi-purpose financing. Collateral mortgages should be substantiated by a qualified mortgage appraisal where the borrower has an existing mortgage which together with the collateral mortgage approximates 75 per cent of the property value. Prior encumbrances on the property should be confirmed in order to determine available collateral equity. Where a prior first mortgage exists on the collateral, the mortgage document should be reviewed to determine whether there is a provision for fluctuating balances (e.g. common for Home Equity line of credit products). It is recommended that the status of prior encumbrances on loans secured by collateral mortgages be investigated annually. A collateral mortgage should always be registered in the appropriate land registry office, and a legal opinion obtained as to title, registration and priority.

Assignment and Pledging of Financial Instruments

Loans may also be secured by an assignment of negotiable securities (note that RRSP's are not assignable), or a pledge (or hypothecation) of other financial instruments may be obtained, such as deposits or receivable instruments.

Taking a financial instrument as security for a loan can be an excellent way to securitize advances, given that certain financial instruments are liquid and can simply be retained in the credit union's custody without registration of a security interest. However, it must be done in a vigilant manner and with due care, so to ensure that the security interest in the instrument is valid. Staff must possess the requisite knowledge and expertise to properly monitor security margins on instruments with fluctuating values.

Hypothecation (pledging) and lodgement of Canada Savings Bonds or term deposits provide the best security because the value will not fluctuate. (The lender must always ensure that the security is transferable; this can be facilitated by contacting the financial institution which issued the security). Hypothecation or assignment of other financial instruments, such as mutual funds, however, can cause problems due to fluctuating valuations or complex security taking procedures. Refer to Schedule 5.25 for a summary of important precautions applicable to the assignment or hypothecation of financial instruments.

Deposits and shares with a credit union, or deposits with other financial institutions, can be pledged as security for a loan. Membership shares, savings or terms deposits may be pledged, but not chequing accounts, due to fluctuating balances. Generally, the hypothecation is for an agreed amount, not usually the entire balance. It is prudent to assert control over the pledged account. If the accounts are deposited with the lender, then a flag should be set up in the computer to indicate that a portion of that account has been pledged. If the pledged account is with another institution, a letter should be sent to that institution notifying them of the pledged amount, which they should similarly monitor to ensure pledged amounts are not withdrawn.

Lodgement of Title

A lodgement of title on real property is generally viewed as a sub-optimal way to secure loans. Taking a lodgement in title is accomplished by taking and physically possessing a borrower's real estate title documents to secure a personal loan. A lodgement of title is not equivalent to a registered collateral mortgage. A lodgement of title does not create a priority interest in security, does not involve a search process which ensures that realty title is free and available to securitize, and will not prevent a borrower from granting mortgage security to another financial institution. Additionally, lodgement of title does not create a right to initiate enforcement, such as power of sale (a remedy under a mortgage). Instead, enforcement requires a court order. For these reasons, lodgement of title is not a recommended form of security.

Schedule 5.25 ***PRECAUTIONS FOR THE HYPOTHECATION OF FINANCIAL INSTRUMENTS***
• Any financial instrument that is part of a RRSP cannot be pledged as collateral in accordance with federal law. • The terms of any financial instrument should be reviewed to determine if it can be negotiated or assigned. • Policy should specifically define the types of “blue chip” securities acceptable to the credit union. Common or preferred shares, for example, should be listed on a Canadian stock exchange with a minimum market share value preferably above $10, but certainly not less than $5. In order to obtain the highest priority of security interest, a member pledging common or preferred shares should obtain a certificate representing the shares and deliver the certificate into the credit union's possession. If share securities are not certificated (i.e. book entries), the credit union should advise the transfer agent of the pledge of the shares and have the credit union noted in the transfer agent's records as the pledgee of the shares. • Bonds should be federal or provincial government, municipal or major corporate issues, and credit unions should determine whether they are coupon bonds, and that all coupons are present. There are strip coupon bonds available in the market which have a substantially lower realizable value than the face value of a bond with coupons. • If a credit union is not familiar with a share or bond security, consideration should be given to obtaining assistance from a broker in establishing its market value and in verifying that the paper is genuine. • A significant margin over advances should be obtained and the value of security be periodically (e.g. monthly) monitored. A significant decline in unit share value may indicate a fall in investor confidence or be the result of a stock split, in which case the credit union should be enforcing its margin requirements, either for a reduction of the loan or, in the case of a stock split, lodgment of new shares. • Security margins should be specified in operating policy; a lending value of 80-90 per cent for municipal bonds and 70-90 per cent for public corporation bonds is recommended depending on the organization's risk rating. For public corporation shares, a security margin of 70-80 per cent of bid market prices would represent a reasonable level. • For stocks, bonds and term deposits, the credit union should obtain a signed power of attorney which conforms exactly to the name(s) under which the security is registered, and a hypothecation to ensure the items are negotiable. • If a financial instrument has been issued by another financial institution, the issuing office should be advised of the assignment and requested not to pay the borrower without the consent of the credit union; additionally the assignment should be accepted and acknowledged in writing before funds are advanced. • There should be strict controls over the safekeeping of liquid securities. Pledged security should be physically segregated from the assets of the credit union, recorded on collateral cards and maintained at all times under dual custody.

Loan Guarantees

Personal guarantees should be viewed as a form of supplemental security due to the many enforcement difficulties lenders face in realizing on guarantees. Frequently, guarantors have reneged on their obligations, claiming the following defences:

- forged signature;
- unsound mind;
- duress;
- lack of understanding of the implications of the guarantee;
- lack of consideration for the guarantee;
- lack of notice of borrower's default;
- lack of independent legal advice;
- inadequate independent legal advice.

In order to avoid these possible defences, it is recommended that the following precautions be taken when requesting a personal guarantee:

- The guarantee must not be taken from a minor or from someone who is not of sound mind.
- The signature must be witnessed, and preferably a legal seal should be placed next to the signature at the time it is provided, since the courts have found the existence of seals on a document import value or consideration.
- Every guarantor which is not a principal of a corporate borrower should be required to obtain independent legal advice with respect to the implications of the guarantee before the guarantee is signed, evidenced by a certificate of independent legal advice. (Refer below for further elements necessary to ensure the validity of independent legal advice.)
- The guarantor must be notified of (and ideally, should agree to) any material changes to the loan as well as all technical defaults on the loan.
- Where possible, a guarantee should be drafted so as to include an indemnity. The benefit in combining an indemnity with the guarantee is that an indemnitor has fewer defences to his or her performance in the event a claim is made than would a guarantor.
- Preferably, any corporate guarantee should be drafted to include a postponement of claim by shareholders.

Guarantor Versus Co-makers

A guarantor pledges to repay the debt of a primary debtor should they not satisfy the debt. A guarantee does not entitle the credit union to realize on the guarantor's assets without first obtaining judgement. The credit rating and credit worthiness of a guarantor, therefore, must always be investigated in the same manner as for a borrower. Similarly, a guarantor should be required to supply security for their guarantee in the same manner as a borrower.

In contrast, a co-maker of a loan (often called a co-signer) is an individual who receives some benefit from the loan proceeds and becomes a co-borrower. The c-maker is legally liable, jointly and severally, with the member requesting the loan. Generally, the co-maker of a personal loan would be a spouse (or some other relative) who has independent income which may be relied upon to help service the loan and thus reduce credit risk. Since the co-maker is considered as a co-borrower, it is required that this individual also be a member of the credit union and have a satisfactory credit rating.

Where a spouse co-signs or guarantees a loan, the debt service ratios should be adjusted to include the spouse's income.

Independent legal Advice

Failure to obtain a certificate of independent legal advice, even where a waiver of independent legal advice is provided in its place, may result in the unenforceability of a guarantee. Where a spouse or family member acts as guarantor, independent legal advice must be obtained from a lawyer whose firm is independent from that of the family lawyer due to possible conflict of interest issues. Independent legal advice should never be obtained from the lawyer who acts for the credit union. The cost of the legal consultation should be borne by the borrower.

Wage Assignments

Another form of supplemental security for personal loans (which is available only to credit unions) is a wage assignment. A number of disadvantages apply when using this type of security. In the event that borrower becomes unemployed, self-employed, or absconds, a wage assignment has no value. If a borrower retires, an assignment of pension income is not legally enforceable. As well, the filing of a Consumer Proposal under the Bankruptcy and Insolvency Act or a voluntary assignment into bankruptcy automatically nullifies the enforcement of any wage assignment.

Since a wage assignment cannot be converted into loan proceeds unless the borrower is employed, it should be considered more as a collection tool than security. For this reason, whenever a credit union requests a wage assignment, it is recommended additional security such as an Assignment of Moneys Receivable also be obtained. Under the terms of an Assignment of Moneys Receivable, should a borrower become self-employed or retire, the credit union would become entitled to other sources of a member's income.

Registering Personal Property Security

In Ontario, the only method of registering a specific security interest in specific personal property (or a general security interest in all the personal property of a debtor), is to register a security agreement under the Personal Property Security Act (PPSA). A minimal cost is incurred when conducting a PPSA search of security interests on a prospective borrower; how-ever, this is commonly borne by the applicant. Where the search result is free of liens, and the borrower has consented, the credit union should act quickly to register its own lien on the security pledged. In the case where a member is discovered to have an outstanding general security interest on all its assets with another creditor, the credit union must investigate whether this other creditor will permit a subordination of its rights to the credit union or whether a purchase money security interest can be arranged before offering credit to this member.

Under the PPSA a security interest in personal property is perfected by the registration of a form called a "financing statement". With the borrower's consent, the financing statement can be registered at any time before or after the security agreement is signed. This does not apply to situations where the collateral is consumer goods, in which case the financing statement can only be registered after the security agreement is signed. In this case, registration should be executed as quickly as possible, preferably within five business days.

For all collateral other than consumer goods, PPSA registration can be effective for a period of one to 25 years or in perpetuity. For consumer goods, the registration period cannot exceed five years.

The cost of each registration period will vary. If the registration period selected is not perpetual, registration must be renewed by the registration of a financing change statement, designated as a renewal, before the expiration of such registration period.

Once a financing statement or financing change statement is registered, a copy of these statements, or of the verification statement, must be delivered to the debtor within 30 days after the date of such registration. After a loan has been extinguished, the security interest that was placed on the collateral must be discharged by the credit union, also through registration of a financing change statement. A copy of the discharge notice must be sent to the borrower within 30 days in order to confirm the cancellation of the lien, if requested by the borrower.

When registering security agreements under PPSA in Ontario, a variety of debtor and security details must be investigated and properly documented. The debtor can be an individual, a corporation, a partnership, unincorporated association, syndicate, joint venture, church or other religious organization, estate of deceased person, trade union, or other artificial body.

The most important detail which must be included in the financing statement is the exact, legal name of the debtor. In the case of individuals, this should be verified by reference to a birth certificate or citizenship document. For corporations, the document governing the corporation should be reviewed (e.g. articles of incorporation, letters patent, etc.).

Unless the name of the debtor and in the case of an individual, the birth date, is accurate, the financing statement and security registration may be of no effect.

Collateral Insurance

Various insurance products are offered which can enhance the security taken on a loan, as well as protect against PPSA registration error. These insurance products are summarized below in Schedule 5.26. Numerous underwriting conditions apply for these products to provide full insurance coverage. Reference should be made to the details of specific insurance contracts. Management should consider carefully the caveats applicable for each type of insurance, as well as the costs of these various products and the likelihood of loss if insurance is not purchased. Human error can contribute to loan loss, however, in some cases, the purchase of insurance may also create negative effects such as looser lending administration, or loan losses if an insurance claim is later denied due to a technical breach in the insurance agreement.

In many instances, personal property security need not be registered under the PPSA. Some of these instances include but are not limited to the following:

- Where the underlying security is in the possession of the credit union, as might be the case with a hypothecation of securities or a pledge of shares or deposits, PPSA registration would not be necessary.
- Where the security is an assignment of life or disability insurance, PPSA registration would not be necessary if the borrower's insurer acknowledges that the credit union is the only assignee of the insurance policy.
- A personal guarantee does not constitute a security agreement as it is merely a promise to pay should the primary borrower default. Therefore a personal guarantee need not be registered under the PPSA (unless the wording of the guarantee also includes an assignment and/or postponement of claims).

Schedule 5.26 ***TYPES OF CHATTEL INSURANCE***		
Type of insurance	**Coverage**	**Common underwriting conditions**
Filing errors and omissions insurance	Insures against: • an error in the completion of a security agreement; • failure to register the agreement; • loss resulting from the registration of a third party's security interest in the chattel during the time period between the insured's initial registry search and the actual registration of the security agreement; • error or omission made by the Registry Office.	• there must be a customary procedure for the insured to file security agreements within 15 days of disbursing funds; • there must only be 15 days between insured's initial registry search and the registration of the agreement; • within 105 days of delinquency, insured must commence repossession proceedings.
Chattel impairment	Insures against: • direct physical loss or damage to a chattel prior to taking physical possession.	• security agreement must require the debtor to procure and maintain insurance, and insured gives written notice of loss to debtor's insurer, if any; • does not apply if the insured has had knowledge for 30 days of lack of or insufficient insurance by the debtor; • within 105 days of delinquency, insured must commence repossession proceedings.
Repossessed chattel	Insures against: • physical loss or damage to a chattel after insured takes physical possession.	• does not apply to chattel <u>owned</u> by the insured.
Chattel non-filing insurance	Insures against: • loss realized if insured chooses not to register security agreement; • an error in the completion of a security agreement; • loss resulting from the registration of a third party's security interest in the chattel during the time period between the insured's initial registry search and the actual registration of the security agreement; • error or omission made by the Registry Office.	• insured should conduct a registry search prior to releasing the funds, to ensure there is no prior charge; • insured must have completed the security agreement before releasing the funds to the debtor, in the customary manner; • within 105 days of delinquency, insured must commence repossession proceedings and file the security agreement at the registry office.

- Where a personal loan is secured by a collateral mortgage, the collateral mortgage must be registered in the appropriate land titles office in order to legally perfect this security, but not under the PPSA.
- Where non-filing insurance is obtained, given the relevant terms and conditions of the policy.

Security for Mortgages

The mortgage security file should include, at a minimum, the registered mortgage document, property appraisal, fire insurance endorsement, sheriff's certificate, property tax certificate and lawyer's final report to the credit union regarding the transaction which should include an opinion on title. Complex real estate transactions may require additional documentation. Credit unions should be guided by their lawyers in this regard.

Registration of mortgage documents by the Land Titles or Land Registry Office should be delegated to a designated real estate lawyer. Refer to Section 5509 on Use of Real Estate Lawyers for objectives in this regard.

Title Insurance for Mortgage Security

Title insurance is available for both residential and for commercial properties which are being mortgaged. For a one-time premium, title insurance protects the lender against title defects, liens, encumbrances, fraud and forgery. The lender is protected against losses suffered as a result of defects that would have been revealed by an up-to-date survey, thus eliminating the need to obtain a survey. The policy also insures against future unmarketability of title, errors or omissions made by the lawyer, or by any third party on which the lawyer is relying. (Title insurance does not protect against any environmental matters). A title insurance policy will not only satisfy any valid claims made against title, it will also pay costs and legal expenses to defend title. Title insurance is offered for both residential and for commercial properties.

Despite the potential protection afforded by this insurance, a credit union must remember that it is ultimately responsible for ensuring it is adequately protected against loss resulting from a defect in title. When deciding to use title insurance, the credit union should therefore confirm the following:

- that the terms, conditions and limitations of the policy of insurance are satisfactory, and that the policy provides proper protection;
- that the credit union's obligations under the policy are understood, and that procedures are put in place to ensure that coverage is not lost through failure to comply with these obligations;
- that the credit union receives benefit commensurate with the expense, and is not exposed to additional risk through use of the insurance;
- that the insurer has sufficient financial capacity to meet potential claims.

It is further recommended that the credit unions refer to legal counsel on the use of the product, and ensure that counsel reviews the specific policy wording to determine the exact coverage provided.

Security for Commercial Term Loans

With respect to a business term loan, the following procedures for loan security are recommended:

- Examine the balance sheet to determine what fixed assets are owned by the company. Generally, those assets which are being financed should be taken as security. Perform a PPSA search on the borrower to verify there are no prior claims on these assets.
- If security available appears inadequate, enquire whether other hard security or guarantees are available (e.g. personal or corporate).

The most common instrument for securing a commercial loan is a general security agreement (GSA). The GSA establishes a security interest for the credit union, in all non-real estate assets of the business (e.g. equipment, vehicles, inventory, receivables and intangibles). Security interests created under the GSA should be registered under the PPSA (refer to previous paragraphs for further details).

Security interests in real estate assets (e.g. land and buildings), cannot be arranged under a GSA or by the PPSA. As a result, where the underlying business assets being financed include real estate, a commercial mortgage should be obtained in addition to a general security agreement. Alternatively, when dealing with large commercial borrowers which are incorporated, consideration may be given to obtaining a debenture. A debenture places a charge over real estate and can also place a charge over personal property. A debenture is the most comprehensive form of security for commercial loans; however, it is not generally requested of small borrowers due to the legal complexities and associated costs.

Two final steps are required in evaluating security for a commercial term loan:

- Determine the realizable value of assets to be pledged.
- Determine the collateral value of these assets. Both of these values should be supported by written documentation.

To determine the realizable or market value of the assets, the following methods are recommended:

- For property - obtain an appraisal, preferably not more than six months old, prepared by qualified appraiser.
- For equipment and machinery - consult equipment dealers, auctioneers, inspect invoices, etc.
- For vehicles - consult reliable car dealers and reliable used vehicle price books.

Once the market value of the security has been established, the collateral value (i.e. the ratio of dollar security to dollar advances), must be determined with appropriate allowance made for age, condition and marketability of the fixed assets being pledged. The size of loan advances compared to collateral value (i.e. loan value ratio) should be monitored on a sufficiently frequent basis to ensure adequate security coverage.

Security for a Commercial Line of Credit

An operating loan may be secured by a security interest in working capital assets such as accounts receivable and inventories under the PPSA. Advances are normally restricted to a fixed percentage of these assets. Depending on the quality of the inventory (function of inventory turnover, obsolescence risk) and the quality of receivables (function of receivables turnover, age and the diversity/credit quality of the customer base), the margin requirement may be higher or lower than the generally applied 50 per cent margin.

Where the credit union takes an assignment of account receivables as specific security (or as part of a general security agreement), the following factors should be investigated:

- Quality of the receivables: is the ageing consistent with the industry? Have receivables over a certain age been deducted for margin purposes (e.g. over 90 days)?
- Concentration of receivables amongst a small number of debtors: what is the credit rating of major customers? Have receivables from debtors with poor credit ratings been deducted for margin purposes?
- Existence of receivables out of province or out of the country: have these been deducted in the calculation of margined receivables?
- Existence of receivables from related parties: have these been deducted from the total receivables pledged to determine collateral value?

Where a credit union takes an assignment of inventories as security for a commercial loan, the following factors should be investigated:

- Type of inventory pledged: under the Bankruptcy Act, as amended in 1992, inventory that (i) remains identifiable as to the originating supplier and that (ii) has been delivered within 30 days of a creditor becoming bankrupt, or being placed into receiver-ship, can be seized by the unpaid supplier to the detriment of the secured credit union. Farmers or fishermen suppliers are further entitled to a super-priority on the debtor's inventory for debts relating to agricultural or fish products that are delivered within 15 days prior to bankruptcy.
- Quality of inventory pledged: is there any obsolete inventory which should be deducted for margin purposes? Has inventory turnover been consistent with the industry?
- Validity of inventory descriptions: have inventories been physically inspected by credit union personnel (e.g. plant tours)?
- Existence of inventory on consignment: have these inventories been deducted from total inventories pledged to determine collateral value?
- Identification of all inventory locations: have all locations for inventory been documented on the security form?
- Existence of adequate inventory insurance: has the insurance been assigned to the credit union?
- Competing security interests, including purchase money security interests: have appropriate searches been undertaken? Have landlords on leased locations acknowledged the priority of the credit union's security?

Where operating lines of credit are in place for commercial borrowers, there will be occasions when one or more of these lines of credit will be exceeded due to member error or funds mismanagement. Whenever these situations occur, lending personnel should immediately investigate the underlying causes. Where there is insufficient security, however, it is recommended that the item causing the credit excess be returned.

Security for a Commercial Mortgage

With respect to evaluating and establishing security for commercial mortgages on income generating properties, the following recommendations apply:

- Obtain a qualified appraisal report on the value of the commercial property. Ensure that a certified commercial appraiser is employed (for a list of accredit appraisers, refer to Section 5508).
- Determine the annual rental revenue of the property by obtaining an up-to-date rental schedule on the building. Determine the number and length in years of remaining leases. What is the outlook for further rental increases? What is the industry vacancy rate, at present and in the future?
- Review the appraisal report to assess the reasonableness of the property value, in light of property income.
- Calculate the property's Debt Service Ratio. This is the ratio of annual principal and interest repayments (including proposed new debt) divided by total operating funds. The debt servicing ratio should not exceed 1.0 before approval of a commercial mortgage is granted, assuming no additional security is being taken.
- Compare the appraised value of the property to the proposed amount of mortgage principal; the principal should not exceed 75 per cent of the value of the property when the loan is made (where the value is the lessor of the appraised value or the purchase price); it is generally prudent to limit this ratio to lesser percentages, such as 60 per cent, for commercial mortgages.
- For income properties, an assignment of leases should be taken and a pledge of fire insurance must be obtained.

Where a commercial property does not generate rental income or does not have sufficient income to support the commercial mortgage, an assessment of other sources of cashflow and security from the borrower is required. Credit and security investigation must be broadened to consider the operations and assets of the entire business, although the requirement that the mortgage principal not exceed 75 per cent of property value continues to apply.

Security for Agricultural Loans

Security investigations for agricultural loans should include a complete appraisal of the farm property. A complete property appraisal should provide an indication of the:

- soil type;
- number of acres of each variety of crop;
- age of plantings, if applicable;
- condition of plantings and/or land;
- drainage;
- value per acre of each variety of crop;
- cold storage facilities or other facilities as required, depending on farm product.

Farm mortgages, including any prior encumbrances, must never exceed 75 per cent of the value of the farm property; a maximum amortization period of 25 years is recommended.

Where farm equipment is being financed, it is recommended that the loan principal not exceed 75 per cent of the market value of equipment which is new, and that lesser percentages apply for equipment which is used. The maximum recommended term for an equipment loan is 10 years, or less depending on the life expectancy of the equipment. A chattel mortgage is recommended as security for farm equipment that is removable. Additional collateral or insurance should be considered when securing farm loans include the following:

- General Security Agreement
- Assignment of Crop Proceeds
- Assignment of Crop or Livestock Insurance
- Key Man Life Insurance
- Collateral Mortgage
- Personal Guarantees
- Farm-Plus (20 per cent guarantee from provincial government at no cost subject to terms and conditions)
- Farm Improvement Loan Act (up to $250,000 guarantee subject to terms and conditions)

While security in the form of an assignment of quota payments can and should be registered with the appropriate marketing board, it may not always be relied upon. The conditions of an operating line of credit for a farm business should always include monthly reporting requirements of aged payables, and where applicable, monthly product shipment volumes (e.g. eggs, milk) and aged receivables.

Loan Renewals

Where a personal or commercial term loan is up for renewal, or a commercial line of credit is being re-extended, it is recommended that the same level of credit authorization and the same type of credit analysis that was originally conducted on either the personal or commercial loan, be repeated to determine whether credit risk remains acceptable. This type of analysis should also be applied to other types of loans where loan payments were repeatedly late. Financial information and credit investigation reports should be updated with the current year's data and retained on file. Where security is registered under the PPSA, a review should be conducted to ensure that the PPSA registration period is long enough to cover the renewal period, or whether it has to be extended.

A loan renewal should not be confused with annual and interim loan reviews, part of the loan monitoring process, and which are covered in the previous section of this Reference Manual.

Mortgage Renewals

Generally, residential mortgages that have operated satisfactorily to date do not require a loan review process before extending renewed credit. The credit union should send a confirmation of all its mortgage renewals, and request the signature(s) of the applicable borrower(s) and guarantor(s), along with proof of up to date property tax payments (where the member is responsible for directly paying property taxes). However, in high risk circumstances (e.g. commercial mortgages, volatile real estate markets, borrowers not meeting the terms and conditions of their mortgage), a review of the mortgage is required.

Each month the credit union should prepare a list of all forthcoming mortgage renewals. This list should be reviewed carefully by the credit manager to identify problem accounts (e.g. delinquent mortgages or slow payers) in addition to real estate mortgages on properties which have reduced substantially in value. As stated above, these mortgages should be subject to further documented analysis, possibly including: mortgage reappraisals, investigations of tax arrears, sub-searches for subsequent registrations or reconfirmation of a borrower's financial status. Alternatively, residential mortgages that have operated satisfactorily to date would not require such a detailed review process before extending renewed credit.

Mortgage Reappraisals

For real estate mortgages on properties which have declined significantly in value, mortgage reappraisals can be useful to measure the exact amount of credit exposure. However, reappraisals are not always useful in reducing credit risk. They are generally not required where the mortgages concerned are in good standing, or the properties are owner occupied. Where reappraisals are not commissioned, management should increase the non-specific loan provision for increased market risk and place these loans on a watchlist to ensure they remain in good standing. Factors for granting mortgage renewals should always be well documented.

Where a reappraisal is conducted and reveals that available equity has fallen below 25 per cent of the value of the property, it may become difficult for a member to refinance elsewhere. A member's knowledge of decreased equity in the home may reduce his/her financial commitment to the property. In this case the lender must proceed with caution. However, if the loan is impaired and the borrower's commitment to the property is in doubt, reappraisals would constitute the first important step in the loan collection process. The cost of reappraisals are generally borne by the credit union, and cannot be forced onto the member.

In the case of delinquent mortgages, reappraisals are recommended to determine likely proceeds from a possible power of sale; in fact, multiple property reappraisals should be commissioned and compared in a declining real estate market before establishing a sales price for the property to avoid subsequent legal liability. In the case of continually slow payers, a credit check on the borrower and a mortgage reappraisal may be useful in alerting the credit union of a deteriorating financial situation. This may necessitate referring the member to another financial institution, or a restructuring of the terms of the mortgage to better accommodate the member's needs.

Collection of Delinquent Loans

Calling of Delinquent Loans

Where possible, it is recommended a credit union establish a loan collection department with staff who have been appropriately trained to deal with loan liquidations. The policies and procedures of the collection department should be clearly documented. All collection activities should be documented in the file of each impaired loan.

It is recommended that the following alternative collection strategies be considered when terminating delinquent loans:

- Request member to refinance the loan through another financial institution or through an equity injection.
- File wage assignment with employer by registered mail.
- Exercise the right of deposit set-off.
- Repossess security or appoint a Receiver.
- Agree to accept partial repayment of principal or to forgive interest.
- Pursue other methods of legal recourse (e.g. use collection agencies, sue borrower, petition borrower into bankruptcy).

The first three strategies are recommended where the borrower has the ability to repay but is unwilling to repay. The fourth strategy, is recommended where the borrower has insufficient cashflow to repay the loan, but where security has some liquidation value, and has been legally perfected. The final strategies should be considered only as a last resort.

In all cases of loan collections, a notice letter demanding payment should be forwarded by registered mail to the last known address of the borrower, and any co-signer or guarantor, specifying a reasonable deadline by which the borrower must comply. The amount of time which should be permitted a borrower to repay a delinquent loan should vary depending on the circumstances of the case. Even where an obligation is payable on demand, and demand has been made, the courts have ruled that a debtor must be given a "reasonable time to pay".

Generally, if there is virtually no prospect of the debtor making payment, the notice period can be fairly short (e.g. more than seven but less than 30 days). On the other hand, if a debtor appears to have the resources to make payment, a longer time frame would be required, assuming this time does not deteriorate the secured position of the credit union. The courts have deemed that the following factors should be considered when assessing what is a reasonable length of time:

- Size of the loan: the larger the debt, the longer the notice period.
- Length of the relationship between debtor and creditor: the more substantial the relationship, the longer the notice period.
- Character and reputation of the debtor: the better the credit history, the longer the notice period.
- Possibilities for quick refinancing: the greater the potential for quick refinancing, the shorter the notice period.
- Risk of loan loss or devalued security: the greater the risk of loan loss or security devaluation, the shorter the notice period.

Where the final factor exists, the credit union should move as quickly as possible to realize its security.

Right of Set-Off

The right of set-off is an effective collection tool, to be employed once a loan becomes impaired. By statute, if a credit union depositor owes a debt to the credit union, then the credit union and the member owe mutual debts to each other and these debts can be set-off against each other, by the credit union without prior notice. The right of set-off cannot legally be exercised on a member's RRSP deposits, deposits held in trust for a designated beneficiary or deposits held jointly with another member. The following steps are recommended when exercising set-off:

- The credit union must ensure that a member has been appropriately advised that the member has indeed defaulted on his/her loan and be given an opportunity to make the loan current. For example, if a member owes money under a demand loan, that member must be given a reasonable period of time to repay the loan following the credit union's demand for repayment. During this time, however, it would be prudent for the credit union to freeze the member's account.
- Notice must be given by the credit union to a member immediately after setting off his/her deposit account. Prompt notice of the set off of a member's account is necessary to prevent the member from continuing to issue cheques on the account and to give the member an opportunity to correct any possible misunderstanding over the status of the loan.

Security Repossession

Every credit union must formulate clear procedures on the process of security repossession. Refer to Schedule 5.27 for a summary of required steps for security repossessions. A letter of intent to enforce security repossession must be sent by registered mail to a borrower before seized collateral is liquidated. (Credit unions can contact their league for a sample notice). Where security registered under the PPSA has been repossessed, legislation requires that at least 15 days written notice of security repossession of non-perishable goods be made prior to the sale of the collateral. Notification must be provided to the secured party, any person having a registered security interest in the collateral and any other person known by the lender to have an interest in the collateral (e.g. guarantor). If no objections are received within the designated time periods, the credit union may act on the security. Where objections are received or where the credit union has limited experience with repossessions, it should consider consulting its lawyer for further legal advice.

Failure to give statutory notice of collateral liquidation may:

- result in the credit union not obtaining the collateral free from the interests of the debtor and subordinate security interests;
- preclude the right of the creditor to claim against the debtor for any shortfall;
- give rise to claims by the debtor or subordinate secured parties who may have had the right, but were not given an opportunity to redeem the collateral.

Schedule 5.27 ***RECOMMENDED STEPS FOR AN INVOLUNTARY REPOSSESSION OF SECURITY***
• Prior to seizure, complete a security search to ensure that the security agreement is properly registered and there are no prior encumbrances. • Contact a bailiff to perform the actual repossession. • Once the security is in the credit union's possession, ensure it is located in proper storage to prevent damage or theft. Log the condition of the collateral and monitor the collateral in storage. • Arrange for insurance coverage of repossessed security. • A "Notice of Repossession and Intent to Sell" is to be sent to the member, guarantor or co-signer generally allowing at least 15 days to redeem the security by paying the loan in full. • On expiry of the waiting period, appraise the value of the security and obtain at least three written bids for purchase. Sell to the highest, reasonable bidder. Keep the written bids on file. To avoid the appearance of a conflict of interest, collateral should not be sold to staff or board members or their related or connected parties.

Collection Through Receivership

Where a credit union has taken back a debenture or a general security agreement for a commercial loan, it should specify the right to appoint a receiver in the event of borrower default in its security agreement. Appointment of a receiver is appropriate where a large collateral pool or a going concern business exists which needs to be realized. The function of a receiver is to liquidate the business or parts of the business as a going concern in order to satisfy the borrower's debts. In order to maximize the security payout to secured creditors, the receiver may elect to foreclose on the debtor's assets, thereby allowing the secured creditors to become the owners of such assets until these appreciate in value. Generally, foreclosure is not recommended due to the uncertainty of future asset values and the costs of continuing ownership.

In the event that the right to appoint a receiver or receiver-manager is not contained in a security agreement, the credit union may go to court to obtain a court appointed receiver or receiver-manager. In that case, the court will determine the rights and duties of the receiver or receiver-manager. A privately appointed receiver, pursuant to the provision of a security agreement, will offer the secured party greater flexibility in dealing with the debtor's assets than would a court appointed receiver and would also expedite the realization process.

Where a receiver is appointed by the credit union, an independent party (e.g. a representative from an accounting firm) must be selected in order to avoid legal liability relating to impartiality. Under both the Ontario and the Canada Business Corporations Acts, the receiver must look after the interests of all persons with a financial interest in the business including the shareholders.

Obtaining and enforcing security in accordance with the covenants contained in a security agreement does not permit the credit union to do anything unlawful. If a debtor is not co-operative (e.g. does not allow the secured creditor access to the collateral to repossess the same or to commence realization proceedings) a security agreement does not entitle a secured creditor to commit acts of unlawful entry, trespass, assault or theft. In this case, the secured party will be required to apply to the courts to obtain an order which will require the debtor to perform and honour the covenants in the security agreement with respect to realization.

Other Methods of Legal Recourse

Where a credit union does not have sufficient security which may be seized to redeem a delinquent loan, or the cost of appointing a receiver is prohibitive relative to loan size, it should consider other methods of legal recourse. These methods generally include: the hiring of a collection agency or the initiation of a law suit through small claims court (for amounts up to $6,000 through the Ontario court - general division). Finally, there is the option of petitioning a creditor into bankruptcy. In choosing a method of legal recourse, all transaction costs should be estimated and compared to the likely proceeds collected. The alternative with the highest likely payback should then be pursued.

Where a collection agency is employed, it is recommended that the agency be given a maximum term of six to nine months to collect the delinquent loans. After the expiry of this term, any uncollected loans should be returned to the credit union for alternative collection strategies.

Where a collection agency is unsuccessful or where a court action will likely recoup a higher portion of the delinquent loan than a collection agency, legal action should be pursued, particularly where it is possible to use a small claims court. Should the court rule in favour of the credit union, the court judgment should be filed as an execution and attached immediately to property of the debtor (e.g. securities, other chattel, residence) and enforced by a local bailiff. A common legal remedy which should be investigated (particularly in instances where insufficient loan security has been taken) is to determine whether the borrower on his/her loan application declared he/she had disclosed all of his/her debts; borrower misrepresentations in this regard will often result in court judgments against the debtor.

Alternatively, where loan collection can be more speedily obtained through the petitioning of a creditor into bankruptcy, this option should be considered. Refer to Schedule 5.28 for the common events which constitute an act of bankruptcy, which must be proven in a court of law by the credit union. Some of these acts are not necessarily a result of financial insolvency.

Schedule 5.28 ***COMMON ACTS OF BANKRUPTCY***
• Voluntary assignment of assets by borrower to a trustee. • Failure to meet obligations as they fall due. • Fraudulent transfer of assets to a third party other than a trustee. • Fraudulent preference; e.g. a payment to one but not all debtors. • An attempt by the debtor to abscond. • An attempt to remove or hide property. • Failure to redeem goods seized under a creditor order of execution which will benefit one creditor to the disadvantage of another. • Failure to meet liabilities generally as they become due.

Consumer Proposal Under the Bankruptcy and Insolvency Act (BIA)

Where financial insolvency is the cause of borrower delinquency, the credit union might suggest the debtor attempt a consumer proposal to settle his/her debts as a means of staying expensive potential lawsuits as well as avoiding the stigma and long term credit consequences of declaring bankruptcy. The Bankruptcy and Insolvency Act (BIA), as amended November 30, 1992, allows an insolvent individual (i.e. a person whose liabilities exceed their assets) with debts under $75,000 to propose to his/her creditors settlement of these debts by paying less than the full amount or paying debts over a longer term. A consumer proposal is started when the consumer debtor obtains the assistance of an administrator, generally a licensed trustee in bankruptcy.

Commercial Reorganizations Under the BIA

The BIA allows an insolvent commercial debtor to stay all creditor proceedings (including realization of security) for a period of time up to 5 months, during which creditors are requested to assess the viability of a business reorganization plan. The process is initiated by the debtor filing a notice of intention through a trustee to its creditors for a reorganization proposal. Within 10 days after filing a notice of intention, the debtor must provide its creditors with a projected cashflow report and a report from a trustee assessing its reasonable-ness. Secured creditors who would be materially prejudiced by the stay can apply to the court for exemption from the stay.

Once a proposal is made, a creditor's meeting must be called within 21 days and the creditors must vote on the proposal by class. A proposal is not binding on secured creditors of a particular class who reject the proposal. Secured creditors in such a class may proceed to realize their security subject to specific notice requirements for security realization. If a proposal is rejected by the unsecured creditors or the court, the debtor is automatically deemed bankrupt; secured creditors are free to realize on their security (provided it is properly registered and perfected) and the trustee shall distribute residual assets to the unsecured creditors.

The amended BIA permits an insolvent debtor the opportunity to negotiate with lenders for loan repayment concessions that will net higher loan recoveries through the continuation of the business than what would otherwise be realized through a business liquidation.

Use of Real Estate Appraisers

In order to comply with the requirements of section 57 of Regulation 76/95 which stipulates that a conventional mortgage not exceed 75 per cent of the value of a property, reliance on professional real estate appraisers is recommended. A procedure on appraisals should require that all properties with financing in excess of 50 per cent of their market value as well as mortgages involving commercial/agricultural properties must be given a full appraisal. For loans that do not meet these criteria, alternative practices should be specified by policy. For example, a letter of opinion (i.e. not a full scale appraisal) or drive-by by a qualified employee should apply.

It is recommended that a qualified professional with an accredited designation be employed for real estate appraisals. Accredited Appraisers of the Canadian Institute (AACI) are appraisers with the broadest qualifications for real estate valuations, including both residential and commercial property. Alternatively, a Canadian Residential Appraiser (CRA) may appraise individual residential lots and residential dwellings containing not more than three self-contained housing units. A Market Value Appraiser-Residential (MVA), may similarly appraise undeveloped residential lots and residential dwellings, comprised of a maximum of two self-contained housing units.

Reliance on other, more accessible appraisal services is acceptable given the credit union confirms that the appraiser meets the following criteria:

- The appraiser can provide documented evidence that he/she is experienced, trained and knowledgeable regarding the real estate market within the area to which the appraisal relates and the type of real estate being appraised (i.e. commercial, residential, agricultural).
- The appraiser uses one or more recognized appraisal techniques such as the sales comparison approach (based on consideration of similar property), the replacement cost approach, and the income capitalization and discounted cashflow approach (for income producing properties).
- The appraiser is independent of the real estate being appraised or of the person whom the institution is dealing with respect to the real estate-related transaction.
- The appraiser is covered by comprehensive "errors and omissions" insurance for appraisal services, with a minimum coverage of $500,000 per incident.

Directors or officers of a credit union should not act as real estate appraisers or be affiliated with organizations that perform appraisals for the credit union in order to avoid conflict of interest situations described in sections 146 and 149 of the Act. Rather, the credit union should formulate a policy which states who the approved qualified appraisers are, and engage the services of these appraisers exclusively. In establishing the approved list, the board should confirm the desired quality and expertise level of designated appraisers and their coverage by errors and omissions insurance.

Use of Mortgage Reappraisals

The need for mortgage reappraisals should be considered whenever mortgages are renewed in an area where general economic and real estate market conditions have significantly declined, where applications for additional credit are received, or where credit problems arise. Generally, residential mortgages that are operating within the terms and conditions of their credit agreements should not require reappraisals at the time of their term renewals.

Use of Lawyers for Mortgage Transactions

The quality of real estate lawyers is particularly important when relying on them to verify and assess mortgage security. Credit union policy should require independent expert lawyers to conduct the necessary legal opinions, tax, title and security searches, and to both prepare and register the mortgage document. Section 149 of the Act prohibits any businesses which are financially associated with directors from providing legal services to the credit union for a fee.

A credit union should develop an approved list of lawyers for corporate use. Periodically, the status of the lawyers on this list should be confirmed by contacting the leagues or alternatively the Membership Records Department of the Law Society of Upper Canada. Additionally, where lawyers are relied upon for large transactions (e.g. over $1 million) confirmation of their practice insurance should be obtained. A similar check should be made when adding a new lawyer to the list, or when a lawyer's qualifications are in issue.

It is recommended that operational procedures designate the lawyers who may be used for mortgage loans. Mortgage funds should always be advanced to a borrower in trust to his/her real estate lawyer. Before funds are advanced, a draft mortgage and title opinion should be requested from the lawyer and reviewed so that when the final mortgage is signed in the lawyer's office, and later registered, it reflects accurately the desired terms of the mortgage and other encumbrances on title are satisfactory. General knowledge of mortgage documentation is required by lending personnel, in order to review and evaluate the lawyer's letter of final report. It is not a recommended business practice for credit unions to register real estate collateral directly without the use of a licensed and properly insured lawyer.

Market Risk Management

(Investment Management)

Executive Summary

The primary objective of investment management is to secure a reasonable return on funds invested in assets other than loans while avoiding undue risk. This is accomplished by establishing parameters on investment quality, term to maturity and rate of return, and where investments are risk bearing, investment diversification.

Investments are defined, for purposes of sound business and financial practices, to be assets of a credit union other than its loans, and other than its liquid assets held for operating liquidity needs. There are four broad categories of investments reviewed in this chapter:

- Financial instruments (debt and equity)
- Real estate (not including mortgages)
- Capital assets
- Investment in subsidiaries

In making investments decisions, a credit union must comply with the conditions and restrictions of the Act and Regulations, and in its investment policy. The regulatory restrictions and conditions dealing with investments are also briefly discussed in this chapter.

Derivative instruments are not discussed in this chapter, because conceptually, they are not investment instruments as much as they are tools of asset/liability management. For a complete discussion on derivative instruments and their use, refer to Chapter 7 on Asset/ Liability Management.

A credit union can meet standards of sound business and financial practices by ensuring it has developed and implemented investment policies, risk and performance measurement techniques, and risk management procedures comparable to those contained in this chapter. Policies, measurement techniques and procedures should be appropriate for the size and complexity of the credit union's operation.

Legislative Summary

Investment related regulatory requirements are prescribed in Part VIII of the Act, Part VIII of Regulation 76/95, and the FSCO Guideline for Prudent Investment and Lending. These regulatory requirements mainly prescribe restrictions on investments made by credit unions.

Restrictions and conditions of investment in subsidiaries is also prescribed in the legislation. Finally, FSCO's Guideline for Prudent Investment and Lending establishes minimum guidelines for establishing lending and investment policies and procedures.

Provided below is a summary of the important regulatory restrictions pertaining to investment management. Readers should refer to the Act, Regulation 76/95 and relevant Ministry Guidelines for a complete description of a credit union's regulatory rights and obligations.

Schedule 6.1
RELEVANT INVESTMENT RELATED LEGISLATION

	The Act	**Regulation 76/95**
Adherence to investment policies and procedures	190	
Establishment of written investment policies and procedures	191	50*
Changes to policies and procedures required by the Superintendent of Financial Services	192	
Eligible investments	198(1)	66-69
Exception - open basket clause	198(2)	E70
Single investment restriction	199	71, 72, 73
Investments in subsidiaries	200	74, 75, 76
Investments in other credit unions	201	
Investments upon amalgamation	202	

* Also refer to FSCO's *Guidelines for Prudent Investment and Lending Policies and Procedures.*

Policy

It is recommended that the credit union adopt an investment policy that addresses:
limits on volume (as a percentage of capital and deposits) and quality of investments (i.e. credit ratings);

- delegated investment approval limits;
- documented criteria for making investment decisions;
- authorized types, limits and concentration of investments, other financial instruments and assets;
- monitoring value and yields of investments;
- identifying, measuring and providing for market impairments
- frequency, form and content for board reporting.

These recommended objectives of investment policy are discussed in greater depth in Sections 6201 to 6206. Adopting an investment policy will assist the credit union to manage risk and to comply with the Standards in DICO By-law No. 5. For recommended operational procedures refer to Section 6500.

Reference Materials

Examples of investment policy are available in the DICO publication Sample Policies, and are available to the industry for customization as appropriate. As well, the information provided in Sections 6201 to 6206 will also assist in establishing policies of investment management.

Regulatory Policy Requirements

Section 191(2) of the Act also requires credit unions to establish investment policies and procedures. FSCO has published Guidelines for Prudent Investment and Lending Policies and Procedures, which sets out guidelines for establishing investment policies and procedures.

When establishing investment policies and procedures, management and the board should ensure they meet FSCO requirements as well as By-law No. 5 requirements. In addition to By-law No. 5 criteria and FSCO criteria, credit unions may elect to establish other investment policies as they see fit.

Regulatory Compliance

Investment policies must not conflict with requirements prescribed by the Act, Regulation 76/95 and any interpretative bulletins or guidelines issued by the FSCO. It is optimal for key regulatory investment restrictions to be repeated in investment policies for greater clarity and ease of reference.

Investment Management Philosophy

Adopting an investment management philosophy is an important first step in drafting investment policy. The investment philosophy sets out the broad goals and objectives of the credit union's investment portfolio, as established by the board of directors. This philosophy should provide guidance in setting investment limits, making investment decisions, and in addressing new situations where policy does not yet exist.

While goals and objectives will differ depending upon the circumstances and environment of the credit union, important principles of investment management should always include the following:

- Investment decisions are made in the best interests of members and the credit union.
- Investment decisions are made in accordance with the general level of risk the credit union is willing to accept.
- Investments decisions are made in accordance with defined performance tests and prudent standards.
- Investment practices adhere to the principles of quality (or safety) of the investment and risk diversification.

Volume and Quality

Investment policy establishes limits on the level of risk in the investment portfolio. Schedule 6.2 below summarizes the different types of risk that can affect the safety or quality of an investment.

Schedule 6.2 *INVESTMENT RISK*	
Credit Risk (default risk)	Refers to the chance that the issuer of the debt security will not meet its obligations of interest and principal payments.
Market Risk (systematic risk)	The risk that changes in the interest rate will reduce the market value of an investment.
Yield Risk (financial risk)	Refers to the chance that the investment will not be profitable.

Eligible Investments

The credit union will want to establish a list of eligible investments for their portfolio. This list should include investments which are considered to have sufficient quality (i.e. safety) given the credit union's level of risk aversion. This list will also have to comply with the eligible investments prescribed in sections 66 to 69 of Regulation 76/95. Refer to Schedule 6.3 for a sample Eligible Investments list.

A credit union may choose to prohibit any investment in some or all of the various risk bearing investments. This may be the case for operations which have historically experienced low levels of liquidity; long term investments may be the out of the question. Consequently, these instruments should be excluded from the Eligible Investments schedule, or specifically prohibited elsewhere in the policy. Investments that are risk bearing are identified in Schedule 6.4 on the following page.

Schedule 6.3 *SAMPLE ELIGIBLE INVESTMENTS SCHEDULE*
Quality investments which may be purchased as part of the financial asset portfolio are as follows: • deposits in a league or a Schedule A bank; • treasury bills issued by Canadian governments; • bonds and debentures unconditionally guaranteed by Canadian governments; • acceptances issued by Schedule I banks or Schedule I banks with a DBRS rating of R-1 low or better; • commercial paper issued by corporations with a DBRS rating of R-1 mid or better; purchase of derivative financial instruments, only if used for interest rate hedging purposes and subject to the constraints in the Asset/Liability Management policy.

Schedule 6.4 *RISK AND NON-RISK BEARING FINANCIAL INSTRUMENTS*	
Non-risk bearing financial instruments (i.e. risk is minimal)	**Risk bearing financial instruments**
• Deposits in a league • Membership shares in a league • Canadian federal or provincial government guaranteed debt • Deposits and acceptances of any Schedule I Canadian bank	• Money market instruments • Long term debt instruments • Corporate shares • Real estate • Capital asset investments • Investment in subsidiaries of the credit union

Investment Limits

Investment limits can help a credit union ensure that its investment portfolio is sufficiently diversified, and that it remains exposed to an acceptable level of risk.

The starting point for setting investment limits should be the comprehensive limits set out in the Act (sections 198 to 202) and Regulation 76/95 (sections 66 to 76). In setting policy, the credit union can either adopt the limits set out in the Act, or select more restrictive limits.

The recommended approach to setting investment limits is to have one set of limits for all broad asset categories, and then a separate set of limits for financial instruments. Schedules 6.5 and 6.6 illustrate sample portfolio limits in this manner. In the first schedule, limits are established in relation to total capital and deposits.

Schedule 6.5 *SAMPLE LIMITS: ASSET CATEGORIES*		
Investments Assets	**Policy Limit***	**Regulatory Limit***
Financial Instruments	see Schedule 6.6	
Aggregate improved real estate for own use and revenue producing purposes	7%	10%
Aggregate investments in subsidiaries	5%	5%
Aggregate equity investments in corporate shares	2%	5%
* Expressed as a per cent of capital and deposits		

In Schedule 6.6, limits are established on investment in financial instruments in relation to the size of the overall investment portfolio. Minimum limits should also be established on the quality of financial instruments (i.e. credit ratings) where available.

Credit unions can determine the quality of a financial instrument by referring to the ratings given by an independent bond rating service. In Canada, there are two bond rating services: Dominion Bond Rating Service (DBRS) and Canadian Bond Rating Service (CBRS). Different rating scales are used depending upon the bond rating service used, and upon the instrument being rated (there is a separate scale for bonds and for commercial paper and short term debt).

A credit union should be familiar with the rating scales used by the bond rating service that they use. Management can establish minimum quality parameters for financial instruments that reflect the level of risk the credit union is willing to undertake. An example of such limits, based on the DBRS rating scale, are provided below in Schedule 6.6.

Schedule 6.6 Sample Limits: Financial Instruments		
Financial Instrument	**% of Investment Portfolio**	**Quality (credit rating)**
(i) league deposits	no limits	N/A
(ii) treasury bills	no limit	R1-M
(iii) government short term paper	no limit	R1-M
(iv) Schedule I banks: deposits, acceptances	no limit	R1-M
(v) Schedule II banks: deposits, acceptances (diversified by bank)	25% of portfolio, maximum	R1-M
(vi) commercial paper	30% of portfolio, maximum	R1-L

Limits can also be set on the term of investment, and on foreign currency risk. For a sample of specific investment limits, see the sample Investment Policies, Versions A and B, provided in the DICO publication Sample Policies.

Investment Options

The following paragraphs provide guidance with respect to sound limits on portfolio composition by investment category, as well as justification for choosing investment limits that are more restrictive than those prescribed in the Act.

Money Market Instruments

These highly liquid instruments include league or Schedule I Bank deposits, Treasury Bills and other federal government securities maturing in one year or less, Bankers' Acceptances, and Certificates of Deposit (CDs). These investments are generally regarded to be free of risk. Schedule 6.7 summarizes the basic differences between different money market instruments.

Commercial Paper and Mutual Funds

Caution should be exercised when investing in commercial paper and money market mutual funds due to their inherent market risk. These portfolio investments will fluctuate in value more than government or bank guaranteed securities and may require accounting adjustments to market value (if values decline) in accordance with generally accepted accounting principles.

Long Term Debt Instruments

Investment of excess liquidity into longer term bonds (i.e. maturities over three years and consisting of government or corporate debt or bond mutual funds) is an alternative investment strategy but not without significant risk. Corporate debt is at risk, and during periods of volatile interest rates, liquidation of a corporate or government bond portfolio or bond mutual funds can lead to significant trading losses.

In order to reduce this investment risk, it is recommended management invest only a small portion, if any, of its excess liquidity in long term debt and set strict quality parameters. For example, limit investment to publicly traded bonds and debentures, which allow credit unions the option to liquidate as required, or to bond mutual funds, which can be redeemed at any time.

These portfolio investments will fluctuate in value and may require accounting adjustments to market value (if values decline) in accordance with generally accepted accounting principles where not held until maturity.

Equities

Management must retain flexibility to convert excess liquidity into loans as members demand. For this reason, it is recommended that long-term equity investment, such as real estate or share securities, not constitute a large portion of the investment portfolio. Appreciation in the value of real estate or share securities generally occurs over a long period of time, and early liquidation can precipitate losses. Additionally, investments in common shares or real estate have no set term, nor guaranteed rate which can be matched against funding sources in order to "lock in" earnings to maturity.

These portfolio investments are more likely to fluctuate in value and therefore require accounting adjustments to market value (if values decline) in accordance with generally accepted accounting principles.

Schedule 6.7 *MONEY MARKET INSTRUMENTS*	
Qualifying Instrument and Description	**Risks**
Certificate of Deposit (CDs): Short term (30 days to 364 days deposits) redeemable early with interest penalty.	Only covered by deposit insurance (coverage varies by jurisdiction).
Guaranteed Investment Certificates (GIC's): Deposits with maturities of one year (up to three years).	Only covered by deposit insurance (coverage varies by jurisdiction).
League Deposits: Current deposits, or deposits with maturities up to five years.	Not insured. Ask your league about the nature of risk for each instrument.
Treasury Bills (T-Bills): Government debt issued bi-weekly with original terms to maturity of 91 to 364 days, issued in denominations ranging from $1,000 to $1 million, not paying explicit interest but sold at a discount, maturing at par (100% of face value). Sellable early through the secondary market.	Fully government guaranteed.
Government of Canada Bonds: Government debt issued with original terms to maturity for 20 or 30 years, issued in denominations ranging from $1,000 to $1 million.	Fully government guaranteed. Sellable through the secondary market with the potential for significant yield changes depending on remaining term to maturity.
Bankers' Acceptance: Commercial debt that has been guaranteed by the corporate borrowers' bank, issued into the money market, on a discount basis, maturing at par value, with terms of 30 days to one year. Sellable early through the secondary market.	Bank, not government guaranteed; investment safety subject to issuing bank's solvency. In certain cases, may be guaranteed by bank/corporation.
Commercial Paper: Commercial debt that is issued directly by a corporate borrower into the money market in interest bearing or discount form with terms between one day to one year. Unsecured; investment and income safety subject to issuing corporation's solvency.	Sellable early through the secondary market without significant yield changes unless issuing corporation's credit rating deteriorates.
Money Market Mutual Funds: Managed portfolio of money market instruments issued in units to investors by investment dealers, redeemable at any time. Investment income derived from annual cash dividends and the potential increase in value upon redemption. Partially secured; investment safety subject to the extent of fund investment in non-guaranteed money market instruments (e.g. commercial paper).	Redeemable at any time with the potential for yield changes depending on the length of time held. May be subject to purchase and sale transaction costs.

Investment Approval

Sound investment management requires that guidelines for investment approval limits be established in policy. At a minimum, the investment policy should:

- set a personal discretionary limit for the general manager of the credit union;
- require that investment decisions above this personal discretionary limit should require approval by the board of directors;
- set out lower limits for financial officers, or provide the general manager with the authority to assign limits to subordinates.

Approval limits can be illustrated using an approval hierarchy. An approval hierarchy establishes different levels of authority necessary to approve investment decisions of different dollar amounts. The higher the dollar amount, the greater the level of authority required to approve the investment. See schedule 6.8 below for an example.

Schedule 6.8
SAMPLE APPROVAL HIERARCHY

Authority	**Limit**
The Board	• any investment greater than *$100,000* • any investments in a subsidiary, joint venture, or other credit union
General Manager	• any investment less than $100,000
Treasurer	• any investment less than $20,000
Manager, Financial Instruments	• any investment less than $10,000
Dollar figures are for illustrative purposes only; each credit union should select numbers based on its own policy limits.	

Approval limits can also vary depending on the type of investment. For instance, in the above example, an investment in a subsidiary or joint venture requires approval by the board.

Investment Process and Criteria

Policy should set out the process for making investment decisions. The policy should address the credit union's investment philosophy (discussed previously in section 6202) and the approval hierarchy (discussed in the previous section). The process and criteria may differ depending on the type of asset in question. Consequently, recommendations regarding process and criteria are discussed below for each of the major investment categories.

Financial Instruments (Debt and Equity)

Process

It is recommended that either the general manager or an officer be given specific responsibility for making investment decisions. Depending upon the size of the credit union, part of this responsibility can be further delegated to qualified staff.

Authority for making investment decisions must be established in board policy. Refer to the previous section on Investment Approval Limits.

Criteria

The following criteria should be considered when making investment decisions in financial instruments:

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

Diversification is also an important consideration when investing in financial instruments that are made outside a league and bear credit risk. Alternately, investment diversification may not be necessary where the amount of investment is relatively small or where investments are solely made through a league.

Real Estate

Process

Investments in real estate should be made in accordance with:

- limits set out in the Act and Regulations (see sections 66 and 68 of Regulation 76/95);
- aggregate limits set out in the credit union's investment policy;
- investment approval limits also set out in the investment policy.

Criteria

Investment decisions should be based on an objective analysis of the purchase. The analysis should be documented in a report, and should consider:

- purpose for the purchase (for use in operations or for income producing purposes);
- comparison of cost and benefits of the property;
- 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;
- transaction costs involved.

Capital Assets

Process

A capital asset is either property or equipment used by the credit union in its operations, and not intended for sale to customers in the ordinary course of business. Capital assets are carried on the balance sheet over time, and are distinguished from supplies, which are depleted during the period.

Investment policy should govern the purchase of capital assets, and the purchase of capital assets should require proper authorization. The level of authority required to make purchasing decisions will depend upon the dollar amount of the purchase. The purchase of office furniture may simply require the approval of the general manager, while the purchase of a new computer system might require approval by the board.

Approval limits should be established for capital asset purchases, either as part of the approval limits discussed in Section 6204, or in the same manner.

The approvals framework should require the board to approve significant capital asset investments; it is up to the board, through policy, to determine this amount. In such situations, management should provide the board with a written analysis of the investment decision, including an assessment of the investment decision criteria set out below.

Criteria

When considering an investment in a major capital asset, the credit union should consider:
impact on the membership;

- financial projections, incorporating start-up costs, ongoing operating expenses, revenue expectations, and growth, establishing expected performance;
- pay-back period: the number of years it takes to recover the original investment from net returns, before depreciation but after taxes;
- examination of alternatives;
- cost/benefit analysis;
- whether sufficient management resources are available, or if there a need for additional expertise;
- the impact of any contingent liabilities (e.g. environmental) that may arise and how they will be dealt with.

Other criteria may also be considered at the discretion of the board or management.

Subsidiaries

Criteria

When considering an investment in a subsidiary, the credit union should consider:

- level of membership support for new business expansion;
- level of start-up costs and payback period;
- level of management expertise required to control the subsidiaries' activities;
- level of expected business growth and profitability;
- costs for alternative procurement of services to be offered by subsidiary;
- increased legal liability.

Other criteria may also be considered at the discretion of the board or management.

Brokers and Investment Counselling

Investment in financial instruments often requires investment counselling, or in-house market sophistication. When considering investment in financial instruments, it is always prudent to consult with a league. Leagues often provide free investment counselling, as well as access to a diversified portfolio of investment instruments, both of which are undertaken with the credit union's long term interests in mind.

Investment advice and services can also be obtained through an investment broker. However, it is important for a credit union to understand the role and duties of brokers. Generally, brokers are not under a strict legal obligation to act in the best interest of their client. Although many do, not all brokers take care to fully understand the investment needs of their clients, or ensure that financial products fit the risk profile of their client.

The following practices are recommended when dealing with brokers, and may be included as part of board policy or operational procedure:

- The use of a schedule specifying qualified and/or trusted brokers with which investments can be made.
- Consultation with more than one broker or investment counsellor to obtain the benefit of a second opinion.
- The use of a formal agreement between the investment broker and the credit union. The agreement should state that the broker is aware of the requirements of the Act, and that all investments made by the broker will be in compliance with these requirements.
- For each transaction, have the broker document the eligibility under the Act and Regulations of their investment choices.
- It is also important to realize that funds left in an account with an investment broker, although relatively safe, may not be insured or guaranteed. Confirm that your broker is a member of the Canadian Investors Protection Fund, which insures clients' funds left in a broker's account.

Concentration Risk

Under Section 199(1) of the Act, credit unions are subject to a single investment restriction. That is, the Act prescribes a limit on the amount of investment a credit union may make in any one person or company, or to a group of financially connected persons or companies.

This restriction, set by Section 71 of Regulation 76/95, is 1.25 per cent of the credit union's total regulatory capital and deposits.

The restriction includes investments to connected persons as well as individuals. Connected persons are defined in Section 73 of Regulation 76/95, but generally include persons or companies that are financially tied to one another. Investments with various financial institutions or through certain government guaranteed programs are not subject to this restriction. Refer to section 199(2) of the Act for these exceptions.

The credit union may accept this limit, or deem it prudent to establish a more conservative single investment restriction (e.g. limit investment in a single corporation to one per cent of assets or some minimum dollar threshold).

In either case, the single investment limit should be included in the board policy on investments, and procedures should be in place to assure compliance with this limit. For more on operational procedures, refer to Sections 6500 and 6501 of this chapter.

Planning

Annually, management and the board of directors must develop a business plan, summarizing the credit union's goals and objectives for the coming year.

This annual business plan includes a strategic financial plan that addresses each area of risk management, including investments. As part of the strategic financial plan, management and the board must set financial targets and plans for investment management. The elements of a investment plan are set out in Chapter 1 on Planning, and should be referred to for planning purposes.

Risk Measurement and Board Reporting

It is recommended that the credit union measure the performance and risk level of the investment portfolio and report these findings to the board.

Risk Measurement

The following are minimum risk and performance measures of the investment portfolio, required by sound business and financial practices:

- 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;
- identification and monitoring of large investments and investments to connected and restricted parties.

The credit union must also meet investment measurement requirements set out in the Act and Regulations. The credit union may track any other measures of the loan portfolio as it sees fit.

These measurements 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 goals. Management can also assess whether there are material variances from the plan which need to be addressed.

Comparison of these measurements against historical performance, where possible, can also identify significant trends which may need to be addressed by management.

Risk Management Techniques

Section 6401 provides techniques for measuring the adequacy of the credit union's investment portfolio.

Board Reports

The above measurements should be reported to the board of directors, so that the board can also monitor the investment portfolio and ensure adherence to regulatory requirements and to the annual business plan. Material variances from plan, and their causes, as well as management's plan to correct the variance should also be included in the report. Management should also provide the board with a summary on compliance with investment policy and relevant regulatory requirements.

Frequency

Management should provide the board with a report on the investment portfolio for each board meeting.

Form

Schedule 6.9 on the following page illustrates a Sample Board Report on Investment Management, which can be used by management to monitor the investments portfolio, ensure regulatory compliance and report findings to the board. The report compiles and compares all the volumes, targets and policy limits required to properly manage the risk of the credit union's investment portfolio. This report can be adopted or amended for use by the credit union.

Information contained in the report can be expressed on a periodic basis (monthly, quarterly), or on a year-to-date, or both, depending upon the preferences of the board and the frequency of reporting.

The frequency, form and content for board reports on investments should be set out in investment policy.

Schedule 6.9
SAMPLE BOARD REPORT ON INVESTMENT MANAGEMENT

Part I - Dollar ($) Volume Limits for Investments (by investment category)

Total capital and deposits= $100 million

Investment Categories	Actual ($)	Planned volume ($)	Limits per policy ($)	Statutory limits ($)	Variance from plan (%)
Financial Instruments					
Income Producing Realty				$10 M	
Capital Assets				$5M	
Subsidiaries				$5M	

Part II - Investment Portfolio Mix, as a percentage of total capital and deposits

Investment Categories	Actual (%)	Planned volume (%)	Limits per policy (%)	Statutory limits (%)	Variance from plan (%)
Financial Instruments					
Income Producing Realty				10%	
Capital Assets				5%	
Subsidiaries				5%	

Variances should be calculated as a percentage of the corresponding figure stated in the business plan.

Part III: Identification of Large Investments to Individuals and their Connected Parties

Single investment limit expressed as a % of capital and deposits: 1.25%	Number of Investments exceeding single investment limit: ________________ Total dollar amount of investments exceeding single investment limit: $___________
List investments exceeding this limit:	

Part IV: Corrective Action/Strategies

Variance	**Corrective Action/Strategy**

Schedule 6.9-1illustrates a Sample Board Report as required under Section 198 (4) of the Act. This report provides a detailed listing of all investments made and held since the last board meeting.

Schedule 6.9-1
BOARD REPORT ON INVESTMENTS MADE SINCE LAST BOARD MEETING

______________________Credit Union Limited

Investment Report

As At Month end: ___________________

Investment Name	**Purchase Date**	**Maturity Date**	**Book Value**	**Rate**	**Market Value**	**Excess/(Deficiency)**
	mm/dd/yy	*mm/dd/yy*	*$*	*%*	*$*	*$*
Totals			$0.00		$0.00	$0.00

Activity Report
(All Investments Purchased and Sold since last Board report)

Investment Name	**Purchase Date**	**Maturity Date**	**Book Value**	**Date of Sale**	**Profit/(Loss)**	
Totals			$0.00		$0.00	

I/We confirm that the investments are in compliance with the Act, Regulations and the Credit Union Investment Management policies

Manager/Treasurer: ________________________

Risk Measurement Techniques

Investment Quality and Return

It is a sound business and financial practice for a credit union to regularly measure or assess the quality and return of its investment portfolio. The method of measuring quality and return varies between the different investment categories, as does the frequency of measurement.

Measuring financial instrument quality and return is relatively straightforward. Most government bonds, corporate bonds, commercial paper, and financial institutions are rated by independent organizations, such as the Dominion Bond Rating Service and Canadian Bond Rating Service. The ratings for financial instruments should be periodically monitored, to ensure that they remain above acceptable levels.

If it is not already known, the return on a financial instrument can be calculated from the discounted price and nominal price of the instrument. The return of a zero coupon bond can be calculated using the following formula:

$$\textbf{Return} = \frac{\textbf{nominal price - discounted price}}{\textbf{discounted price}}$$

The rate of return for the investment should be calculated, at least monthly, so that management can assess the performance of the investment against expectations in the annual business plan, and against other investment opportunities. This will involve calculating the average yield of the securities portfolio, preferably using a weighted average (this is illustrated in Schedule 6.10).

Schedule 6.10
CALCULATING THE WEIGHTED AVERAGE YIELD

Assume there are three financial instruments in the portfolio:

Instrument #1: $50,000 @ 10% per annum
Instrument #2: $30,000 @ 5% per annum
Instrument #3: $20,000 @ 7% per annum

Total portfolio: $100,000

Weighted average return equals:

= sum (return) x (% share of portfolio) for all instruments

$$= 10\% \times \frac{\$50{,}000}{\$100{,}000} + 5\% \times \frac{\$30{,}000}{\$100{,}000} + 7\% \times \frac{\$20{,}000}{\$100{,}000}$$

= .10 x .50 + .05 x .30 + .07 x .20

= .05 + .015 + .014

= .079 or 7.9% per annum

Income Producing Realty

Annually, a credit union should prepare an assessment on the quality of its income producing real estate. This assessment can be based upon the most recent professional appraisal. The assessment can also include a qualitative summary of any significant market changes that would affect the value of the property, such as falling or rising rental rates, upcoming lease renewals, trends in the industry vacancy rate, zoning changes, and changes in property tax rates. Management should review the appraisal report to assess the reasonableness of the property value, in light of the above mentioned factors.

Management may also wish to estimate the market value using one or more recognized appraisal techniques such as:

- the sales comparison approach (based on sound consideration of similar property);
- the replacement cost approach;
- the income capitalization and discounted cashflow approach (for income producing properties).

An annual rate of return for the property should be calculated, so that management can assess the performance of the investment against expectations in the annual business plan, and against other investment opportunities. Methodologies for determining the return on property can be found in an advanced real estate appraisal text. (Refer to The Appraisal of Real Estate, 11th 3d. (the Appraisal Institute of Canada)).

Investments in Subsidiaries

Management should also prepare an annual assessment on the quality and return of investments in subsidiary operations.

Quality of a subsidiary investment can be measured by a number of factors, including the quality of the underlying assets of the subsidiary, the earnings and earnings potential of the business, and the quality of management. Management should prepare an annual assessment of these factors, including a summary on the level of risk that the subsidiary represents to the credit union.

An annual rate of return from the subsidiary should be calculated, so that management can assess the performance of the investment against expectations in the annual business plan, and against other investment opportunities.

Risk Management

Corrective Action

An important activity in the effective management of risk is management's timely response to unauthorized risk or poor performance developments. As a follow up to the investment risk measurements taken by the credit union (and discussed in Section 6400), management should investigate all significant performance variances relative to the annual business plan and to historical performance, and respond by taking action to correct these variances. Management must similarly respond to any contravention of board policy or regulatory requirements, or other unauthorized risk.

Operational Procedures

Procedures can assist management in ensuring regulatory and policy requirements are met with respect to maximum investment limits, and minimum investment quality. The procedures can also assist in safeguarding investments. It is recommended that the credit union have the procedures in place which ensure compliance with:

- maximum investment limits, set out both in legislation and in board policy;
- minimum investment quality limits, set out both in legislation and in board policy.

Section 6501 discusses procedures that can assist management to ensure compliance with investment limits. To assist in implementation, procedures should be both appropriate and cost effective given the size of the credit union's operations.

It is a sound business and financial practice for credit unions to document procedures. Written procedures result in higher staff productivity and better control over resources.

Operational Procedures

The following procedures can assist management to ensure that investment limits set out in policy and in the Act and Regulations are met.

Monitoring the Investment Portfolio

Regardless of the investment choices made by a credit union, management must abide by the legal requirements of the Act and by the limits set out in board policy. In this regard, it is recommended that management review all investments held, at least quarterly, to ensure compliance with all regulatory requirements and investment policy, and report their findings to the board.

Mainly, the review is concerned with ensuring that the credit union complies with:

- maximum investment restrictions as set out in the Act and Regulations (summarized in Section 6100);
- maximum investment limits set out in policy (summarized in Section 6202);
- minimum investment quality limits set out in policy, with respect to risk bearing investments (also summarized in Section 6202).

The first step the board can take to ensure compliance is to confirm that management is measuring dollar volumes, portfolio mix and investment return and quality as part of the credit union's information reporting system. (See Risk Measurement in Section 6400). This can be done through regular board reporting, using a report similar to the Sample Board Report on Investment Management, illustrated in Schedule 6.9.

The other tool that can be used to monitor the investment portfolio is a Current Investment List. This summary list sets out particulars of a financial instruments portfolio, including the name and type of investment, the dollar volume, the individual investment limit as set out in policy (which is within the limits established under the Act), the investments quality rating, and the minimum quality rating as set out in policy. This list should be maintained and updated whenever securities are purchased and sold. The list can be used to ensure the credit union does not exceed policy limits.

A sample Current Financial Investment list is provided in Schedule 6.11. Any similar report, detailing investments and comparing them, either individual or as an aggregate to policy and regulatory limits, is acceptable for these purposes.

Management should review these reports with the board, and inform the board of any incidence where board policy or legislation has not been met. Where this is the case, management must also provide the board with an action plan to correct the non-compliance.

Schedule 6.11 *SAMPLE CURRENT FINANCIAL INVESTMENTS LIST1*				
Company	**Amount**	**Limit**	**DBRS Rating[2]**	**Minimum Limit by Category**
Government				**R1-M**
Canada T-bills	$490,000	No limit	R1-H	
Province of Ontario	$35,000	$300,000	R1-M	
Province of Alberta	$165,000	$300,000	R1-M	
Province of BC	$142,000	$300,000	R1-M	
League	$920,000			**R1-M**
Schedule "1" Banks				
C.I.B.C.	$221,000	$300,000	R1-M	
National Bank	$243,000	$300,000	R1-M	
Royal Bank	$222,000	$300,000	R1-H	
Schedule "2" Banks				**R1-M**
Credit Lyonnais	$10,000	$100,000	R1-L	
Hongkong Bank	$15,000	$100,000	R1-M	
Mitsubishi	$42,000	$100,000	R1-M	
Corp. & Fin. Paper				**R1-L**
Mobil Oil Canada	$20,000	$100,000	R1-M	
Ford Credit Ltd.	$22,000	$100,000	R1-L	
GMAC	$20,000	$100,000	R1-L	
Total Portfolio Volume	$2,567,000			
As a % of Assets	8.6%			

1. Figures are for illustrative purposes only. Total assets = $30 million.
2. Credit ratings are as of a specific date, and are subject to change.

Procedures for Purchasing Securities

Cash flow should be calculated, to determine if there are surplus funds available to invest in the short-term money market. Quotations for financial instruments should be obtained from the league or broker. A spreadsheet (quotation sheet) can be useful to keep track of cash flows available for investment, as well as to record and compare quotations for financial instruments from the league and from different brokers. The credit union may want to seek assistance from its league in developing a quotation sheet.

Once a decision is made to purchase or sell specific securities, the officer will be quoted a finalized price from the broker. This price should be verified by the treasury officer. The price can be verified using the formula in Schedule 6.12 below. A difference of more than $50 should be questioned.

Schedule 6.12
CALCULATION OF MONEY MARKET INSTRUMENT PRICING

Actual Price = the **Discount Factor** rounded to 5 decimal places and multiplied against the face value where:

$$\text{Discount Factor} = \frac{1}{1 + (T/365 \times \text{interest rate})}$$

T = Number of days until maturity date of the instrument.

Maturity Calendar

All purchases of securities should be recorded in a Maturity Calendar. The calendar should note, on a daily basis, what securities are maturing, the rate at which they were purchased, the principal amount of the security, and whether they were purchased from a league or brokerage firm (and if the latter, which brokerage firm).

Structural Risk Management

(Asset/Liability Management) (ALM)

Executive Summary

The goal of asset/liability management (ALM) is to properly manage the risk related to changes in interest rates, the mix of balance sheet assets and liabilities, the holding of foreign currencies, and the use of derivatives. These risks should be managed in a manner that contributes adequately to earnings and limits risk to the financial margin and member equity.

Proper management of asset/liability risk is facilitated through board approved policy, which sets limits on asset and liability mix, as well as the level of interest rate risk and foreign currency risk to which the credit union is willing to expose itself. Policy should also set out guidelines for the pricing, term and maturity of loans and deposits. The use of derivatives, if any, should also be controlled by policy, which should state among other things that derivatives must only be used to limit interest rate risk and must never be used for speculative or investment purposes.

Credit unions which offer either fixed rate loans or deposits will mitigate interest rate risk by ensuring that management is properly measuring risk. The standard measure of this risk is balance sheet gap, and it is essential that management measure this regularly. Techniques for measuring, monitoring and reducing interest rate risk are covered in depth in this chapter.

A credit union can meet standards of sound business and financial practices by ensuring it has developed and implemented asset/liability board policies, risk and performance measurement techniques, and risk management procedures comparable to those contained in this chapter. Policies, measurement techniques and procedures should be appropriate for the size and complexity of the credit union's operation.

Legislative Summary

Legislation relevant to ALM mainly deals with the management of interest rate risk (refer to Part IX of Regulation 76/95). Legislation also prescribes limits on various asset/liability categories (refer to Part VIII of Regulation 76/95). Finally, FSCO prescribes guidelines on the use of derivatives.

Provided below is a summary of the legislation as it pertains to ALM. As only a summary is provided, readers should refer to the Act, Regulation 76/95 and relevant FSCO guidelines for a complete description of a credit union's regulatory rights and obligations.

Schedule 7.1 *RELEVANT ALM RELATED LEGISLATION*	
	Regulation 76/95
Interest rate risk (IRR) management defined	77
IRR policies and procedures	78(1)
Regulatory shock test	78(2),(3)
Reporting requirements	78(4),79(2),80
IRR corrective action	79(1)
Also refer to FSCO's guideline on Accounting Principles for Derivative Instruments.	

Balance Sheet Volumes/Mix

There are various regulatory requirements relating to the maximum category size of certain types of assets (e.g. commercial, agricultural loans) and investments (e.g. share stocks, subsidiaries).

For these limits, refer to the relevant sections of Regulation 76/95 and Sections of this Reference Manual identified in the Schedule 7.2.

Schedule 7.2 *BALANCE SHEET VOLUME AND MIX: RELEVANT REFERENCES*		
Refer to:	**Regulation 76/95**	**Reference Manual**
Regulatory Lending Limits	51 - 63	5101
Regulatory Investment Portfolio Limits	64 to 67	6101
Regulatory liquidity requirements	16 to 21	8101

Interest Rate Risk

In order to assist a credit union in the control of interest rate risk, section 78 of Regulation 76/95 requires the establishment of minimum policies and procedures to address:

- exposure to interest rate risk;
- techniques to measure interest rate risk;
- internal controls;
- corrective action for high levels of exposure;
- reporting requirements.

The limits on the exposure of the credit union to interest rate risk should be designed to complement the organization's overall risk profile (e.g. capital adequacy, liquidity, loan quality and investment risk).

Examples of ALM policy are available in DICO Sample Board Policies, which have been published by DICO and are available to the industry for review, customization and elective adoption.

Section 78(2) Shock Test

Subsection 78(2) of Regulation 76/95 sets out a maximum limit on interest rate risk exposure, as measured by an earnings shock test. The shock test measures the extent to which a "likely change" in interest rates (both higher or lower) affects a credit union's net interest margin. The earnings limit established under subsection 78(2) is set at 0.15 per cent or 15 basis points of total assets. An acceptable estimate for a "likely change" in interest rates is 1 per cent, however, a credit union is free to use another rate of change, so long as it may "reasonably be expected to occur" (section 78(3) of Regulation 76/95).

The Act requires a credit union to prepare a quarterly report for the board on its management of interest rate risk, setting out all the information that the deposit insurer requires to be reported in its statistical returns. These reports should contain a supported statement of opinion by management as to whether the credit union is currently in compliance with the board's policy on interest rate risk.

A credit union which exceeds the preliminary limit for income for two consecutive quarters is required under Regulation 76/95 to submit to the Superintendent of Financial Services and to DICO a board plan, that describes the steps the credit union intends to take to bring itself within those limits. (See section 79(2) of Regulation 76/95).

Use of Derivatives

A credit union may only enter into derivative contracts for hedging purposes and to manage interest rate risk (section 66 of Regulation 76/95). Credit unions, therefore, cannot enter into derivative contracts for income speculation purposes.

Accounting methods for derivatives must satisfy regulatory requirements outlined in FSCO's Accounting Principals for Derivatives Instruments.

Policy

It is recommended that the credit union adopt an asset/liability management policy (ALM policy) that addresses:

- limits on the maximum size of major asset/liability categories;
- pricing loans and deposits;
- correlating maturities and terms;
- controlling interest rate risk and establishing interest rate risk measurement techniques;
- controlling foreign currency risk;
- controlling the use of derivatives;
- requiring management analysis and expert consultation for derivative transactions;
- frequency and content for board reporting.

These recommended objectives of ALM policy are discussed in greater depth below. Adopting an ALM policy will assist the credit union to manage risk and to comply with the Standards in DICO By-law No. 5. For recommended operational procedures, refer to Section 7500.

Reference Materials

Examples of ALM policy are available in the DICO publication Sample Policies, and are available to the industry for customization as appropriate. As well, the information provided in Sections 7201 to 7210 will also assist in establishing ALM policy.

Regulatory Compliance

ALM policy must not conflict with requirements prescribed by the Act and Regulations, and any relevant interpretive bulletins or guidelines issued by FSCO. It is optimal for key regulatory requirements to be repeated in ALM policy, for greater user clarity and ease of reference.

Section 78(1) of Regulation 76/95 also requires credit unions to establish ALM policies and procedures. FSCO's policy and procedure guidelines differ slightly with the policy and procedure requirements of By-law No. 5. When establishing ALM policies and procedures, management and the board should ensure they meet FSCO requirements as well as By-law No. 5 requirements. In addition to By-law No. 5 policy criteria and FSCO criteria, credit unions may elect to establish other ALM policies as they see fit.

Asset/Liability Management Philosophy

Adopting an asset/liability management philosophy is an important first step in drafting ALM policy. The philosophy should set out the broad goals and objectives of the credit union's asset/liability portfolio, as established by the board of directors, who represent the membership at large. This philosophy governs all ALM policy constraints and helps address new situations where policy does not yet exist.

While goals and objectives will differ depending upon the circumstances and environment of the credit union, the ALM philosophy should always address the following principles:

- The credit union will manage its asset cashflows in relation to its liability cashflows in a manner that contributes adequately to earnings and limits the risk to the financial margin.
- Product terms, pricing and balance sheet mix must balance members'product demands with the need to protect the equity of the credit union.
- Financial derivatives instruments must only be used to limit interest rate risk and must never be used for speculative or investment purposes.

Balance Sheet Mix

ALM policy should establish portfolio limits on the mix of balance sheet liabilities such as deposits and other types of funding, as a percentage of total assets, considering the differential costs and volatility of these types of funds. Similarly, prudent portfolio limits on the mix of balance sheet assets (e.g. loans by credit category, financial instruments, etc.) should be set by policy considering differential levels of risk and return.

This recommended practice may not be practical for smaller, less complex credit unions which have a limited membership base, a simple balance sheet without much product diversification (e.g. savings and personal loans) or which do not have sufficient financial resources to effectively promote diversification. If this is the case, ALM policy should state that an appropriate mix of deposits and other liabilities will be maintained to reflect member expectations and to correlate (by term and pricing) to the mix of assets held. The mix of assets (loans, investments) return should be guided by annual planning targets, lending licence constraints and regulatory restrictions on investments.

Schedule 7.3 illustrates a sample schedule of policy limits for balance sheet mix that may be used by larger credit unions. These credit unions must be able to manipulate business to stay within prescribed policy constraints. For example, if a credit union chooses to limit its personal loans to 40 per cent of its total assets, it must be large enough and have the financial capacity to do so (i.e. it must be able to turn away, if necessary, loan requests that constitute higher risk without jeopardizing overall membership). Policy limits should be realistic (based on historical trend analysis) but also effective in terms of shaping overall business so as to maximize future viability and market competitiveness of the organization.

Schedule 7.3 *SAMPLE BOARD POLICY LIMITS ON THE SIZE OF SPECIFIED ASSET/LIABILITY CATEGORIES*	
Categories	**Policy Limits as a Percentage of Total Assets**
Assets	
Commercial loans	10.0%
Agricultural loans	0.0%
Personal loans	20.0%
Residential mortgages	40.0%
Financial investments (including assets held for liquidity)	20.0%
Other investments	7.0%
Capital assets	3.0%
	100.0%
Liabilities	
Term deposits	50.0%
Demand deposits	35.0%
Foreign currency	3.0%
Brokered deposits	10.0%
Liquidity borrowings	2.0%
	100.0%
This schedule sets limits on the maximum size of certain balance sheet categories in order to diversify risks and returns. These are sample limits and are offered for illustrative purposes only.	

Managing Liabilities

This Section provides direction on setting policy constraints on the size and types of deposits and borrowings so as to minimize the cost of funds and maximize opportunities to finance growth.

Sources of funds for a credit union can be summarized into three types: capital, deposits and borrowings. Refer also to Chapter 4 on Capital Management for more details on managing funds from capital sources.

Strategy

Schedule 7.4 summarizes the various strategies which management may adopt in building its liability base.

Schedule 7.4 *ALTERNATIVE ASSET/LIABILITY MANAGEMENT STRATEGIES*
• Attract loans to meet deposit supply. • Attract funds to meet loan demand. • Adopt a mixed approach in order to match the maturity structure of liabilities with the maturity structure of assets at the cheapest cost.

As highlighted above, the first approach, reflecting deposit driven growth, generally results in limited satisfaction of members' long term lending needs because of depositors' preference for short term instruments. The approach can result in excess liquidity and reduced earnings for the credit union.

The second approach, which reflects asset driven growth, results in higher than average funding costs because of the need to guarantee financing to borrowers, which may necessitate funding by external borrowings. Both strategies may cause an unfavourable divergence from market rates.

Due to the major disadvantages inherent in the deposit driven and the asset driven strategies, a compromise approach to liability management is recommended. The credit union should rely on natural deposit growth, fostered through competitive "at market" interest rates, in order to influence loan pricing and growth.

Loan demand which exceeds the natural deposit base can be filled through limited price stimulus on deposits, assuming sufficient profitability. Term deposits, for example, may be offered at higher rates than demand deposits in order to finance the demand for longer term assets such as mortgages. Long term deposits (e.g. two to five years) should generally be sought if term mortgage loan business is available. Alternatively, an interest rate swap or a long term investment can be purchased to match against term deposits. Interest rate swaps and other derivative instruments are discussed in more depth in Section 7210.

Alternatively, if loan growth has increased beyond the natural growth of deposits, the ALM policy could encourage the solicitation of new members with deposits who otherwise would not meet the bond of association (this may require a revision to the membership by-law). Persons normally ineligible for membership could become members under the basket membership clause of section

31 of the Act (to a limit of three per cent of total members). Deposit accounts to pursue could include community agencies which generally have an interest in improving community relations. If loan growth continues to exceed natural deposit growth, then loan syndication, asset sales, asset securitization or loan referrals involving other co-operative institutions should be addressed by ALM policy. Under the statute, credit unions cannot accept the deposits from members of other credit unions, although they can consider taking brokered deposits. This strategy, however, is generally a high cost alternative and not a recommended practice over the long term. (Brokered deposits are covered later in this Section).

Term Deposits

The following operational policy alternatives should be considered for cost effective management of the deposit base of a credit union. These strategies should be evaluated in light of corporate philosophy and members' service expectations.

- Offer a three or four tiered deposit rate structure for term deposits in excess of certain dollar thresholds (e.g. $1,000, $5,000, $10,000) to avoid paying a premium rate on all deposits.
- Offer an attractive first year rate on term deposits with a “wait and see” clause for subsequent annual rates.
- Establish minimum monthly balances for short term deposits, which pay higher rates to rate sensitive members without raising the cost of all funds in these accounts.
- Adopt a policy of substantial penalties for premature term deposit withdrawals in order to maximize available funds.
- Offer non-callable deposits at a premium over callable deposits with like terms, for the same purpose.
- Alternatively, offer callable deposits subject to a penalty equivalent to the applicable interest rate differential. Establish reasonable flat or volume driven service charges or termination fees for the operation of deposit accounts to offset interest costs.
- Establish in policy the requirement for periodic measurement and analysis of the cost of funds of various deposit accounts to determine those deposit categories which may not be cost effective, and which should be redesigned or discontinued.
- Require in policy the manager's authorization for any substantial deposit withdrawals in order to give the manager an opportunity to determine if and why funds are being transferred by members to other financial institutions.
- Require in policy or operational procedures, how various deposit accounts are designed to operate to effectively meet different members'needs; e.g. chequing accounts, chequing savings, daily interest chequing, regular savings, RRSP's, RRIF's, OHOSP's etc. These various accounts should be analyzed in terms of their sensitivity to interest rate change and promote those accounts with low interest rates and low sensitivity to rates.
- Establish in policy or operational procedures ongoing monitoring of the amount of variable and fixed rate deposits (where applicable) through a perpetual inventory system. Staff should prepare a periodic (e.g. weekly) treasury report indicating the availability of funds in the variable and term categories. Funding categories may be labeled as "excessive", "sufficient" or "low" so that loans with appropriate maturities and rates may be promoted by staff to match deposits.

- The volume of deposits in categories where loan demand is scarce can be discouraged by unattractive deposit pricing. This practice may cause membership flight and other alternatives such as interest rate swaps should be considered to manage members demand for term loans. Refer to Section 7502 for an explanation of interest rate swaps.
- In accordance with section 181 of the Act, operational policy should require deposit accounts to never be overdrawn. Delinquent overdrafts can increase funding costs significantly, and thus must be prohibited.

Diversification

In addition to minimizing the cost of its deposit base, the credit union must promote the stability of its deposits. In this regard, policy should encourage the diversification of members' deposits by origin and term structure. Operational policies should encourage that funding is not unduly concentrated with respect to:

- an individual member;
- market source of deposit (e.g. commercial versus personal);
- deposit term to maturity;
- foreign currency.

Concentrated funding sources expose the credit union to potential liquidity problems because of the likelihood of unexpected deposit withdrawals. Credit unions with excessive funding concentrations should maintain additional liquid assets. Refer to Chapter 8 for further recommendations on Liquidity Management.

Brokered Deposits

Brokered deposits are funds referred for deposit to a credit union through an investment/deposit broker. The credit union typically solicits these deposits from local investment agents and brokers (usually for an introduction fee) in order to finance unexpectedly high loan demand. New depositors, via arrangements with a broker, will invest in a credit union because they may receive a higher rate of return than other financial institution deposits.

Brokered deposits can benefit credit unions which need immediate deposit financing to fund loan growth. However, there are risks when relying on brokered deposits. The credit union may need to:

- pay finder fees/commissions to the deposit broker;
- pay higher interest rates to attract brokered deposits;
- manage greater liquidity risk due to more volatile deposit re-investment behaviour;
- ensure the deposits are properly administered for deposit insurance purposes.

Brokered deposits generally represent a more expensive source of funds owing to potential fees and higher interest rates. Additionally, they are usually larger in size than other deposits and liquidity problems could result if large brokered deposits were suddenly withdrawn from the credit union on maturity.

With respect to administration for deposit insurance purposes, in order for any Canadian currency deposit to be eligible for deposit insurance, the depositor must qualify as a member (per the bond or the three per cent basket membership clause) and hold the prescribed number of shares as outlined in the credit union's by-laws.

In summary, brokered deposits represent a high-cost source of funds that should be regarded as temporary until more permanent financing arrangements can be put in place. When reviewing alternatives for temporary financing, credit unions should also consider league borrowings.

Borrowings

In addition to the deposit base, credit unions may rely on external league/bank borrowings to finance their asset portfolio. Since external borrowings may be a more expensive source of funding, policy should require limited reliance on these borrowings, and observance of the regulatory ceiling on league borrowing. External loans should always be viewed as temporary financing. Lines of credit with leagues or other financial institutions, however, should be established in order to regulate operational liquidity; refer to Chapter 9 on Liquidity Management for further information.

Managing Assets

This Section provides direction on setting policy constraints on the size and types of loans and investments so as to make the best use of available funds, maximize financial margin while maintaining an appropriate level of safety. The assets of a credit union can be classified into two broad categories: earning assets and non-earning assets. ALM policy should promote the maximization of earning assets which reward the credit union for its operating risks. Earning assets are those assets which generate direct revenues for the credit union. Refer to Schedule 7.5 for a sample classification of assets in each category.

Schedule 7.5 ***CLASSIFICATION OF ASSETS***	
Earnings Assets	**Non-earning Assets**
• Productive Loans • Short Term Investments • Long Term Investments	• Cash on Premises • Non-accrual Loans • Payroll Receivables • Pre-paid expenses

Non-earning assets should therefore be minimized, i.e. investment in cash, non-accrual loans/investments and capital (e.g. fixed) assets.

Under Regulation 76/95, there is a requirement for credit unions to maintain a certain amount of its assets in liquid form. This liquidity need not be held in cash, but can be in the form of callable deposits of a league or a Canadian chartered bank/trust company (see section 16 of Regulation 76/95). Despite the legal flexibility, surplus cash is often left on the premises of a credit union rather than being placed into interest bearing accounts.

Operational procedures should limit the maximum amount of cash left on premises. High teller floats or ATM balances, excessive funds in transit (e.g. balances that are not cleared daily for deposit with the league), or idle cash in non-interest current accounts will increase the amount of non-earning assets and lower financial spread. In the case of teller floats or ATM balances, operational procedures should set maximum limits that can still accommodate members' needs.

Members' needs should be determined by a historical review of cyclical fluctuations in daily cash deposits/withdrawals, and estimates of future requirements. By decreasing surplus cash, management can increase financial margin; if cash balances can be reduced, for example, by $100,000, at a reinvestment rate of three per cent, annual net income will improve by $3,000.

With respect to other non-productive loans and investments, it is recommended management move quickly to identify and liquidate any assets which bear unrewarded risk (e.g. non-accrual loans or non-income producing capital assets).

The best contributor to earning assets in a credit union are productive loans; these assets presumably earn the highest yields. In order to maximize financial margin, ALM policy should require management to periodically measure and compare the gross yields for various asset categories (e.g. mortgages, personal loans, business loans, etc.) and maximize volumes in the most profitable categories without attracting unsatisfactory levels of risk. Refer to Section 7202 for setting policy limits on various asset and liability categories.

Pricing

ALM policy specifies that the pricing of all loans and deposits offered should be established so that overall, a net contributions to earnings is provided.

In order to ensure that deposit and lending rates are sufficiently responsive, policy may delegate to management the authority to set interest rates without board approval but in accordance with pre-established criteria as described below.

Deposit Pricing Policy

Rates offered on deposits should be tied to external benchmarks in the local market and should generally approximate the average of these market indicators (for example, the bank rate or the prime rate). Policy should allow management flexibility to negotiate more favourable rates within a prescribed range to maintain key deposit accounts. In order to protect financial margin, credit unions should avoid engaging in price wars with competitor financial institutions including other credit unions. Pricing strategies of competitor institutions will reflect the need for funds in these organizations. Liquidity requirements of the competitor institution may differ vastly from the credit union's needs; therefore, caution should be exercised when setting rates.

Loan Pricing Policy

It is recommended that loans be priced at market rates, and subject to interest rate rebates only at the end of the year, if sufficient earnings and reserves are available. The interest rates offered on loans should reflect an adequate margin above the rates on deposits being used to fund loans, in order to cover all operating expenses and capital requirements.

Loan pricing can also be used to balance minor gap mismatches. Where funding from deposits is high for a particular term of loan, the price for these loans could be made more attractive than terms whose funding sources are scarce. For larger gap mismatches, however, a derivative instrument may be a more practical option. (Refer to Sections 7210 and 7502 for more information on derivatives).

Loan pricing is crucial for establishing a successful lending program. In order to establish fair interest rates for both the borrower and the credit union, the following factors should be considered: Cost of funds and the spread required for financing the loan.

- Market rates offered by the competition.
- Excess liquidity position of the credit union.
- Maturity and repayment terms of the loan.
- Credit risk of the loan (e.g. loan purpose, size and security).
- Length of loan amortization period (generally, the longer the period, the higher the rate).

Share Pricing Policy

When issuing capital shares, discretionary dividend rates should be subject to ALM policy criteria approved by the board. Dividend rates should be set with due regard to the average cost of alternative funds such as deposits, other classes of shares and borrowings. When stock dividends are offered as an alternative to cash dividends, the future costs of increased fixed dividends should be analyzed for ongoing affordability, before stock dividends are declared. Refer to Section 4204 on Distribution of Earnings.

Terms

ALM policy should set reasonable limits on the terms of loans and deposits. These limits should be broad enough so that management can set varying terms for individual products in operational procedures based on product purpose, so long as these do not exceed the maximum term limits approved by the board.

There are no regulatory requirements for the maximum term on any assets or liabilities which a credit union can assume.

Term Deposits

It is recommended that the board establish maximum term limits on term deposits. Operational procedures can describe the availability of alternative term deposits and correlate differential pricing for these products within this limit.

The board may want to set a general five year maximum term on deposits in policy, and require that any products with terms greater than five years require special board approval.

Term Loans

It is recommended that the board establish maximum term limits on term loans. Operational procedures can describe the availability of alternative term loans and correlate differential pricing for these products within this limit.

The board may want to set a general five year maximum term on loans in policy, and require that any products with terms greater than five years require special board approval.

Operational Procedures

The criteria for offering term loans of varying length can be specified in operational procedures. Operational procedures can require that loan terms be set to similar lengths as the life of the security (e.g. large loans secured by higher valued assets would normally have longer terms to maturity). Due to the higher repayment and security risks of longer term loans, and the usually limited consumer demand for term deposits in excess of five years, it is recommended that generally, term loans be offered with five year maximum maturities.

For increased competitiveness, however, loan maturities in excess of five years may occasionally be sanctioned up to a prescribed policy limit or approved by the board on an exception basis.

Mortgage terms of seven to ten years have become more commonplace in the market but generally should only be offered by credit unions if arrangements are in place to manage the gap between five year funding deposits and those longer term mortgages. Credit unions should consult with their league for appropriate strategies prior to offering extended term mortgages.

Term loans should be substantially matched by contractual maturity dates against non-callable term deposits. For mortgages with terms exceeding one year, selective prepayment penalties should be established by operational policy.

Interest Rate Risk

Interest rate risk is the risk of an impact on an institution's earnings and capital due to changes in interest rates. One of the primary causes are mismatches in the terms of a credit union's deposits and loans.

Interest rate risk should be periodically measured, and can be controlled through proper management or matching of the institution's assets and liabilities. (Matching is discussed in the next Section).

Exposure to Interest Rate Risk (IRR)

Earnings Impact Measure

ALM policy establishes limits on the amount of interest rate risk exposure a credit union is willing to assume. Exposure is normally expressed as a change in potential earnings caused by a likely fluctuation in interest rates; this is an earnings impact measure of interest rate risk.

Regulatory Maximum Exposure

Subsection 78(2) of Regulation 76/95 prescribes a maximum limit for interest rate risk exposure. This limit is described in Section 7101 of this Reference Manual.

Measuring IRR

In order to ensure that exposure to IRR remains within policy levels, the credit union will need to periodically measure its exposure to interest rate risk caused by asset/liability mismatches.

IRR must be measured at least quarterly. It is recommended that institutions with fixed loans or deposits greater than 10 per cent of total assets measure this exposure on a monthly or weekly basis. Some of the more common techniques for measuring interest rate risk are discussed in more depth in Section 7404 on Interest Rate Risk Measurement.

Corrective Action

Where interest rate risk exposure is above policy limits or regulatory limits, management must initiate timely corrective action to deal with the exposure and restore compliance with policy and with section 79(1) of Regulation 76/95. Corrective action is discussed in more depth in Section 7500 on Risk Management.

Matching Maturities

Policy should require that, as much as possible, liability maturities and cashflows correlate to asset maturities and cashflows.

"Matching" refers to the process of structuring the balance sheet so that maturities of interest rate sensitive assets correspond closely to the maturities of interest rate sensitive liabilities. If the balance sheet is well-matched, a change in interest rates will have little or no impact on margin, because assets and liabilities re-price at the same time. The better a credit union is matched, the more likely it is to have stable profits.

The periodic measurement of interest rate risk exposure (introduced in Section 7207) will quantify the extent of balance sheet mismatch. Techniques for measuring interest rate risk are covered in Section 7404 of this Reference Manual.

Balance sheet mismatches can be corrected through the use of traditional portfolio manipulation techniques (discussed in Section 7502). Alternatively, financial derivative instruments can be put into place to hedge against cashflow mismatches. (Refer to Section 7210 and 7502 for a discussion of financial derivative instruments).

Foreign Currency Risk

Fluctuations in the value of foreign currency investments or deposits can pose a risk to credit union earnings. ALM policy should define the maximum amount of permissible unhedged foreign exchange risk and require that this be monitored closely. The monitoring and management of foreign currency risk should also be addressed by ALM policy. The volume of foreign currency deposits accepted by a credit union should be minimal relative to Canadian fund deposits, due to ineligibility for deposit insurance.

Monitoring Exposure

Where a significant amount of foreign currency liabilities are held by the credit union, the Canadian dollar impact of unrealized gains or losses of these liabilities should be measured and disclosed to the board at least quarterly. Where the level of foreign liabilities is significant, measurement/monitoring of exposure should be undertaken on a more frequent basis (e.g. monthly, weekly, depending upon the size of the holdings). Additionally, the credit union could estimate foreign exchange exposure assuming a range of currency exchange fluctuations.

Hedging Foreign Exchange Risk

Policy should require that significant amounts of foreign currency deposits be matched against loans or investments in the same currency and with the same term. As deposits compound in size as a result of interest payments, foreign currency risk associated with interest payments can only be eliminated by arranging the same magnitude and timing of income flows from offsetting foreign currency loans and investments. Provincial leagues and brokers normally make available to credit unions a variety of foreign currency investment vehicles. The repricing terms offered and the available liquidity on foreign currency investments should be considered prior to offering foreign currency deposit services to members.

Derivative Financial Instruments

Policy could also authorize the use of external hedging instruments, i.e. derivatives, which could be purchased to eliminate material unhedged foreign exchange risk. Such instruments include spot transactions, forward purchases, and cross currency swaps. (Refer to Sections 7210 and 7502 for more information on derivatives financial instruments.)

Financial Derivatives

It is a sound business and financial practice for a credit union to use financial derivatives to hedge the balance sheet and manage interest rate risk, where the level of exposure outweighs the derivative transaction costs.

A derivative instrument is a financial contract whose value fluctuates in relation to the performance of an underlying asset or market index (e.g. a debt or equity security, stock market index, interest or foreign exchange rates). These instruments can enable a credit union to reduce gap mismatch, or set up a hedge against fluctuations in interest rates or foreign exchange rates.

Derivatives Policy

The use of derivative instruments should be either prohibited or authorized in the ALM policy itself. Where the use is authorized in policy, then policy should also address the following parameters of derivative use:

Policy Objectives

Policy should define the purpose for relying on derivatives, whether they will be used to manage interest rate risk within regulatory limits, or whether they will be used to hedge (i.e. eliminate) specified types of risk (e.g. foreign currency risk).

Policy must prohibit the use of derivatives for speculative purposes.

Authorized Instruments

Policy shall optimally state the instruments which management is authorized to use in implementing hedging strategies, including any prohibitions. (Schedule 7.12, found in Section 7502, contains a survey of common derivative products). Credit unions should generally avoid the use of writing options, puts or calls, as they are extremely risky instruments.

ALM policy can also specify the amount, term and nature of permissible coverage, or even establish the volume and risk limits for derivatives.

Expert Consultation

The derivative policy should require the credit union to obtain expert advice and analysis before entering into a derivative transaction. Expert advice should include consultation with external financial advisors whenever derivatives for a particular purpose are first purchased and until management acquires significant in house expertise.

It is recommended to seek such advice from a league. If brokers are used by the credit union, a list of approved brokers for derivative transactions should be created.

Purchase Authorization

The policy must define appropriate authorization for entering into derivative instruments, and require transactions to be made only with the credit union's league or from approved brokers.

Board Approval

To ensure the proper use of derivatives, derivative transactions should be reported to the board at the first board meeting following their transaction, so that the board can ensure these transactions were entered into for either interest rate risk management or for hedging purposes, in accordance with the Act.

When the board determines that the transaction was entered into for hedging purposes, the board will pass a declaration stating that fact. Where the board believes the transaction is for a purpose other than permissible interest rate risk management or hedging, management must be directed to unwind the transaction, or where this would cause significant economic harm, management should be instructed to hedge that derivative transaction.

Monitoring Derivatives

The policy must mandate the appropriate monitoring of derivative transactions and positions. Monitoring includes periodic measurement (at least quarterly) of derivative market values if material. Measurements must be made in accordance with generally accepted accounting principles, and FSCO's Accounting Principles for Derivative Instruments. Monitoring should consist of:

- appropriate contract documentation;
- reliable systems for measuring risk;
- monitoring processes that are independent of the employees authorized to invest in derivatives;
- appropriate accounting treatment and disclosure.

Policy should specify the corrective actions to be taken to unwind or neutralize derivative transactions, or appropriate contingency plans for unexpected balance sheet or interest rate developments.

Survey of Derivative Instruments

Refer to Schedule 7.12 in Section 7502, which lists various derivative instruments that may be used by credit unions to manage interest rate risk.

Planning

Annually, management and the board of directors must develop an business plan, summarizing the credit union's goals and objectives for the coming year.

This annual business plan includes a strategic financial plan that addresses each area of risk management, including asset/liability management. As part of the strategic financial plan, management and the board must set financial targets and plans for asset/liability management. The elements of a asset/liability management plan are set out in Chapter 1 on Planning, and should be referred to for planning purposes.

Risk Measurement and Board Reporting

It is recommended that the credit union measure the performance and risk level of the credit union's asset/liability management activities, and report these findings to the board.

Risk Measurement

The following are minimum risk and performance measures of ALM, required by sound business and financial practices:

- Periodic measurement of overall balance sheet mix.
- Periodic measurement of asset, liability and capital growth or decline.
- Periodic measurement of operational cash flows.
- Periodic measurement of financial margin.
- Periodic measurement or projection of the impact of interest movements.
- Periodic measurement of the level of unhedged foreign currency funds.
- Periodic assessment of the appropriateness of financial derivatives held.

The credit union must also meet ALM measurement requirements set out in the Act and Regulations. The credit union may track any other measures of the loan portfolio as it sees fit.

These measurements 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 goals. Management can also assess whether there are material variances from the plan which need to be addressed.

Comparison of these measurements against historical performance, where possible, can also identify significant trends which may need to be addressed by management.

Risk Management Techniques

Sections 7401 to 7405 provide techniques for measuring and monitoring the adequacy of the credit union's ALM activities.

Board Reports

The above measurements should be reported to the board of directors, so that the board can also monitor ALM activities and ensure adherence to regulatory requirements and to the annual business plan. Material variances from plan, and their causes, as well as management's plan to correct the variance should also be included in the report. Management should also provide the board with a summary on compliance with ALM policy and relevant regulatory requirements.

Frequency

Management should provide the board with a report on the ALM portfolio at least quarterly.

Form

Schedule 7.6 on the following page illustrates a Sample Board Report on ALM Management, which can be used by management to monitor the credit union's ALM activities, ensure regulatory compliance and report findings to the board. The report compiles and compares the important measures of asset and liability portfolio mix, interest rate risk, foreign exchange risk and derivatives use. This report can be adopted or amended for use by the credit union.

Information contained in the report can be expressed on a periodic basis (monthly, quarterly), or on a year-to-date, or both, depending upon the preferences of the board and the frequency of reporting.

The frequency, form and content for board reports on ALM activities should be set out in ALM policy.

Schedule 7.6
SAMPLE BOARD REPORT ON ASSET/LIABILITY MANAGEMENT

Part I - Asset/Liability Mix

Total assets = in ($) millions

Asset/Liability Categories	Actual volume	Mix as a % of assets	Limits per Policy	Target Mix	Variance from plan
Commercial loans	$	%	%	%	%
Agricultural loans	$	%	%	%	%
Personal loans	$	%	%	%	%
Residential mortgages	$	%	%	%	%
Other loans	$	%	%	%	%
Financial investments	$	%	%	%	%
Other investments	$	%	%	%	%
Capital assets	$	%	%	%	%
Gross liquid assets	$	%	%	%	%
Term deposits	$	%	%	%	%
Demand deposits	$	%	%	%	%
Foreign currency	$	%	%	%	%
Brokered deposits	$	%	%	%	%
Liquidity borrowings	$	%	%	%	%

Part II - Asset/Liability Growth

Asset/Liability Categories	Volume (this year)	Volume (last year)	Growth from last year	Projected Growth	Variance from Plan
Commercial loans	$	%	%	%	%
Agricultural loans	$	%	%	%	%
Personal loans	$	%	%	%	%
Residential mortgages	$	%	%	%	%
Other loans	$	%	%	%	%
Financial investments	$	%	%	%	%
Other investments	$	%	%	%	%
Capital assets	$	%	%	%	%
Gross liquid assets	$	%	%	%	%
Term deposits	$	%	%	%	%
Demand deposits	$	%	%	%	%
Foreign currency	$	%	%	%	%
Brokered deposits	$	%	%	%	%
Liquidity borrowings	$	%	%	%	%

Schedule 7.6 (continued) *SAMPLE BOARD REPORT ON ASSET/LIABILITY MANAGEMENT*					
Part III: Operational Cash flows (If available, attach a Cash Flow Statement with this report)					
	Cash in-flows	**Cash out-flows**	**Planned In-flows**	**Planned out-flows**	**Variance from Plan**
This Quarter	$	$	$	$	%
Part IV: Financial Margin					
Financial Margin (as a % of total assets)	**Actual**	**Per Plan**	**Variance from plan**	**Last Year**	**Last Quarter**
This Quarter	%	%	%	%	%
Year to Date	%	%	%	%	
Part V: Exposure to Interest Rate Risk					
Per Section 78 of Regulation 76/95, what is the credit union's exposure to a 1% change in interest rates, on a shock test basis, as at the period ending date of this report? $____________________					
(Optional: If the credit union uses an alternative shock test:) Other measures of interest rate risk exposure, based on a methodology documented in operational procedures?					
Part VI: Exposure to Foreign Currency Risk					
				Volume $	**As a % of total assets**
How much foreign currency is held as deposits by the credit union?				$	%
How much of this foreign currency is not hedged by loans or derivative instrument?				$	%
Part VII: Use of Derivatives					
Derivative transactions currently held by the credit union		**Notional $ Value**		**Purpose of the derivative instrument**	
		$			
		$			
Part VIII: Corrective Action/Strategies					
Variance		**Corrective Action/Strategy**			

Mix and Yields

In order to facilitate appropriate management and board monitoring of ALM, the actual mix and yields of major categories of assets and liabilities need to be measured on a periodic basis (at least quarterly) and compared to plan and (where possible) historical performance.

It is important to monitor for variances from the business plan in the volume and mix of loans, investments and deposits, as this could have serious effects on net financial margin. Different types of loan and investment categories will provide different yields. Measurement of the portfolio mix can alert management to future declining margins caused by an unfavourable shift towards lower yielding loans. Conversely, higher than expected asset yields could reflect an undesired shift toward higher risk loans and investments. Written explanations for changes in mix and yields should be provided by management to the board for its periodic review of the financial statements.

The average costs of other sources of funding (borrowings and equity) should be monitored at least quarterly by board and management to determine if they are reasonable. Where interest/dividends are paid to members at the end of the year, these should be estimated and accrued for interim reporting.

Growth

The credit union’s reporting system should also measure the growth and decline of the major categories of assets and liabilities. These measurements need to be reviewed and assessed relative to plan and historical performance. Measurement and review should be conducted at least quarterly.

Loan volumes should be compared to plan and historical volumes to assess the extent and rationale for loan growth. Stagnant loan growth should be analyzed in terms of the local competitiveness of the institution's pricing and marketing, membership demographics and new product needs, as well as lending staff capabilities. Confirmed causes of low loan growth should be addressed immediately as that this situation is often the cause of declining credit union viability.

Deposit growth needs to be similarly measured and should approximate the rate of loan growth, otherwise excess liquidity will cause spreads to decline. Deposit pricing and product mix may need to be reconsidered mid year if unfavourable variances persist. In this case, management should document new deposit growth strategies for the board to consider and ratify.

Financial Margin

Financial margin should be measured at least quarterly and compared to planned and (where possible) historical earnings. Differences in expected performance should be explained in terms of the unanticipated behaviour of factors impacting spread, and where applicable, strategies. This information should be included in the report to the board, for review and discussion at their regularly scheduled board meetings.

Financial margin measures the profitability of the credit union's balance sheet. Financial margin is net interest income after loan costs expressed as a percentage of average assets, and can be calculated as follows:

Schedule 7.7 *FINANCIAL MARGIN*
Financial Margin = <u>Net Interest and Investment Income less loan costs</u>   **Average Assets**
Where net interest and investment income is calculated as:
+ Loans Interest Income
+ Investment Income
- Interest expense on deposits
- Other interest expense and dividends
= Net interest and Investment Income

Monitoring financial margin is important to ensure there are sufficient earnings to cover operating expenses. Refer to schedule 7.8, which highlights non-balance sheet items affecting financial margin.

Schedule 7.8 *INFLUENCES ON FINANCIAL MARGIN*
• Pricing policy
• Asset/liability mix
• Timing of loan/deposit repricing
• Investment yields
• Level of excess liquidity
• Interest rate fluctuations
• Foreign currency fluctuations

Interest Rate Risk Measurement

An important element of asset/liability management is the measurement of interest rate risk. This topic was introduced in Section 7207. Interest rate risk is the risk of an impact on an institution's earnings and capital due to changes in interest rates. One of the primary causes are mismatches in the terms of a credit union's deposits and loans.

Interest rate risk exposure can lead to significant operating losses, and deterioration of capital, and therefore must be periodically measured and where appropriate, managed effectively.

Measuring Interest Rate Risk

In most credit unions, the interaction of portfolio volumes, rates, maturities and yield curves is so complex that it cannot be left to intuitive judgment to quantify interest rate risk. Therefore, techniques for accurately measuring interest rate risk are required.

The following are some techniques that can be used to measure interest rate risk:

- Gap (Matching) Schedule analysis;
- Gap Ratio analysis (30/70 Rule);
- Earnings Shock Test;
- Dynamic Gap analysis;
- Simulation analysis;
- Dollar Duration analysis.
- These techniques are each discussed in this Section.

Gap Schedule

The most common tool used to measure interest rate risk is the gap, or matching schedule (also termed asset/liability matching report).

In a gap schedule, all of the institution's balance sheet items (both on and off) are placed into a series of "time buckets". A "time bucket" is a consecutive period of time (usually three months or one year). Balance sheet items are placed into the time bucket which corresponds to the amount of time remaining before the interest rates on that item are re-priced. Refer to Schedule 7.9 for a sample Gap Schedule and an illustration of how various balance sheet items should be classified.

In Schedule 7.9 there are two special buckets for non-interest sensitive items and variable interest items. The gap schedule should include all balance sheet items (fixed rate as well as variable rate and non-interest bearing assets and liabilities) in order to ensure that all items are accounted for.

Term

Gap schedules do not have to have limited terms. A proper gap schedule should measure the balance sheet for the entire life of its assets and liabilities. This can best be accomplished by having a final time bucket covering any repricing/maturity after five years.

Buckets

A credit union may choose the size and number of time buckets that appear on its gap schedule. A common approach is to segregate time buckets into monthly time buckets for the first year, then into annual time buckets for the next four years, and one final bucket for any items repricing after five years.

Another approach is to have quarterly time segments for the first year, six month buckets thereafter for another four years, and one final bucket for any items repricing after five years.

Time to Repricing

Assets and liabilities should be categorized into time buckets on the basis of their "time to repricing" for an accurate measurement of gap. An instrument such as a deposit or a loan "reprices" when its interest rate changes. An example of this is when a mortgage reaches the end of its term, and the new interest rate is established for a fixed period of time, usually between six months and five years. Floating rate instruments are considered to reprice daily.

The "time to repricing" is the period of time over which a fixed interest rate will remain fixed. For some assets or liabilities, this is generally the time left until maturity. However, for other items, it may be sooner. For example, a personal loan with a one year term and repayment amortized over three years may be subject to annual repricing, posing interest rate risk to the credit union at each date that it is repriced. In the gap schedule, such an instrument should be placed into the one year time bucket.

Compliance

The completion of a gap schedule is required to be submitted annually to DICO in the Annual Member Institution Return (the AMIR), completion of which is a condition of deposit insurance.

Schedule 7.9 SAMPLE ASSET/LIABILITY MATCHING (GAP) REPORT ($000's)												
	Variable Rate	Under 30 days	30-60	60-90	90-365	1-2 yr.	2-3 yr.	3-4 yr.	4-5 yr.	Over 5 years	Non-Interest Bearing	Total Assets
Cash	1000											1000
S.T. Investments			1000	1000	2000							4000
L.T. Investments										500		500
Business Loans	1000		800	200	1000							3000
Personal Loans	1500		200	800	500	1000						4000
Mortgages		1000	1500	2000	4000	4000	4500	4000	3000			24000
Accrued Int.											1500	1500
Other Assets											2000	2000
Total Assets	**3500**	**1000**	**3500**	**4000**	**7500**	**5000**	**4500**	**4000**	**3000**	**500**	**3500**	**$40000**
Daily Int. Savings	1500											1500
Var. Rate Deposits	500											500
Other Deposits			2000	1500	1000							4500
RRSP's		500	1000	1000	1000	4000	2000	3000	2000			14500
GIC's		500	1000	1000	1000	4000	3000	3000				13500
Accrued Interest											1000	1000
Accounts Payable											500	500
External Borrowings	500											500
Surplus & Capital											3500	3500
Total Liabilities/ Equity	**2500**	**1000**	**4000**	**3500**	**3000**	**8000**	**5000**	**6000**	**2000**	**-0-**	**5000**	**40000**
Mismatches (gap)	**1000**	**0**	**(500)**	**500**	**4500**	**(3000)**	**(500)**	**(2000)**	**1000**	**500**	**(1500)**	
% matched	71%	100%	88%	88%	40%	63%	90%	67%	67%	0%	70%	
Gap Ratio	**29%**	**0%**	**12%**	**12%**	**60%**	**37%**	**10%**	**33%**	**33%**	**100%**	**30%**	
Policy limit	**30%**	**30%**	**30%**	**30%**	**30%**	**30%**	**30%**	**30%**	**30%**	**30%**	**30%**	

The extent of interest rate mismatch or gap is calculated by subtracting, for each time bucket, the volume of liabilities (including equity) subject to repricing from the volume of assets subject to repricing. If more assets than liabilities are being repriced in a given time bucket, the gap is "asset sensitive" or "positive". Conversely, if more liabilities than assets are being priced in a given time bracket, the gap is "liability sensitive" or "negative".

Positive gap for time bucketX = AssetsX - (LiabilitiesX + EquityX) > 0

Negative gap for time bucketX = AssetsX - (LiabilitiesX + EquityX) < 0

Gap Schedule Analysis

General conclusions about interest rate risk can be made from a preliminary view of the gap schedule. Schedule 7.9 shows a typical gap schedule, where liabilities in time buckets less than one year tend to exceed assets in those buckets (negative gap). At terms over one year, assets tend to outweigh liabilities (positive gap). In a rising interest rate environment, this situation results in declining financial margin in the first year, as the cost of deposits rises with repricing while revenue from assets stays constant.

Since the fluctuations of interest rates are unpredictable, credit unions should speculate on interest rate movements through their gap position. Instead credit unions should monitor and manage their interest rate exposure, within reasonable levels, to minimize the downside risk of adverse interest rate movements.

The optimal gap position depends on the risk preference of the credit union, the financial strength of the organization to assume such risks, and the competence of the staff to manage interest rate risk.

Techniques for dealing with mismatches, however, are briefly discussed in Section 7502. Where a credit union experiences difficulty in understanding and selecting appropriate strategies, it should obtain external assistance from its league or other qualified financial advisors.

Interest rate risk can be measured from the gap schedule, either by measuring the individual gap mismatch for each time bucket (the gap ratio), or by aggregating the gap mismatches for all time buckets to determine the gap mismatch for the entire balance sheet (the earnings impact or shock test). These two techniques are discussed below.

Gap Ratio

The gap ratio is a simple measure of balance sheet mismatch. It is a very focused measure, as it only measures the level of mismatch for one particular time bucket.

The gap ratio is defined as the ratio of net assets (or liabilities and equity) within a particular time bucket divided by the greater of their two amounts.

For time bucket x, the gap ratio =

Absolute value of (AssetsX - (LiabilitiesX + EquityX))

Maximum of (AssetsX or (LiabilitiesX + EquityX))

This measure is useful for assessing and prioritizing large dollar exposures to interest rate risk. Generally, it is recommended that material dollar mismatches in time buckets not exceed 30 per cent.

The gap ratio has been calculated for each time bucket identified in Schedule 7.9. Refer to the second last line of that gap schedule for the gap ratio for each time bucket. It should be noted, however, that the gap ratio test is not as accurate as other available techniques. Its primary shortcoming is that it may miss small percentage exposures that can add up into large dollar exposures. Also, it does not take into account that an exposure in one time bucket could offset an exposure in another.

Measuring the Earnings Impact of Gap

A gap schedule can provide management with a dollar measurement of interest rate risk. A simple quantification of earnings risk over the coming year can be accomplished through the calculation of the earnings shock test.

By recognizing the inherent time value of money, a nominal dollar gap schedule (such as the one in Schedule 7.9) can be modified to effectively calculate the likely annual earnings impact of changing interest rates. For example, weighing the gaps in each time bucket by the length of time that they are sustained gives a better assessment of the actual interest exposure during the fiscal period. Under this methodology, a weighting factor is applied to each gap calculated for each time bucket. Weighted mismatches for all time buckets are then totaled.

Schedule 7.10
SAMPLE EARNINGS IMPACT TEST (SHOCK TEST)

Total assets = $95.4 M

	$ are in 000's	Variable Rate	Up to 3 months	3 to 6 months	6 to 9 months	9 to 12 months	over 12 months	Total
A	**Assets**	500	1,000	3,000	6,000	5,000	79,900	95,400
B	**Liabilities & Equity**	6,000	4,000	3,000	1,000	5,400	76,000	95,400
C	**GAP (A-B)**	**(5,500)**	**(3,000)**	**0**	**5,000**	**(400)**	**3,900**	
D	**Weight**	1.000	0.875	0.625	0.375	0.125	0	
	Weighted Factor (CxD)	**(5,500)**	**(2,625)**	**0**	**1,875**	**(50)**	**0**	**(6,300)**
							Weighted Cumulative GAP	(6,300)
							1 per cent of Weighted Cumulate GAP (6,300 x 0.01)	(63)
							Exposure in terms of total assets = 63/95,400	(0.066%)
							Conversion to basis points	(6.6)

Schedule 7.10 computes an estimated dollar gain or loss in annual earnings attributable to an immediate interest rate change of one per cent. The total change in earnings is calculated by multiplying the weighted average gap by the magnitude and sign of the assumed interest rate change (i.e. one per cent). As illustrated in Schedule 7.10, an interest rate increase of one per cent would decrease earnings for the year by $63,000, or 6.6 basis points. Similarly, a decrease in interest rates of one per cent would increase earnings for the year by $63,000.

Shock Test

The methodology used to measure interest rate risk exposure in Schedule 7.10 is sufficient to meet the specifications of the shock test prescribed in section 78(2) of Regulation 76/95. (The shock test was introduced in Section 7101 of this Reference Manual).

Measuring Interest Rate Risk Exposure over one year

The gap schedule illustrated in Schedule 7.10 measures interest rate risk exposure over a one year period only. However, most credit union's have assets and liabilities repricing or maturing over much longer time horizons. Adapting the gap schedule to determine the effects of interest rate fluctuations on current net interest income for longer periods can be achieved by changing the weights applied to each time bucket. For more information, contact your league or financial advisor.

Limitations of Gap Analysis

The earnings measure illustrated in Schedules 7.10 provides valuable insight into the effects of interest rate fluctuations on the credit union's earnings and reported balance sheet position. However, the projected results are dependent on a number of underlying assumptions. Some of the major limitations of the two techniques include the following:

- An assumption that interest rate changes of one per cent, or multiples thereof, occur at the beginning of the year and are sustained throughout the year which may not be realistic. An assumed one per cent increase in rates which is immediate and sustained for a year, would be roughly equivalent, in terms of its effect on earnings, to a two per cent gradual increase taking place over the same interval.
- An assumption that any change in interest rates simultaneously affects all the balance sheet items subject to repricing in the same way, but this generally does not happen.
- An assumption that the existing structure of the balance sheet will remain static over the next 12 months. New business and deposit compounding in addition to unanticipated early withdrawals or prepayments will affect the gap position and thus the exposure to interest risk during the year.

Other Techniques

More sophisticated gap measurement techniques are available that take into account additional variables of interest rate risk and realistic assumptions regarding market conditions and that analyze interest rate risk for a greater number of interest rate variations. These techniques, dynamic gap analysis, simulation, and dollar duration, can provide a more accurate measure of interest rate risk.

These techniques, which are described below, generally require a high level of financial expertise and in some instances, require sophisticated computer models. For more information on such techniques, the credit unions can contact their league or other financial advisor.

Dynamic Gap Analysis

Estimates of early prepayments of personal loans can be accounted for in the gap schedule using the average term historically experienced on these types of open loans, rather than their contractual maturity dates. Subjective estimates for new business cash flows can also be included. A gap schedule which takes into account these types of assumptions is commonly referred to as a dynamic gap schedule.

Simulation

The analytical process of calculating earning outcomes for alternative interest rate scenarios is termed "simulation". The simulation technique, which is a type of income sensitivity analysis, is most efficiently and conveniently performed by computer, although it can also be performed manually.

Dollar Duration

Duration is a portfolio valuation technique which measures the life of an asset or liability based on the present value of its cash flows. The duration technique provides an estimate of the rise or decline in the market value of equity of a portfolio, under various interest rate scenarios.

Conclusion

Several techniques have been discussed in this section regarding the measurement of interest rate risk. For a credit union with a sizeable and complex balance sheet, all of the above techniques should be considered. It may also wish to contact its league or financial advisor for advice in selecting a measurement technique or to obtain technical expertise.

Monitoring Derivatives

The use of financial derivatives to hedge interest rate risk and foreign exchange risk were discussed in Sections 7209 and 7210. It is recommended that credit unions which use financial derivative monitor the instruments on an ongoing basis. The monitoring of financial derivatives involves:

- measuring the value of each instrument on a periodic basis (at least annually);
- assessing the instruments appropriateness as a hedge against interest rate risk given the current economic environment (at least annually);
- reporting this information to the board (at least annually);
- disclose the market value of derivatives instruments annually in the notes to the financial statements.

For guidance on how to value derivative instruments, and how to record them for accounting purposes, refer to:

- FSCO's Accounting Principals for Derivatives Instruments;
- the Canadian Institute of Chartered Accountants (CICA) Handbook;
- an accountant;
- the credit union's league.

Risk Management

Corrective Action

An important activity in the effective management of risk is management's timely response to unauthorized risk or poor performance developments. As a follow up to the asset/liability risk measurements taken by the credit union (and discussed in Section 7400), management should investigate all significant performance variances relative to the annual business plan and to historical performance, and respond by taking action to correct these variances. Management must similarly respond to any contravention of board policy or regulatory requirements, or other unauthorized risk.

Operational Procedures

Procedures can assist management in ensuring regulatory and policy requirements are met with respect to asset/liability mix, interest rate risk exposure, foreign exchange rate exposure, and derivatives use.

It is recommended that the credit union have procedures in place which ensure that:

- balance sheet limits for major asset/liability and capital categories have not been exceeded;
- product pricing has been conducted in accordance with policy;
- interest rate risk had been measured and monitored in accordance with policy;
- uncovered foreign currency exposure does not exceed policy limits.

Sections 7501 and 7502 discuss procedures that can assist management in complying with policy and regulatory requirements. To assist in implementation, procedures should be both appropriate and cost effective given the size of the credit union's operations.

It is a sound business and financial practice for credit unions to document procedures. Written procedures result in higher staff productivity and better control over resources.

Reliance on Qualified and Competent Staff and Volunteers

In larger credit unions, the chief financial officer or manager of finance would be responsible for ALM, together with the management of liquidity, investments and capital. These functions combined are commonly referred to as treasury operations. In smaller organizations, the treasurer manager would coordinate these activities.

The establishment of an advisory Asset/Liability Management Committee (ALCO) to assist the person chiefly responsible for treasury operations is recommended. In smaller institutions, this committee would typically be a subcommittee of the board, including the treasurer manager. In larger organizations, the committee could be comprised of board and management representatives, or limited exclusively to senior management, where operational issues are very complex. Refer to Schedule 7.11 for Sample Terms of Reference

Schedule 7.11

SAMPLE TERMS OF REFERENCE FOR ASSET/LIABILITY MANAGEMENT COMMITTEE

Purpose: ALCO assists the chief executive officer (CEO) and chief financial officer (CFO) manage the mix, yields and maturities of assets and liabilities and interest rate exposure to meet policies and targets as set by the board of directors.

Composition: ALCO has five members: CEO, CFO, credit manager, controller, and manager sales & marketing.

Authority: ALCO acts in an advisory capacity to the CEO and CFO and has no direct authority to make financial decisions.

Organization: The CFO acts as ALCO Chair, the CEO acts as ALCO Vice Chair and the Controller acts as ALCO Secretary.

Notice of Meetings: The CFO or CEO distributes verbal, electronic or written notice of upcoming ALCO meetings in advance of the meeting. Normally, the date and time of the next meeting is set at the conclusion of each ALCO meeting.

Meeting Materials: The following written materials are distributed to each ALCO member in advance of each regular meeting:

- Agenda for the meeting (to be amended, completed and adopted at the meeting).
- Minutes of the last regular ALCO meeting and minutes of other, previous ALCO meetings not yet adopted.
- Reports related to asset/liability, investment, liquidity and interest rate risk management.

Minutes: The ALCO Secretary prepares minutes of every meeting and presents them to the next ALCO meeting. All corrective action decided upon or ratified shall be entered into the minutes and form part of the credit union's corporate records.

Committee Expenditures: ALCO may recommend expenditures in areas such as marketing, but such commitments are authorized by the Manager responsible for the applicable area of operation or by the CEO if such expenditures have not been budgeted. ALCO has no direct spending authority.

Managing Interest Rate Risk

This section summarizes some of the procedures that may be followed to reduce interest rate risk. These procedures are intended to assist credit unions which face significant asset/liability mismatching. The following interest rate risk management techniques are discussed in this section:

- Traditional portfolio manipulation techniques (e.g. incentive pricing, staggered deposit renewals, etc.).
- External hedging techniques (e.g. use of derivatives, such as interest rate swaps).

Procedures for reducing interest rate risk should be devised within the framework of existing strategies of the organization, its current risk position and the economic constraints which the credit union faces in adjusting its asset/liability mix.

Traditional Portfolio Manipulation Procedures

Traditional portfolio manipulation procedures for the following three different mismatch scenarios are discussed below: reducing exposure to rising interest rates (closing a negative gap), reducing exposure to falling interest rates (closing a positive gap), and reducing seasonal exposures. Although effective, traditional measures of controlling interest rate risk have impacts on members, usually by changing deposit and loan rates to induce members to change their choices of borrowing and deposit terms. More transparent alternatives for reducing interest rate risk, mainly derivatives, are discussed later in this Section.

Procedures for Reducing Exposure to Rising Rates (Closing a Negative Gap)

During a period of climbing interest rates, a credit union which is funding its long term loans with short term deposits (negative gap) will experience rising financing costs as its deposits float at increasingly high rates. In order reduce this exposure, the following procedures may be applied to shorten the term of assets and lengthen the term of liabilities:

- Price products so that favourable rates encourage shorter maturities for loans and longer maturities for deposits. Unfavourable rates should be used to discourage loan/deposit terms that will enlarge the negative gap.
- Where pricing policy will not stem demand for longer term, fixed rate assets, restrict the availability of fixed rate loans.
- Change portfolio mix in favour of variable rate loans. Promote variable rate consumer loans over fixed rate mortgages. Consumer or commercial loans earn a higher yield and can be matched against variable rate deposits.
- Market/promote products which will close the gap position. Recommended methods of promoting products include advertisements, in-branch posters and contest prizes. Inform staff of their priority to increase certain product volumes through cross selling efforts.
- Where new business is not available to correct the gap position, encourage the conversion of maturities in the existing portfolio. Allow members to negotiate in mid-term an extended maturity for fixed rate deposits, or convert closed fixed rate loans to open loans to encourage prepayment.
- Consider selling a portion of the fixed rate mortgage portfolio to other industry players. Such an arrangement allows ongoing member contact, the correction of an unfavourable mismatch and the option to earn a return for continuing service.

- Use the investment portfolio, if necessary, to correct a negative gap by maintaining investments in short-term instruments.

Procedures for Reducing Exposure to Falling Rates (Closing a Positive Gap)

The same procedures as those described above may be used to reduce exposure to falling rates (close a positive gap), except that the opposite tactics should be employed. In an environment of falling interest rates, a credit union which is funding short-term loans with long-term deposits will experience shrinking revenues and financial margin as it's loan interest income falls while deposit interest expense remains fixed. In brief, the following approaches are recommended to reduce exposure to falling interest rate (close a positive gap):

- Price products to dampen demand for variable rate loans and fixed rate term deposits.
- Where pricing does not stem demand, restrict funds available for variable rate loans.
- Change portfolio mix in favour of fixed rate mortgages.
- Market and promote products which close the gap.
- Allow members to extend mortgage terms at current fixed rates.
- Create incentives for members to cash term deposits early.
- Invest excess liquidity of the investment portfolio into longer term vehicles.

Reducing Seasonal Mismatches

Credit unions that are subject to large seasonal fluctuations in product cash flows (e.g. RRSP deposits, Canada Savings Bonds purchases, mortgage advances and renewals) will experience a seasonal mismatch on one side of the balance sheet or the other which they may want to adjust. These seasonal fluctuations can be dealt with by introducing staggered maturity dates on products such as RRSP's, term deposits, loans or mortgages. Where necessary, price should be used as an incentive for the promotion of odd terms. Refer to the recommendations below to reduce seasonal mismatches:

- Stagger RRSP and RRIF deposit renewals by arranging terms to mature on the member's birthday.
- Introduce payroll deduction savings plans that take in deposits periodically, thus spreading the deposits over time.
- Promote products at certain times of the year using contests.
- Offer additional options on mortgage terms, e.g. 18, 30 or 42 month maturities, so that the renewal dates for these loans can be spread throughout the year.
- Promote short-term mortgages (e.g. six month terms) prior to RRSP season so these will mature when heavy deposits are coming in.

Drawbacks of Traditional Portfolio Manipulation Procedures

Sometimes traditional manipulation procedures will trigger unwanted side effects. Consider an attempt by a credit union to correct an exposure to rising rates by:

- halting longer term mortgages to their members;
- increasing the rate on longer term deposits;
- dropping the rates for shorter term mortgages;
- a mix of any of the above.

Each of these techniques for influencing members have their drawbacks. Ceasing to offer four and five year mortgages runs the risk of losing members and their business to another financial institution. Offering higher deposit rates without an equal increase in lending rates will reduce financial margin.

Also, a potential conflict of interest may exist. Although the credit union may match longer term mortgages on its gap schedule, the members may not benefit from being persuaded to invest for longer terms.

Finally, despite all the effort, sometimes attempts to influence members just does not work. Even a high premium may not be enough to convince members to invest at longer terms.

Due to the possible adverse impacts of traditional methods on members, financial institutions often employ other methods of controlling interest rate risk through the use of derivative instruments. These are discussed below.

Derivative Instruments

A derivative instrument is a financial contract whose value fluctuates in relation to the performance of an underlying asset or market index (e.g. a debt or equity security, stock market index, interest rate or foreign exchange rate). (Derivatives were introduced in Section 7210.)

Derivative instruments can be used by a credit union to reduce gap mismatch, and to reduce exposure to interest rate risk and foreign exchange risk. Derivatives must be used for hedging purposes only, and must not be used for speculative or investment purposes.

The most common derivative transaction used for managing interest rate risk is the interest rate swap, which is discussed below. Other derivative instruments are described in Schedule 7.12.

Interest Rate Swaps

Interest rate swaps (swaps) are legal agreements between two parties; one party agrees to pay a fixed rate of interest for a specific term in exchange for the other party paying a variable or floating rate of interest. The fixed rate payment acts as a hedge for the longer term gaps and the floating part of the swap will hedge the short or variable term. Interest rate swaps can often provide efficient, conservative, and prudent solutions to interest rate risk management problems.

It is useful to monitor rates for trends prior to transacting a swap. On the floating side, swap rates are closely tied to rates in bond markets. The swap's fixed rate is generally set by using a specific Government of Canada bond plus the swap spread. Typically, any fees or commissions are included in the swap rate.

Schedule 7.12
REVIEW OF FINANCIAL DERIVATIVES

Interest Rate Swap

Allows an organization to exchange interest expense (or interest income) cash flows with another counterparty either to fix or obtain more attractive rates, without exchanging the underlying financial instruments. Swaps may be used to hedge an interest rate gap or manage interest rate risk within regulatory limits.

Floors, Caps, Collars

A minimum (floor) and a maximum (cap) interest rate or a range of rates (collar) are determined for a variable-rate financial instrument. May be used to hedge an interest rate gap or manage interest rate risk.

Interest Rate/Foreign Exchange Forward Agreements

These are agreements between two parties, frequently a financial institution and its client, setting in advance the interest rate (or exchange rate) relating to a future payment or receipt. Forwards may be used to hedge either interest risk or foreign currency risk on large institutional deposits.

Foreign Currency Futures Contracts

These are agreements to take delivery of, or deliver a set amount of foreign currency on a particular date at a stipulated price through a futures exchange. (These may be used to hedge foreign currency risk).

Securities Options

A security option is a contract between two parties which is legally binding only on the seller of the option. An option grants the purchaser of that option the right – but not the obligation – to purchase (call option) or sell (put option) a security at a specified price, commonly referred to as a strike price, up to a specified date. The seller of an option grants that right to the purchaser for the extra income received. Options can be used to hedge against volatile portfolio investment values.

Stock Index Options

Same as above, but the value of these options fluctuate in relation to specific stock market indices. These options can be used to hedge an entire securities portfolio.

Liquidity Risk Management

Executive Summary

The ability of a financial institution to meet demand for deposit withdrawals and other cash outflows is a visible indicator of its viability. If a credit union cannot meet depositor withdrawal requirements, general creditor expenses, or if it is forced to significantly limit new lending, a lack of member confidence can develop.

The level of liquidity which is maintained must at a minimum meet regulatory requirements. Liquidity must also be sufficient to satisfy demand for cash withdrawals, financing commitments for approved loans, and routine operating cash outflows. Too much liquidity (excess liquidity), on the other hand, can be an inefficient use of funds, and can restrict the profitability of the credit union.

Liquid assets should be managed with due regard to principal safety, yield volatility, and, where liquid assets bear risk, investment diversification. Credit unions should have access to supplemental lines of credit or segregated liquidity pools to satisfy liquidity requirements.

A credit union which has not met legislated liquidity requirements is restricted from regular lending and investment activities (see section 20(1) of Regulation 76/95). Insufficient liquidity may also lead to intervention by DICO.

A credit union can meet standards of sound business and financial practices by ensuring it has developed and implemented liquidity policies, risk and performance measurement techniques, and risk management procedures comparable to those contained in this chapter. Policies, measurement techniques and procedures should be appropriate for the size and complexity of the credit union's operation.

Legislative Summary

Sections 16 to 21 of Part V of Regulation 76/95 contain minimum liquidity requirements for credit unions. These sections prescribe three different liquidity requirements. The first, under section 16, requires the maintenance of a one per cent reserve of cash or near cash items. The second liquidity measure requires the maintenance of a 10 per cent reserve of liquid assets prescribed under sections 17 and 18 (or eight per cent if the credit union is a member in a liquidity pool).

The third liquidity requirement is partially set out in section 21 of Regulation 76/95. This last requirement examines liquidity less short term borrowings. All three liquidity requirements are examined below, as well as FSCO's reporting requirements which are set out in sections 20 and 21.

Schedule 8.1 provides a summary of the important regulatory restrictions pertaining to liquidity management. As only a summary is provided, readers should refer to the Act, Regulation 76/95 and Ministry Interpretative Bulletins for a complete description of a credit union's regulatory rights and obligations.

Schedule 8.1
RELEVANT LIQUIDITY RELATED LEGISLATION

	The Act	**Regulation 76/95**
Adequacy of liquidity	84	
Superintendent's orders - additional liquidity requirements	85-88	
Report to Superintendent on liquidity	89	
Adequate liquidity		16-18
Liquidity pool		19
Non-compliance		20-21
Borrowing powers	183	
Pledging of assets	184-185	
Subordinated indebtedness	186	
Limits on credit union borrowing	187	
Borrowing from other credit unions	188	
Monitoring by board	189	

Policy

It is recommended that the credit union adopt a liquidity policy that addresses:

- sources and acceptable ranges of operational liquidity;
- quality of assets used for liquidity purposes;
- maximum limits on liquidity borrowings;
- maturity matching and/or hedging of large deposits;
- frequency, form and content of board reporting.

These recommended objectives of liquidity policy are discussed in greater depth in Sections 8201 to 8205. Adopting a liquidity policy will assist the credit union to manage risk and to comply with the Standards in DICO By-law No. 5. For recommended operational procedures, refer to Section 8500.

Examples of liquidity policy are available in the DICO publication Sample Policies, and are available to the industry for customization as appropriate. As well, the information provided in Sections 8201 to 8205 will also assist in establishing policies of liquidity management.

Liquidity policy must not conflict with the requirements prescribed by the Act, Regulation 76/95, and any interpretative bulletins or guidelines issued by FSCO. It is optimal for key regulatory liquidity requirements to be repeated in liquidity policy for greater clarity and ease of reference.

Liquidity Management Philosophy

Adopting a liquidity management philosophy is an important first step in drafting liquidity policy. The philosophy sets out the broad goals and objectives of the credit union with regards to liquidity, as established by the board of directors. This philosophy governs all liquidity policy constraints and helps address new situations where policy does not yet exist.

While goals and objectives will differ depending upon the circumstances and environment of the credit union, important principles of liquidity management should always address the following principles:

- ensuring enough liquidity to guarantee the orderly funding of members needs;
- providing a prudent cushion for unforeseen liquidity needs;
- investing liquid funds in a manner which emphasizes the need for security and liquidity.

Adequate Range of Liquidity

From a business perspective, the gross liquidity requirement stipulated in legislation represents only an arbitrary minimum for most credit unions.

A minimum operating liquidity level should be established to maintain a comfortable cushion beyond the minimum statutory requirement, in order to meet cash needs. A desired target maximum for operating liquidity also needs to be established to reflect the fact that too much liquidity has a negative effect on earnings. Accordingly, a target range for operating liquidity, stated as a percentage of assets, needs to be established.

In order for a financial institution to decide the optimum level of liquidity for its operations, it should look at the following factors:

- cash flow needs for the immediate future (one year);
- previous years liquidity fluctuations (at least two years);
- expected increases/decreases in loan demand;
- income requirements for the year;
- volume of deposit withdrawals;
- volume of institutional deposits and large deposits;
- any other known factors which may have an effect on available liquidity.

Part of this process includes having a comprehensive understanding of the nature of the credit union's assets and liabilities, and the cash flows these represent. This type of information can be obtained from the cash flow analysis statement.

Sources of Liquidity

Sections 16 to 18 of Regulation 76/95 list the assets that may be used by a credit union for liquidity purposes. These include, among others, the following deposit instruments:

- deposits in a league;
- deposits in a chartered bank;
- treasury bills issued by Canadian governments;
- bonds and debentures unconditionally guaranteed by Canadian governments;
- Canadian dollar deposits with or acceptances issued by Schedule I banks or Schedule II banks with a DBRS rating of R-1 low or better.

When purchasing liquid assets, the credit union should rely either on its league, or on brokers that have been authorized by the credit union. (A list of authorized brokers should form part of the credit union's investment policy; this list can be the same for both investment and liquidity purposes).

The credit union may also wish to establish policy limits on the maximum terms (length of time) that securities can be purchased for. Assets purchased for the liquidity portfolio should generally have a contractual maturity of less than one year.

Minimum Quality of Liquid Assets

Purchases of liquid assets should also adhere to minimum investment quality limits. Generally, the credit union should ensure that the quality of their liquidity investments comply with the limits prescribed in Regulation 76/95. However, a credit union which is dealing with chronically low levels of liquidity may choose to elect more restrictive limits on quality. A credit union which has a sophisticated or complex liquidity portfolio may also want to set more restrictive quality limits on all or a percentage of its portfolio.

Limits on Borrowing

In situations of liquidity shortages, credit unions may need to borrow funds to meet liquidity needs and minimum statutory requirements. When doing so, the credit union should be aware of regulatory limits on borrowing. Section 183 of the Act prescribes regulatory limits on external borrowings: 25 per cent of a credit union's regulatory capital and deposits in ordinary circumstances; and 50 per cent of regulatory capital and deposits in circumstances where a specific by-law of the credit union permits higher borrowings. As well, section 21 of Regulation 76/95 prescribes a liquidity adequacy test which deducts certain forms of short term borrowing.

Funds borrowed to meet statutory liquidity requirements or general liquidity needs can prove costly to a credit union due to its negative impact on profit. Consequently, borrowings should be used on an exception basis, when non-anticipated withdrawals of a significant amount or unexpected loan growth threaten to bring liquidity below statutory levels.

Credit unions should consider using borrowings as a short term solution for liquidity shortages only. It should consider more permanent options to reduce liquidity shortages in the long term, such as appropriate financial and marketing strategies (see Section 8501 for examples of these). To discourage use of borrowings over the long term, policy could require board approval for use of borrowings over periods of six months.

Finally, the credit union may want to establish limits on liquidity borrowings that are more restrictive than those set out in the Act.

Lines of Credit

Whenever a credit union establishes a supplemental line of credit with a league or a chartered bank, the relationship should be in writing and should be specific to the amount and conditions of possible use. A credit union should keep the arrangement under constant review, and provide full disclosure to the lender of fluctuating liquidity requirements. A credit union's lender will be keenly interested in the client's credit worthiness; in particular, the level of capital in the credit union and the quality of the loan portfolio. The higher the level of capital, the lower the risk to the lender and the more likely the availability of supplemental lines of credit.

Large Deposits

It is generally acknowledged that a credit union which relies on a significant number of large deposits is in a less favourable liquidity position than one whose deposit base consists of many average sized accounts. The withdrawal of large deposits due to interest rate competition or members' investment discretion can significantly impair liquidity and should be avoided.

In this regard, the credit union should adopt a policy which requires the identification of deposits held by one member that are over a certain size. The following elements of a large deposits policy are recommended:

- Policy should define what it considers a large deposit for these purposes. Generally, a large deposit is one that if withdrawn, would have a significant impact on operational liquidity. The size can best be expressed as a percentage of assets or deposits.
- When defining large deposits, the policy may want to distinguish between large institutional deposits and large member deposits.
- When determining what qualifies as a large deposit, management should consider the total amount of deposits that belong to an individual and group of connected persons.
- Policy should require the appropriate maturity matching of any large deposits. This involves ensuring funds equal to the amount of the deposits are invested in liquid assets, in addition to normal operating liquidity.
- Alternately, policy may require a 60 day notice period before withdrawal of large deposits.

Planning

Annually, management and the board of directors must develop an business plan for the credit union, summarizing the credit union's goals and objectives for the coming year.

This annual business plan includes a strategic financial plan that addresses each area of risk management, including liquidity. As part of the strategic financial plan, management and the board must set financial targets and plans for liquidity management. The elements of a liquidity plan are set out in Chapter 1 on Planning, and should be referred to for planning purposes.

Risk Measurement and Board Reporting

It is recommended that the credit union measure the performance and risk level of the liquidity portfolio and report these findings to the board.

Risk Measurement

The following are minimum risk and performance measures of liquidity management, required by sound business and financial practices:

- the volume of liquid assets, relative to the plan and to historic levels, and compared against regulatory requirements;
- the average liquidity yield;
- the amount of short term borrowings (i.e. less than 100 days);
- identification of large deposits (as defined in Section 8205).

The credit union must comply with any liquidity related measurement requirements set out in the Act and Regulations. The credit union may track any other measures of the liquidity portfolio as it sees fit.

These measurements 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 goals. Management can also assess whether there are material variances from the plan which need to be addressed.

Comparison of these measurements against historical performance, where possible, can also identify significant trends which may need to be addressed by management.

Risk Measurement Techniques

Due to the similarities between the investment portfolio and liquidity portfolio, the techniques used to measure liquidity risk are the same as the techniques used to measure investment risk. Therefore, the discussion on risk measurement techniques in Section 6401 should be referred to when developing risk measurement techniques for liquidity management.

Board Reports

The measurements of liquidity risk discussed earlier should be reported to the board of directors, so that the board can also monitor the liquidity portfolio and ensure adherence to regulatory requirements and to the annual business plan. Material variances from plan and their causes, as well as management's plan to correct the variance, should also be included in the report. Management should also provide the board with a summary on compliance with liquidity policy and relevant regulatory requirements.

Frequency

Management should provide the board with a report on the liquidity portfolio for each board meeting.

Form

Schedule 8.2 on the following page illustrates a Sample Board Report on Liquidity Management which can be used by management to monitor liquid asset portfolio, ensure regulatory compliance and report findings to the board. The report compiles and compares all the volumes, targets and policy limits required to properly manage the risk of the credit union's liquid asset portfolio. This report can be adopted or amended for use by the credit union.

Information contained in the report can be expressed on a periodic basis (monthly, quarterly), or on a year-to-date, or both, depending upon the preferences of the board and the frequency of reporting.

The frequency, form and content for board reports on liquidity should be set out in liquidity policy.

<table>
<tr><th colspan="6">Schedule 8.2
SAMPLE BOARD REPORT ON LIQUIDITY MANAGEMENT</th></tr>
<tr><td colspan="6">Part I: Liquidity, Liquidity Borrowings and Liquidity Yields</td></tr>
<tr><td colspan="6">Latest projected liquidity needs: $________________________</td></tr>
<tr><td colspan="2">Actual</td><td>Per Plan</td><td>Per Policy</td><td>Statutory Requirement</td><td>Variance from Plan</td></tr>
<tr><td>Total liquid assets, as a % of deposits and borrowings:</td><td>%</td><td>%</td><td>min: %
max: %</td><td>%</td><td>%</td></tr>
<tr><td>Total short term borrowings (i.e. less than 100 days) as a % of deposits and borrowings):</td><td>%</td><td>%</td><td>%</td><td>%</td><td>%</td></tr>
<tr><td>Average yield on liquid assets (%):</td><td>%</td><td>%</td><td></td><td></td><td>%</td></tr>
<tr><td colspan="6">Variances should be calculated as a percentage of the corresponding figure stated in the business plan.</td></tr>
<tr><td colspan="6">Part II: Identification of Large Deposits</td></tr>
<tr><td colspan="3">Large deposits defined as exceeding: $</td><td colspan="3" rowspan="4">Number of large deposits:_____

Has sufficient additional liquidity been set aside for large deposits:
YES / NO
How much: $____________________</td></tr>
<tr><td></td><td>Actual</td><td>Same Month Last Year</td></tr>
<tr><td>Dollar volume of large deposits:</td><td>$</td><td>$</td></tr>
<tr><td>Large deposits as a % of deposits and borrowings:</td><td>%</td><td>%</td></tr>
<tr><td colspan="6">Part III: Corrective Action/Strategies</td></tr>
<tr><td colspan="2">Variance</td><td colspan="4">Corrective Action/Strategy</td></tr>
<tr><td colspan="2"></td><td colspan="4"></td></tr>
<tr><td colspan="2"></td><td colspan="4"></td></tr>
</table>

Risk Management

Corrective Action

An important activity in the effective management of risk is management's timely response to unathorized risk or poor performance developments. As a follow up to the liquidity risk measurements taken by the credit union (discussed in Section 8400), management should investigate all significant performance variances relative to the annual business plan and to historical performance, and respond by taking action to correct these variances. Management must similarly respond to any contravention of board policy or regulatory requirements, or other unauthorized risk.

Operational Procedures

It is recommended that credit unions have procedures in place which will ensure compliance with:

- minimum liquidity requirements, set out both in legislation and in board policy;
- minimum investment quality limits, set out both in legislation and in board policy;
- and that large deposits are properly hedged or matched, so that operational liquidity will not be greatly affected if these deposits were withdrawn.

Section 8501 discusses procedures that can assist management to monitor cash flow needs, monitor compliance with regulatory and policy liquidity needs, and address liquidity shortages or excesses. To assist in implementation, procedures should be both appropriate and cost effective given the size of the credit union's operations.

It is a sound business and financial practice for credit unions to document procedures. Written procedures result in higher staff productivity and better control over resources.

Operational Procedures

The following procedures can assist management to monitor cash flow needs, to monitor compliance with regulatory and policy liquidity needs, and to address liquidity shortages or excesses.

Monitoring Liquidity Needs

The credit union's liquidity needs should be reviewed on a periodic basis. For most credit unions, this will mean at least on a weekly basis. This review should encompass a detailed forecast of imminent liquidity requirements and a broad projection of cash needs for the next three month period.

Summary measurements of liquidity needs should be prepared for board review at each board meeting, in addition to the risk measurements discussed in Section 8400.

To determine immediate cash flow needs, a cash flow statement can be used to develop projections for the next three months. Periodic (weekly or monthly) cash flow projections can predict whether excess or deficient liquidity levels will be experienced by the credit union in the near future. If deficiencies are below operational levels, management will have to take action to correct these levels.

Liquidity Shortages

Whenever deficient liquidity levels are discovered, management must prepare marketing and financial strategies to align liquidity levels within desired targets, or take defensive actions.

Defense actions to protect the liquidity position of a credit union would normally include:

- marketing measures to improve deposit levels;
- judicious use of standby lines of credit;
- judicious use of borrowings for liquidity support;
- temporary curtailment of lending;
- sale of assets to a third party.

It should be recognized that the above noted defense actions are listed in order of most attractive to least attractive option. Curtailment of lending activity is considered least desirable because of the negative effect on member confidence, however, certain restrictions on lending may become a necessary trade-off in a liquidity crisis. Early reaction, in terms of moderate or temporary curtailment of lending, will often overcome the need for drastic measures at some later stage.

Alternative liquidity defense strategies such as an available overdraft facility and an approved line of credit facility with a league or chartered bank are recommended sound business and financial practices. The use of an overdraft facility permits a credit union to maximize the value of its float without jeopardizing the clearance of its negotiable instruments. One example of an aggressive cash management strategy would be to make the greatest possible use of short term call deposits in the money market while permitting the current account to be in occasional overdraft position, in order to maximize earnings.

Excess Liquidity

Where a credit union has significant liquidity in excess of statutory requirements due to unanticipated net cash inflow, management should examine options to reduce liquidity to an appropriate level. High levels of liquidity generally have an unfavourable effect on profitability, as the rate of return earned on short-term investments is usually not as high as the yield on loans, and cash held in the credit union earns no interest. In order to reduce liquidity which is in excess of operational requirements, management should ensure it has exhausted all credit granting opportunities, without compromising on credit quality. Alternatively, the credit union should undertake membership drives to expand loan demand.

Where the promotion of credit does not fully utilize excess liquidity, interim investment of funds should generally be made in short-term investments, so that conversion to new loans may readily occur. During an economic downturn or in situations where aging member demographics are difficult to reverse, board and management may determine that a portion of excess liquidity is likely to persist for longer than the current fiscal period. In such situations, management should look for safe investments with terms in excess of one year that would generate higher yields. For more on investments, refer to Chapter 6 on Investment Management.

Operational Risk Management (Internal Controls)

Executive Summary

The board should establish an operational risk management policy that sets includes the requirements, purpose and scope of related internal controls. Management should document internal controls in the credit union's operational procedures. Documentation assists in ensuring that internal controls are properly authorized and complete, and assists in their maintenance and revision.

Operational risk management includes implementing:

- defined levels of authority to make corporate decisions;
- safeguards to protect the premises and assets of the credit union;
- an operational and secure management information system (MIS) which accurately records transactions;
- staffing and monitoring controls appropriate to the size of the credit union;
- a framework for technology development
- a process for outsourcing services
- appropriate monitoring controls.

The specific elements of a comprehensive internal controls system are set out in DICO's By-law No. 5. Internal controls relating to credit granting practices are covered in Chapter 5 on Credit Management.

In designing a system of internal controls, management must review the costs and benefits of implementation. The cost of establishing a particular control must be measured against the expected savings attributable to loss prevention (e.g. reduction of fraud). A particular internal control may not be required where in its absence the likelihood of financial loss is small due to the size of the operations or the existence of compensating controls.

A credit union can meet the standards of sound business and financial practices by ensuring it has developed and implemented policies and procedures comparable to those contained in this chapter. Policies and procedures should be appropriate for the size and complexity of operations.

Authority and Approval

A primary factor of operational risk management is the existence of a framework of defined levels of authority to make corporate decisions. Management must design and implement a framework for approval authorities, for all areas of operations which ensures that responsibilities and approvals for transactions are assigned to the proper and appropriate individuals within the organization.

The following essential elements of an approval framework should be required by board policy, and should be documented in internal control procedures:

- General approvals;
- Specific approvals;
- Designated signing authority;
- Organizational chart;
- Designated suppliers of professional services.

General Approvals

General approvals need to be set within the procedures and job descriptions, for a group or class of transactions. They should provide staff with the authority to complete a transaction without receiving specific approval.

Specific Approvals

Specific approvals are those that will require an authorizing action, evidenced by signature, before the transaction can be completed. Specific approval authorities document:

- to whom the approval is delegated (by position or by individual);
- the absolute or incremental authority being delegated;
- restrictions, if any, placed on the authority;
- whether the person can further delegate the authority.

Signing Authority

The approvals framework should govern the signing authority of credit union's officers and management. The framework should address signing of:

- corporate cheques;
- documents under seal (e.g. mortgage discharges);
- all contracts accepted on behalf of the credit union.

Cheques over a prescribed dollar amount should require signatures by two officers, or at least one officer and one staff member.

Authority to Enter into Contracts

Internal controls should provide for the following safeguards when officers or staff enter into the contracts on behalf of the credit union:

- Contracts which are entered into should comply with legislated requirements and the objects of the credit union.

- Where the approval of a contract results in a conflict of interest for a director or officer, the individuals involved must be guided by sections 146 to 149 of the Act, as well as legislation on restricted party transactions, in Part IX of the Act and Part X of Regulation 76/95. (Refer to Section 2104 for further details in this regard.)
- Contracts over a specified dollar amount should be subject to the control of dual, independent signatories. The specified amount should be determined by the board in relation to the organization's asset size and transaction base.
- Contracts which commit the organization to external borrowings must be subject first to board approval, and then require the manager and other senior officers' signature for validation.
- Smaller purchases or contracts which commit the organization to daily business activities should have the signature of one or more operating officers and should be in compliance with the credit union's capital budget, as approved by the board.
- With respect to the authorization of loan contracts between the organization and its members, refer to Section 5502 of this Reference Manual on Loan Approvals and Disbursements.
- Investment contracts should be authorized in compliance with a documented board policy on investments. Refer to Section 6204 of this Reference Manual on Investment Approvals.

Organizational Chart

An organizational chart illustrates lines of reporting, responsibility and authority between staff, and is a useful tool in representing the authority framework of the credit union.

Designated List of Professional Service Suppliers

The credit union should specify in policy or procedures designated suppliers of professional services. The purpose of this process is to ensure that the credit union retains professionals whose credentials and qualifications have been investigated.

This can be ensured by requiring such investigation before a professional can be added to the designated list, and by limiting the credit union to only retaining professionals from that list. Investigation should ensure that professionals have the proper qualifications and insurance. Operational procedure (or policy) should specify the process for adding qualified professionals to the list.

Professional services which should be covered in the list include:

- legal counsel;
- real estate appraisers;
- financial advisors (brokers, investment dealers, and other financial service providers).

A review of internal controls at the end of the year should include a check to ensure only professionals from the designated list were retained by the credit union.

Safeguarding of Premises and Assets

The safeguarding of premises from theft, burglary, robbery and other physically hazardous conditions which may cause harm to staff, members, or general property should be a key objective of policy. In order to reduce the risk of such acts being committed against the credit union, four basic areas of risk management are recommended:

- Access to the credit union's property should be monitored and subject to certain physical controls.
- Storage of valuables must be strictly regulated and protected in fire and theft resistant receptacles (e.g. safes, vaults, etc.).
- Security procedures should be defined and followed by staff.
- Insurance coverage should be utilized to reduce the risk of monetary loss from accidents.

The extent of protection and the degree of precaution which must be implemented under each of these categories will vary amongst credit unions, and should be determined based on:

- the incidence of crimes against the particular office or financial institutions in the area in which the office is located;
- the amount of moneys, securities or other negotiables exposed to robbery, burglary, or theft;
- the distance of the office from the nearest law enforcement offices, guards, or security personnel and the time required for such personnel to arrive at the office;
- other security measures in effect at the office or within the area, such as the office being located within the complex of a business or factory which has security, etc.;
- the physical characteristics of the office structure and its surroundings.

Detailed recommendations on these categories of risk prevention for physical premises and assets follow.

Access to Physical Premises

It is recommended that at a minimum the following security equipment be installed to deter unauthorized access to the premises of the credit union.

- A lighting system must be in place which effectively illuminates all areas surrounding exterior entrances to the premises, including the parking lot and any automated banking machines.
- Minimal lighting of the interior office should be provided after hours, and curtains should be left open to permit police and/or security personnel to detect illegal entry.
- The vault or safe door should be visible from outside the office if possible to promote direct surveillance by the public and the police.
- Where public resources are available, arrangements could be made with local police or other security personnel to inspect the exterior of the premises with reasonable frequency.
- Emergency lighting (and alarm) facilities must be equipped with an independent source of power, such as a battery, in the event of failure of the usual source of power.
- Tamper resistant locks should be installed on exterior doors and windows. Rear and/or basement windows should be protected by burglary resistant bars or grills. It is recommended that all outer door locks have dead-bolts with keys that are registered and cannot be cut by ordinary locksmiths without written authority.
- Keys to the premises, the vault/safe or other safekeeping drawers must be maintained under a strictly applied policy of key control. An inventory of all keys should be prepared, listing the authorized personnel to whom they have been assigned during the day.
- Underwriter Laboratories of Canada (ULC) certified alarms should be installed on all safes/vaults. In addition, premises alarms can be installed for peripheral safety (e.g. motion detectors). The alarm system should provide for employee (e.g. teller) activation after a robbery, preferably a silent activator, that is connected to the police or a security agent. The equipment should have a visual and audible signal capable of indicating improper functioning or tampering with the system.
- A camera surveillance system should be installed, where practicable, to monitor all entrances, tellers' counters, ATM areas and vault access. Notice of the existence of such devices should be prominently displayed and surveillance equipment continuously supplied with new tape or film as required.
- Customers and other members of the public should be kept away from rooms or areas that are not used to serve the public.
- ATM facilities should be established in well lit areas, preferably near paths of public traffic for surveillance purposes.
- Where a staffed drive-through teller window is used by a credit union to service members, the window should have bullet proof glass installed. The teller in a drive-through teller window should be protected by a robbery alarm activator and video/camera surveillance.
- Local police should be consulted in designing an effective program of crime prevention.

Security Procedures

The existence and enforcement of routine policies and procedures for the opening and closing of premises is another important element of risk management. The general manager, or other officer responsible for internal controls, should devise and oversee implementation of these practices at the credit union.

Where a perimeter alarm and motion detector is not in place, the following practices are recommended for the opening of premises:

- Specific senior employees should be designated to open the office or the branch on a daily basis. Employees should enter the premises through the front or main entrance doors, paying attention to suspicious persons who may be loitering near the office. When in doubt, police should be notified.
- At least two persons should be present during the office opening. One person should remain outside the office while the other(s) inspects the interior premises, and gives clearance to exterior staff for entry. When clearance is not given within a reasonable time, the staff outside should contact the police from an outside location.
- If there is only one employee, he/she should telephone a responsible person by a specified time, advising that everything is in order using a code word.
- If upon entry, a break-in is discovered, staff should evacuate the premises, and call police from an outside location. Caution should be used so that fingerprints or other evidence is not destroyed.

Specific senior employees should be assigned to close the branch or office each night. The following safety procedures are recommended:

- All doors and windows must be locked and checked thoroughly for damage and improper locking mechanism. Rooms, closets and basement should be inspected to ensure unauthorized persons have left the building.
- Cash drawers and anti-hold-up units should be left empty and should remain open with keys removed. The cheque protector, certified cheque and other stamps should be locked away.
- All securities and records should be stored in appropriate containers and locked; wastebaskets should not contain confidential data.
- Combinations on teller lockers should be spun off. The vault/safe should be locked and all security and alarm devices should be checked to ensure these are activated.

Once the office is closed for the evening, it is strongly recommended that individual staff not remain behind after hours. Where it is necessary to do so, two persons should be in attendance. The alarm company should be notified that staff are still on the premises so that employees are not mistaken as intruders.

Storage of Valuables

It is recommended that suitable storage units be used to protect the valuables of the credit union from theft or destruction. Refer to Schedule 9.1 below for a list of recommended equipment.

Schedule 9.1 *STORAGE OF VALUABLES*	
Type of Valuable	**Recommended Storage Unit**
Teller Cash	Teller drawers, drop safes and anti hold-up units
Cash In Transit	Night depositories and armoured vehicles
Surplus Cash and Negotiable Securities	ULC certified vault or safe with a time lock and delayed action timer
Member Personal Valuables	Safety deposit boxes
Member Records	Fire resistant storage cabinets
Loan Security Documents	ULC certified vault or safe

- Burglary ratings for all safes and vaults should be investigated with a league, or the bonding insurance company; equipment purchases must be in compliance with the requirements for bonding purposes.
- A written certificate from the contractor, manufacturer or supplier of the equipment should be obtained, documenting that the equipment meets or exceeds recommended qualifications.
- All key and combination locks which are installed on storage units should also be in compliance with recommendations made by a league or the bond insurer.
- It is strongly recommended that all vault combinations have time delay mechanisms which require pre-setting for daily operations, and require two combinations to open.
- A record of all combinations for combination locks should be kept in safekeeping, under dual custody preferably off premises. Combinations should be changed at least annually, after servicing or whenever there is staff turnover.
- All storage devices should be regularly inspected, tested (e.g. at least annually) and serviced by competent persons to assure maximum performance and safety. A record should be kept of all inspections and servicing.
- A perpetual inventory list of all equipment and fixed assets owned by the credit union should also be maintained.

Cash, Travelers' Cheques and Other Negotiable Instruments

Cash, travelers' cheques and other negotiable instruments represent a significant portion of the stored assets of a financial institution. As a result, this area warrants special focus. The following general internal controls are recommended:

- Cash and negotiable securities must never be left unguarded when outside of the vault, and should be secured at all times.
- Where possible, dual control of negotiables by independent persons should be exercised, meaning that at least two staff members should be required to access valuable property.
- Where single control of cash and negotiable instruments is required for operational expediency, (e.g. a teller's control of his/her cash drawer) the property which is entrusted to a single employee should be counted.
- Controls should be in place to log all transactions while funds are entrusted to an employee. When cash is returned to treasury or to another employee, it should be counted by the persons responsible for treasury.
- Procedures should exist for establishing the accountability of cash shortages. Tellers should be required to balance their cash at the end of their shift.
- Detailed internal control procedures for the handling of cash should be documented by the credit union, and must be distributed to all staff who handle funds.

Internal controls may also be necessary to provide proper safeguards for cash, cheques, and negotiables located in:

- tellers' drawers;
- treasury;
- transit;
- night boxes and ATMs;
- safety deposit boxes.

Criminal Activity

Internal controls must address the threat of criminal activities from both within and outside the credit union. While the indemnification of losses from most criminal activities is provided for by mandatory bonding insurance, strategies are needed to minimize the likelihood and the effects of these activities, in order to protect members and employees from harm, and to keep bonding insurance premiums to a minimum. Refer to Schedule 9.2 for a sample list of criminal activities which should be addressed by internal control policy and procedures. A credit union can contact its league for assistance is setting up these procedures. One of the more common forms of criminal activity, money laundering is discussed below in greater detail.

Schedule 9.2 *COMMON CRIMINAL ACTIVITIES FACING CREDIT UNIONS*
• Bomb threats • Extortionist telephone calls • Kidnapping of employees • Robbery • Burglary • Embezzlement • Mysterious disappearance • Forgery • Money laundering • Cheque kiting

Approaches to managing associated media publicity that results from detected criminal activities should also be incorporated into these procedures.

Money Laundering

Money laundering is defined as a criminal process whereby the existence of an illegal source, or illegal application of income is concealed by the re-circulation (laundering) of that income through legal deposit taking institutions. Money laundering makes illegal cash appear legitimate. Generally the process is accomplished by individuals depositing illegal cash into a variety of accounts, in periodic instalments that do not arouse suspicion. The deposit of illegal proceeds into a financial institution is often accompanied by the practice of frequent cash transfers by wire or other methods, the conversion of cash into money orders, travelers' cheques, precious metals or other negotiable instruments, or the frequent changing of currency into different denominations of cash. Under Canada's Criminal Code, it is a criminal offence for anyone, including credit union staff, to knowingly assist in laundering the proceeds of crime.

Credit union staff should be advised of the likely indicators of money laundering and should be trained to be suspicious of transactions that do not appear legitimate. It is recommended that the following unusual member behaviour be documented by tellers or service representatives, and communicated to the general manager, controller or internal auditor:

- Unusually high and frequent cash deposits made by a member in person, by automated teller or night depository, usually followed by transfers clearing the account.
- Irregular large cash deposits or withdrawals made by a business that seem unreasonable for the nature of the enterprise or which would normally be dominated by cheques or other instruments.
- Members which decline or provide minimal information for new accounts or for other banking services which would be valuable to them.
- Members which frequently seek to exchange small denomination bills for larger ones, or whose deposits contain counterfeit bills.

In general, credit union general managers and staff should be familiar their members and their sources of funds, while at the same time noting and questioning any suspicious transactions. Where criminal activity is suspected, supervisory staff should transfer any evidence to the Risk Management personnel of the appropriate league, bonding agency or to police.

Management and staff must also be aware of and comply with the federal regulations on money laundering. The Proceeds of Crime (Money Laundering) and Terrorist Financing Act requires the credit union to implement a compliance regime for identifying and reporting certain large and suspicious transactions.

This includes:

- the appointment of a Compliance Officer (for each branch location)
- development, approval and application of written compliance policies and procedures
- implementation of an ongoing employee compliance training program
- a regularly scheduled review of policies and procedures by internal/external auditors to test their effectiveness, adopt changes in legislation and correct any weaknesses

Further information is available directly from FINTRAC (**Web site** http://www.fintrac.gc.ca**), y**our league or Credit Union Central of Canada.

Safety Procedures

Steps should be taken by the credit union to conduct routine safety inspections of all office property, property in possession and foreclosed real property. The following guidelines are recommended:

- The credit union should at least annually inspect fire prevention equipment including office sprinklers and fire extinguishers.
- The need for installation of fire walls should be considered where the credit union's office is adjacent to fire hazardous occupants in the same building (e.g. restaurants, laundries, etc.).
- Employees should be trained in fire prevention, and regular fire drills should be conducted. The local fire department should be consulted in establishing a fire prevention program.
- All heating and electrical equipment should be routinely inspected to prevent performance failures and/or explosions.
- Elevator shafts and vents within a building should be kept free of trash, dust and other combustible materials.
- Waste should always be stored in enclosed metal containers, away from heating sources.
- Entrances, stairways, office aisles and loading platforms should be kept unobstructed by trash or storage boxes.
- Floors should be clean and dry to prevent accidental slippage.
- Outside areas such as parking lots and sidewalks must be cleaned of snow and ice, and must be brightly lit at night. Walkways and steps should be in good repair.
- Office equipment should be sturdy and safe for employee use. Large, clear plate glass windows should be marked at eye level, and not located where persons can accidentally walk through them.
- Where the office is situated in an industrial plant, management should ensure hazardous industrial materials are not located close to the office.

Property and Casualty Insurance

Adequate property and casualty insurance should be obtained by each credit union from a general insurer. The extent of coverage must be assessed relative to the original and replacement costs of insured property.

The purpose of property and casualty insurance is to safeguard the organization against damages caused by accidental occurrences such as the following:

- Fire and similar damages - arising out of fires caused by lightning and explosion, smoke, water, chemical, etc.
- Weather and other perils - such as hail, windstorm, explosion without fire, vandalism, etc.
- Automobile accidents - for both owned and non-owned automobiles.
- Theft - including larceny, robbery and burglary.
- General liability - arising out of injury to persons entering upon the premises.

Bonding Insurance

In accordance with section 151 of the Act, bonding insurance for officers and staff must be obtained.

The prescribed minimum amount of coverage is set out in section 27 of Regulation 76/95. The coverage that is provided by a fidelity bond should include indemnification for losses caused by counterfeit money or securities, robbery, burglary, theft, forgery, or employee/director/committee member dishonesty.

Although a regulatory minimum is prescribed in Regulation 76/95, the board of directors still need to review the amount of bonding insurance coverage held by the credit union to determine if it is sufficient given the credit union's operations. Increased coverage, even that greater than the regulatory minimum, should be obtained if necessary to provide sufficient protection for the credit union.

Certain maximum limits and exclusions for liability are specified in the insurance agreement which should be fully reviewed. Management should be aware of these.

Credit unions not covered through a league master bond program must obtain bonding insurance directly from the insurance company. Bondability of an employee is a requirement of bonding insurance, and therefore the credit union must ensure that all current staff are bondable.

Similarly, any new staff must be bondable as well. Details of procedures for bonding new staff members can be obtained from the insurance company, or from the league if it institutes a master bond program.

Management Information Systems (MIS)

The board shall establish a policy that will addresses the operation and security of a management information system (MIS). The objectives of an MIS is to provide timely and accurate processing of authorized transactions in a controlled manner and to produce informative monitoring reports for management purposes. It is therefore recommended that policy require the following:

- the accurate operation and security of a management information system, which:
  - records all transactions accurately and on a timely basis;
  - enables management to monitor and analyze the financial condition and performance of the credit union;
  - provides an audit trail for all transactions;
  - protects the integrity of system hardware, software and data through appropriate access and process controls
  - addresses the audit and regulatory record retention requirements of the organization;
- a Disaster Recovery Plan that can respond to situations of severe damage to the physical premises or computer system of the credit union (including data back up);
- a system of record retention, storage and destruction.

These elements are discussed in Sections 9301 to 9309 of this chapter.

Operation of an MIS

A management information system (whether manual or electronic) should be designed to collect relevant data on a timely basis and to generate reports which satisfy management's decision making requirements, as well as the board's monitoring function. Financial data collection should permit management to:

- prepare financial records and books of account;
- monitor and analyze the credit union's financial condition and performance (including determining and explaining financial trends);
- compare key financial ratios to targets in the annual business plan, historic performance and peer/industry performance;
- satisfy regulatory requirements, such as monitoring compliance with the Act and Regulations, and record retention.

Accounting Records

The MIS should include a set of accounts, general and subsidiary ledgers and a prescribed flow of standardized documents which will record accurately the effect of all economic transactions on each financial statement component. The MIS should maintain the following records for each main office or branch of a credit union:

- General ledger control accounts which provide a summary record of all the transactions which affect the assets, liabilities, income, expenses and equity of the credit union.
- Schedules for the support of balances in general ledger accounts including:
    - allowance for doubtful loans;
    - depreciation schedules;
    - monthly bank reconciliation;
    - investments schedules;
    - other such schedules as may be required.
- Subsidiary ledger records for all member accounts, in balance with their respective general ledger control accounts including the following:
    - individual loan accounts (including personal, mortgage, commercial, etc.);
    - individual chequing accounts;
    - other individual deposit accounts (savings, RRSP, term deposits, etc.);
    - individual share accounts;
    - individual loans that have been written off;
    - other such individual subsidiary ledgers as are necessary to account for and support a general ledger account.

  Note: Subsidiary ledger accounts should be reconciled to general ledger accounts by someone who is not involved in making transactions to either ledger, and checked by a supervisor.
- An "inter-branch" general ledger account for the recording of the net shifting of funds between branches, where applicable.

Where a credit union has branch operations (i.e. branches permitting member sign-up and the completion of loan applications), it is recommended that the records of each branch be maintained separately in order to monitor the branch's business volume, costs and revenues of operation. Account numbering across branches should be standardized with individual branch codes identified.

Where the branch operation is part of an interactive data processing system, accounting transactions should be recorded, where initiated, in separate branch controls for branch information purposes. All transactions should also be consolidated in a central control account for head office monitoring.

Reports

Each credit union must develop a policy on what management reports shall be produced by the system and to whom these reports shall be distributed. Refer to Chapter 1 on Risk Measurement and Reporting for financial information recommended to be prepared and reviewed on a periodic basis by the board.

At a minimum, each main office or branch of a credit union (where feasible) should produce monthly accounting reports which include:

- a balance sheet;
- a statement of income;
- supporting financial statement schedules (e.g. allowance for doubtful loans);
- loan activity report;
- statistical reports for regulatory purposes.

Where there are branches in operation, a consolidated financial report of all branch reports (including a consolidated loan activity report) should also be prepared by head office. In this report the inter-branch control account must be equal to the sum total of all "inter-branch" general ledger accounts.

Risk and Performance Measurement

The MIS should also enable management to measure actual performance and business risk, and report the results of these measurements to the board, as required in DICO By-law No. 5.

The results of these measurements must be reported on a periodic basis to the board, either in one comprehensive report, or by operational area, as detailed in Schedule 9.3.

Schedule 9.3
BOARD REPORTING ON RISK AND PERFORMANCE MEASUREMENT

Report by Operational Area	Frequency of Board Reports
Capital board report	every board meeting
Credit board report	monthly
Investments board report	every board meeting
Asset/liability management board report	at least quarterly
Liquidity board report	every board meeting
Internal Controls board report	at least quarterly

Monitoring the Accuracy of the MIS

The MIS, whether manual or electronic, must be efficient and reliable, generating a minimal number of errors. The following procedures can assist to ensure the accuracy of the MIS:

- A log of processing mistakes should be maintained and reviewed by management to analyze and correct system errors.
- A management review of system design and capacity should be performed at least annually, for the purpose of identifying required improvements.

These procedures should be practical and reasonable given the size and complexity of the MIS. The more sophisticated the system, the greater the availability of reports to detect system bugs, errors and possible fraud. Schedules 9.4 lists some sample transaction edit reports and system activity reports for this purpose.

Schedule 9.4

TRANSACTION EDIT REPORTS AND SYSTEM ACTIVITY REPORTS

Transaction Edit Reports

- Loan payments report
- Loan disbursements report (records all new loans)
- Loan status report (records override adjustments to terms and conditions of member loans)
- Deposit master file report (records changes to interest rates, interest recipients)
- Large debits report (records deposit withdrawals over a certain size)
- General ledger activity report
- Dormant account activity report
- Suspense account activity report
- NSF and stop payment report

System Activity Reports

- System console log (e.g. log of all system activity including inquiries)
- Job runs processed by the computer (most software for P.C. based systems have a job logging facility)
- Data error reports
- Operator job interventions (e.g. system overrides)
- Terminal user password violation attempts
- Terminal restriction violation attempts
- Report of files updated (e.g. loan master file changes)
- Report of file status (e.g. file is full)
- Daily schedule of reports issued by the system

Security of MIS

Computerized facilities that are used to record monetary transactions of members and/or general ledger activities of the credit union must be adequately protected, whether the equipment has been provided through a service bureau or it is an in-house system.

Schedule 9.5 summarizes the basic type of controls that should be used to protect the security and accuracy of a computer system. The most important of these controls is the frequent creation of back-up files for transactions and financial data, and storage of the back-up data at an off-site location.

Schedule 9.5 **COMPUTER RISK MANAGEMENT**	
Internal Controls	**Protects Against:**
Equipment safeguarding • Restricted access computer area • System maintenance • Disaster planning	• Theft and vandalism • Equipment failure • Loss of data during natural disasters or fires
File storage controls • File library • Off site back up of files • Record destruction policy	• File mislabeling • File destruction • Permanent loss of information
File access controls • File access codes (passwords) • File activity logs • Data encryption	• Unauthorized data tampering or monitoring
Organizational controls • Program design and testing • Staff training and supervision • Segregation of duties	• Poor management reports • Untimely processing
Data input/output controls • Error logs • System edit checks • Controlled source documents • Management review of output	• Inaccurate data processing • Unauthorized data processing
Documentation • Documentation of all software • Log kept of all software updates • Changes to software documented	• deterioration in business relations with data suppliers • data supplier goes out of business
Web sites and Internet Banking • Safeguards • Firewall security	• unauthorized access • fraud

Disaster Recovery Planning

It is a sound business practice for the credit union to have a disaster recovery plan. A disaster recovery plan is a contingency plan for the recovery of data processing facilities, and for the protection of financial data caused by short, medium and long-term system interruptions.

The disaster recovery plan should outline in detail the alternate procedures to be followed during system interruptions. Procedures should be tested periodically to ensure they are operable and that staff are aware of their implementation. The plan should be managed by a designated senior member of staff who functions as a disaster recovery controller and should be reviewed by the credit union's audit committee (section 26.12 of Regulation 76/95).

Recovery plans should be documented and include the following:

- The board policy which commits the organization to disaster planning.
- Emergency reaction and disaster control steps which must be taken immediately.
- Identification of the back-up location where data processing operations will continue
- Back-up data processing facilities or agreement with data supplier to provide new equipment within 24 hour period.
- A step by step action plan for each department or functional unit of the credit union to return operations to normal.

Adequate insurance coverage should include business interruption, the cost of data reconstruction and/or lost data, as well as alternate processing capacity. Refer to Schedule 9.6 for a summary checklist on disaster planning.

Schedule 9.6

DISASTER RECOVERY CRITICAL PATH

Emergency Reaction Steps

- Detection and notification of emergency to:
    - o Fire department
    - o Police department
    - o Hospitals
    - o Utilities
- Evacuation procedures
- Clear and secure site
- Minimize loss of life, property, business interruption

Disaster Control Steps

- Control access to site
- Consider and evaluate staff requirements during the disaster
- Activate back up facilities or obtain new equipment for immediate processing
- Assess damages and make insurance claims
- Co-ordinate clean up
- Co-ordinate press communications

Business Survival Steps

- Establish telecommunication links, cash, courier and mail deliveries to a back up site
- Re-establish office conditions on a full or limited basis by leasing office equipment
- Communicate with suppliers and staff on new arrangements
- Arrange for adequate security at new site (e.g. fire and theft alarms, temporary vault, security guards)
- Implement public relations plan for members and the public
- Manage and prioritize key profit areas

Reconstruction Steps

- Employ contractors and restoration companies for refurbishing office as may be required
- Reconstruct records
- Return operations to normal
- Document and evaluate experience of what happened

Records Retention

The operational records of a credit union provide important evidence of its business activities. These records may be called upon by regulators, tax authorities, members, employees, auditors and lawyers in a variety of circumstances. A procedure on records retention, specifying which records should be retained, for how long, and in what form, is required.

The procedure must accommodate various reporting obligations imposed by statute, including:

- the *Credit Unions and Caisses Populaires Act*;
- the *Income Tax Act*;
- the *Unemployment Insurance Act*;
- the *Canada Pension Plan Act*.

Other acts such as the Canada Evidence Act, the Evidence Act of Ontario and the Statute of Limitations create additional implications for the nature and timing of record retention. Certain documents must be retained for as long as the credit union is in operation; others may be destroyed after a specified time interval.

The procedure on records retention should include a Schedule of Records Retention, which specifies the types of documents that must be retained, in what fashion, and for how long. This schedule should be copied and distributed to all personnel handling member and financial documents. The procedure should be reviewed periodically for its continued applicability.

The disposal of outdated records and the transfer of inactive files to archives should take place at least once a year, most preferably after the fiscal year end and audited financial statements have been completed.

The following materials provide detailed recommendations on record retention.

Records of a Permanent Nature

Sections 230 and 231 of the Act specify that certain corporate documents be retained on a permanent basis, that is for as long as a credit union is in operation. The following is a list of the records which should be considered permanent, and must be retained:

- Share register (e.g. share ledger account) which includes the names and addresses of members, the number of shares held, the date of registration and the dates on which persons ceased to be members (s. 230 of the Act).
- Articles of incorporation (s. 231(1) of the Act).
- By-laws, including all subsequent resolutions and special resolutions (s. 231(1) of the Act).
- Register of the names, addresses, occupations and terms of office for members of the board of directors, the credit committee, the supervisory committee and audit committee (s. 231(1) of the Act).
- Register of all securities held by the credit union (s. 231(1) of the Act).
- Books of account and accounting records detailing all financial and other transactions of the credit union as required by the Superintendent of Financial Services (s. 231(1) of the Act).
- Minutes of all meetings of the members, the board of directors, and any committees (s. 231(1) of the Act).

Section 232 specifies the form for which a record may be kept for purposes of the Act. The section allows for keeping records in forms other than their original (e.g. photocopies, microfiche).

Other acts such as the Income Tax Act, the Trustee Act and the Winding Up Act also require documents to be kept permanently. The following is a list of such documents, as well as other documents which it is recommended that the credit union should retain permanently:

- Certificates and permits to operate in Ontario or outside the province.
- Deeds, titles, abstracts, collateral documents to land, buildings, and equipment.
- Records recording insurable members' savings accounts.
- Audited financial statements (including a balance sheet, a statement of operations, a statement of undivided earnings, and a statement of reserves and any other financial information the by-laws require).
- Special agreements or contracts mentioned in the audited financial statements.
- Reports of the auditor.
- Official correspondence of a permanent nature received from the Superintendent of Financial Services and other government sources.
- Official correspondence received from DICO (e.g. DICO By-laws).
- Technical bulletins received from the league.
- Records destruction list detailing which documents have been destroyed.

Insurable Members' Savings Account

Many credit unions offer a life insurance policy on members' shares or other savings accounts with insurable values based on the date of deposit. These records should be retained for an indefinite period of time after a members' death to handle subsequent inquiries regarding settlement.

Records to be Held Over the Long Term

Tax Supporting Documents

The *Income Tax Act* and the *Statute of Limitations* have pervasive implications for long term records retention by the credit union. From the perspective of the income tax authorities, documents (other than those designated as permanent records) may be destroyed without permission six years after the end of the taxation year to which the books and records relate. In order to be conservative, it is recommended that credit unions retain these records for a period of seven years.

Refer to Schedule 9.7 for a list of accounting data and other source documents pertaining to members' transactions which should be retained (also refer to section 95 of Regulation 76/95).

Schedule 9.7 *DOCUMENTS QUALIFYING FOR SEVEN YEAR RETENTION*
Accounting Data • General ledger, cash journals, audited financial statements • Loans subsidiary ledger • Deposits subsidiary ledger • Employee payroll subsidiary ledger and employee expense records • Bank statements, returned cheques, deposit and debit slips of the credit union • Clearing reports • Supplier invoices/expenses statements • Periodic financial reports (e.g. budget to actual comparisons) **Members' Account Data** • Account operating agreements and signature cards following closure of an account • Debit/credit memos • Copies of members' statements • Microfilmed members' cheques (generally retained by clearing agent) • Members' deposit/withdrawal slips and transfer vouchers • Term deposit certificates with members • Loan files containing loan applications, details of loan analysis, client correspondence and any collection action • All memoranda received or created concerning account operation

Records that support the calculation of other taxes such as sales tax, withholding taxes etc., and all payroll deductions such as unemployment insurance, Canada Pension Plan etc., must also be retained for six years from the end of the taxation year to which they relate for possible government inspection.

The contents of documents and books of account which must be archived for tax purposes have not been specifically defined by the tax authorities; the general guideline is that records retained must substantiate the determination of tax liability, and must be supported by vouchers or source documents. The six year retention period applicable to a document that supports a tax liability is determined by the last taxation year that the record was used for the calculation of tax, and not the year that the underlying transaction occurred or the year the record was created.

Books of Account

Books of account must be maintained in an orderly manner at the premises of the credit union, and must be made available to income tax authorities for review purposes at any reasonable time. Revenue Canada recognizes as acceptable the following methods of keeping records:

- traditional books of account;
- records maintained in a machine sensible data medium which can be read by current hardware equipment and which can be related back to supporting source documents;
- microfilm reproductions of books of account and source documents if produced under a microfilm program which conforms with Revenue Canada's standards.

Defending against Legal Action

The possibility of a credit union becoming involved in a legal action provides additional rationale for members' source documents to be retained on a long term basis (e.g. documentation of a loan write-off). A record should only be destroyed once the credit union ascertains that the document is not and cannot become an essential link in defending or prosecuting a court action.

Mergers

In the event that a credit union merges with another, the permanent records of the acquired credit union should be considered the permanent records of the continuing credit union, and should be maintained under the same standard of care.

Dormant Accounts

Dormant accounts should be reviewed annually for the purpose of confirming future account liability. Balances in dormant accounts should be communicated to members by mail.
It is suggested that at a minimum:

After two years without any customer initiated activity	▪ Forward notice to the member's last known address
After five years without any customer initiated activity	▪ Forward notice to the member's last known address ▪ Transfer funds to "Unclaimed Balances" (general ledger) account

The accessing of dormant accounts by unauthorized personal or by staff is also a specific area of risk which should be addressed and subject to controls. Once an account is designated as "dormant", any deposits and withdrawals should require supervisory authorization. Authorization to "reactivate" a dormant account should require the signatures of two employees, one of who is a supervisor.

Note: Section 45 of the Credit Union and Caisses Populaires Act, 1994 has not been proclaimed.

Accordingly, there is currently no requirement to forward unclaimed credits to the Ministry of Finance.

Operational Records

With respect to operational records, other than books of account and members' transaction documents discussed earlier, credit unions must adopt guidelines for archiving records of historical significance, i.e. operating files which have become inactive but support important internal decisions taken by senior management (e.g. product/branch/human resource decisions). A retention period of five to six years is recommended for these documents; however, the retention period for these records is entirely at the discretion of management. Duplicate copies in the hands of other users may be destroyed earlier. Refer to Schedule 9.8 for a sample retention schedule for operational records of historic significance.

Schedule 9.8   ***OPERATIONAL DOCUMENTS OF A HISTORIC SIGNIFICANCE***   ***ELIGIBLE FOR LONG TERM RETENTION***
• Planning documentation (directional plan, strategic plan, budgets)   • Policies and procedures   • Employee files including performance reviews   • Product analysis   • System studies   • Marketing surveys   • Cost/benefit analysis and regulatory compliance analysis for investment decisions   • Official league correspondence (e.g. operational or loan reviews)   • Public relations activities   • On-site verification reports, auditor's reports and auditor's management letters

Records Preservation

The following are recommendations for the general storage of documents:

- Ensure records are protected from fire, smoke, heat, water, dirt, and accidental and malicious damage.
- Store accounting and members' transaction records in a vault, safe or fire resistant cabinet when not in use.
- Make duplicate copies of computer disks, computer tapes and microfilm and store them separately from the originals in fire proof receptacles, or at another site.
- Ensure the credit union's insurance program includes "business interruption" coverage or an "extra expense" policy that will cover the cost of recovering or replacing records that have been damaged or destroyed.
- Where a credit union uses a service bureau to process its data, confirm that the service bureau is bonded and the company is reputable, to ensure the confidentiality of records.
- Consider using a commercial service to microfilm and/or store records; where reliance is placed on external agents for these functions, sufficient investigation must be made into the quality and reliability of such services.

Storage of Vital Records

Credits unions are advised to develop a procedure on the storage of vital records. Vital records are defined as those records which are necessary to re-establish operations after a disaster. These would include documents such as the general ledger, tax records, investment contracts, employee records, and up-to-date balances of members' deposits and loans.

The procedure must ensure that duplicates of vital information be stored off-premises in the event that a disaster occurs and the original records are destroyed. This procedure can be developed in conjunction with, or as part of, the Disaster Recovery Plan.

The following information, at minimum, should be copied and transferred regularly to an off-site storage location:

- A listing of the members' share and/or deposit and loan balances as of the record date by individual account number.
- A financial report which includes a list of all asset and liability accounts as of the record date.
- Names and addresses of the credit union's deposit holding institutions and clearing agent, location of safety-deposit boxes and other places where records are stored.
- List of insurance policies such as fire, casualty, life savings and borrowers' protection, fidelity bond, etc. with the names and addresses of the insurers.
- A detailed listing of all investments.
- Up-to-date documentation of the credit union’s in-house computer system.

Manual tape listings, copies of original manual records, computerized reports, magnetic tape or microfilm are all considered acceptable forms of documentation in this regard.

Records Destruction

With the exception of records that must be retained permanently (listed above), corporate documents should be scheduled for disposal in a systematic manner, in accordance with board policy, internal controls procedures, and an approved Schedule of Records Retention. The major objective of systematic records disposal is to ensure effective and efficient use of space, material and staff in the management of records.

The following guidelines regarding destruction of records is recommended:

- Consider retaining paper waste for a minimum number of days before destruction, in order to find teller differences or important lost documents.
- If feasible, dispose of all documents by shredding or incineration.
- At a minimum, records containing confidential data must be destroyed in this manner. Non-confidential records may be disposed of in the regular garbage removal system or by sending documents to a commercial recycling center.
- Where confidential document disposal services are contracted from an outside agency, ensure the reputation and reliability of the agency is adequately investigated.

Staffing and Monitoring Controls

The credit union should establish staffing and monitoring controls which protect against fraud, theft or misappropriation. These controls should be appropriate given the size of the organization, and the level of risk the credit union faces from such incidents. Such controls, which should be specified in policy and documented in procedures, include:

- staff supervision;
- segregation of duties;
- proper hiring practices;
- internal audit - investigation and correction of internal control weaknesses;
- board follow-up of auditor reports and on-site verification reports.

Staff Supervision

Staff supervision is a fundamental component of effective internal controls as well as part of human resource management. Two important objectives of staff supervision are:

- Quality control - which assures that adequate supervisory assistance is made available to staff in new positions, during periods of excess volume, when there is an urgent problem to resolve, and when additional expertise is required.
- Protection against fraud, theft or misappropriation - which should be pursued through the monitoring of internal controls by supervisory personnel.

Supervisory personnel must have sufficient training and experience in managing and motivating staff. Supervisors should be instructed to treat all employees equally and fairly.

Supervisory staff should be responsible for the following employee practices, and respond immediately to any irregularities that are detected:

- Require that all overtime be approved.
- Require regular vacations be taken.
- Be aware of any change in attitude or morale.
- Be aware of any change in the financial condition of an employee, which may lead to fraud.
- Require proper expense reporting (e.g. presentation of receipts).
- Conduct surprise cash counts and/or inspections of job stations.
- Encourage job rotations for new skill development.
- In situations where fraud is suspected, the internal auditor or the audit committee should review employee accounts for unusual transactions.

Segregation of Duties

Segregation of assigned staff duties is a necessary control to avoid staff error, and to avoid staff fraud or theft. The following recommendations on segregating job functions include:

- Job responsibilities of all personnel should be clearly defined before a division of duties can be properly assessed.
- An organizational chart, detailing lines of reporting, responsibility and authority.
- Written operating procedures or flow charts, is recommended in order to analyze and separate various operational processes.
- As a general rule, duties should be separated to allow for the performance of automatic checks.
- No person should be permitted to dominate a transaction from start to finish.
- Transaction initiation, authorization, custody of related assets and record keeping should be handled by independent individuals where the size and resources of the credit union allow.

Limited Resources

Where a credit union has too few employees to allow for adequate segregation of duties, certain adaptations must be made. The associated risks of unilateral control are employee dishonesty and/or a greater frequency of transactional errors, given the absence of investigative checks. The following alternative business practices are recommended to reduce these risks:

- Employees who authorize transactions may be permitted to record the transactions but should not be permitted singular custody over the related assets; e.g. these persons should neither receive nor disburse funds unilaterally.
- Cheques and large transactions should require the signature of the general manager and a board member, usually the chair.
- Members of the audit committee should review transactions processed by the general manager and staff.

Hiring Staff

The most valuable asset of the credit union is its staff. The organization, as a result, must have specific plans in place for recruiting, selecting, training and promoting its personnel. This topic is covered in other areas of this Reference Manual:

- For planning human resource requirements, refer to Section 1503 on the Human Resource Plan.
- For relevant employment legislation, refer to Section 2102 on Duty to Comply.
- For a discussion of employment discrimination and nepotism, refer to Section 2105 on Unethical Conduct.
- For a discussion of appraising staff performance, refer to Section 3101 on Staff Performance.

Each new employee should receive an orientation program to the credit union, and informational literature. The literature should include a list of job responsibilities and key performance targets, work policies and procedures, the credit union's mission statement and core values, employee benefits and the personnel policy handbook.

New staff should be required to sign a "Declaration of Ethical Conduct", in which they agree to "hold in strict confidence all transactions of members". A sample declaration is provided in the Sample Code of Conduct, which can be found in Section 2106.

The credit union should advise all staff of employee behaviour which may result in immediate dismissal (a written policy is recommended), including:

- criminal activities such as fraud, forgery, theft, larceny or any similar offence;
- violation of the Act or Regulations (including the employee's agreement to confidentiality);
- harassment of other employees;
- material insubordination;
- deliberately writing NSF cheques or cheque kiting.

Conclusion of Employment

The following activities should be carried out by management before an employee permanently departs the credit union:

- Count cash and verify other assets which may have been under the control of that employee (this should be done in the presence of the departing employee).
- Retrieve all keys, identification cards, and corporate credit cards.
- Retrieve access authorization (computer facility) and change passwords.
- Ensure no confidential information accompanies employee.

Immediately following the departure of the employee, the following activities should be carried out by management:

- Revoke the employee’s signing authority (if any).
- Cancel the employee’s name with the alarm company.
- Change applicable combinations and door locks.

Detecting Employee Fraud

Where an employee is suspected to be responsible for a dishonest or fraudulent act, the credit union may no longer be insured under its fidelity bond against future losses attributable to that employee. In this case, the credit union should:

- immediately suspend the employee, with pay, until an investigation is complete;
- contact their legal counsel to determine the credit union's legal position and obligations in this situation, and whether the employee should be terminated.

Where fraud is discovered, it is recommended that the credit union:

- contact its bond insurer/master policy holder immediately after a loss is detected due to the time constraints for filing notice on bonding claims;
- inform the police, the Superintendent of Financial Services, its league, and the deposit insurer.

Role of Internal Audit

The primary objective of conducting an internal audit is to objectively evaluate the nature and quality of internal controls. Internal controls are required:

- to produce reliable accounting records;
- to determine whether board policies and board directives have been properly applied;
- to safeguard assets from fraud, theft or physical deterioration.

Internal audits should be conducted by designated internal audit staff, who are independent of the areas being audited and can report their findings to the audit committee (the audit committee will in turn report findings to the board). Alternatively, an independent contractor, the external auditor on special assignment or the members of the audit committee should execute regular inspections. (For more information relating to the roles and responsibilities of the audit committee, refer to Section 303 in the Introduction of this Reference Manual).

The recommended approach to an evaluation of internal controls is as follows:

- Conduct a system review which documents the flow of transactions in the credit union by function (e.g. loans, deposits, investments, other) through the use of narrative descriptions and/or flow charts.
- Consider the types of weaknesses that could occur from the system's current design, by individual function, and list the internal control procedures that are in place which will prevent such weaknesses.
- Compare these internal controls to what has been authorized by policy. Summarize what internal controls are missing. (The use of internal control checklists is recommended for this step. Refer to the league or an external auditor for these checklists).
- Test existing controls by reviewing historic transactions to determine compliance with expected policies and procedures. Recommend improvements to internal controls, where weaknesses are found.
- Test general compliance with by-laws, board approved policies and operational procedures.

Schedule 9.9 summarizes the recommended areas of investigation of an Internal Audit.

Schedule 9.9 **RECOMMENDED INTERNAL AUDIT CHECKLISTS**	
1. Internal Audit Planning	• audit emphasis and timetable • internal controls evaluation summary (sample attached)
2. General Controls	• human resources (e.g. segregation of duties, hiring, authorization, supervision) • premises security • accounting functions and management information system
3. Cash	• cash authorization limits and cash counts • cash records • cash shipments and storage • negotiable instruments • ATMs and night depositories
4. Investments and Fixed Assets	• purchases • dispositions • custody controls • records and inventory counts
5. Loans	• loan evaluations, approvals and authorizations • loan records • loan disbursements • security administration • connected party loans limits • restricted party loans limits • delinquent loans
6. Shares and Deposits	• new and closed accounts • account records • current accounts • term and RRSP deposits • related party deposits • dormant accounts
7. Revenue and Expenses	• revenue controls • expense controls • profitability and capital maintenance
8. Computer Information System (CIS)	• security of the CIS • electronic and telephone banking • documentation of the CIS code • access to the CIS
9. Policies and procedures	• test compliance with by-laws, board policies and operational procedures

Schedule 9.10 is a sample Internal Controls Evaluation Summary which should be completed by the designated internal auditors, first on a preliminary basis, in conjunction with studying organizational and internal control designs, and then on a final basis after testing for evidence that in fact these internal controls are working.

Schedule 9.10
INTERNAL CONTROLS EVALUATION SUMMARY

	PRELIMINARY				
	G	**A**	**W**	**NE**	
GENERAL CONTROLS Conclusion					
CASH CONTROLS Conclusion					
INVESTMENTS & FIXED ASSETS Conclusion					
LOANS Conclusion					
LIABILITIES Conclusion					
REVENUES & EXPENSES Conclusion					
COMPUTER INFORMATION SYSTEM Conclusion					
POLICIES & PROCEDURES Conclusion					

Legend:
G: Good
A: Adequate
W: Weak
NE: Not Evaluated

Where internal audit analysis is thorough and well documented, it should be shared with the external auditor who is permitted to rely on this analysis and could therefore be in a position to reduce the external audit fee.

The results of the internal audit process and follow up recommendations must be presented on a timely basis to the board and management for their review.

External Auditors

Section 159 of the Act requires a credit union, at its annual meeting to appoint its external auditors. The duty of the external auditors is to assess and report on the reliability of the organization's financial statements. Normally, the board recommends the appointment of the auditor to the general membership at the annual meeting.

Section 160 of the Act sets out qualification of auditors. The external auditors must not be anyone who is a director, officer, committee member or employee of the credit union, or who is financially associated with the same.

Audit Committee

It is part of the audit committee's function to act as liaison between the external auditors and the board. The specific duties of the audit committee in this regard are defined in section 26 of Regulation 76/95.

Scope

The external auditors begin their work by becoming familiar with the policies and internal controls of the organization, in particular its accounting procedures. Subsequently, tests of the accounting records are conducted to determine whether the records have been prepared in accordance with these policies and procedures, as well as generally accepted accounting principles, and whether these can be substantiated by evidence of the underlying transactions.

In accordance with section 167 of the Act, management must comply with the information requests and the investigative procedures of the auditors so that their work may be conducted efficiently and with sufficient scope on which to base an audit opinion.

Auditor's Report

The auditors' report, when completed, should be shared with management and the audit committee. It is the audit committee's function to report the findings to the board of directors for follow-up. Finally, the auditors are required to present their report to the membership at the annual meeting in accordance with section 169(2) of the Act.

Section 172 and the Management Letter

Section 172 requires auditors to report to the general manager, the audit committee and the board of directors, any transaction or conditions that have come to the auditor's attention affecting the well being of the credit union, that, in the auditor's opinion, are not satisfactory and require rectification.

Such transactions or conditions can include, but are not limited to:

- transactions not within the powers of the credit union, as defined in the Act or the credit union's by-laws;
- large loans (defined as greater than one half-per cent of total assets) where, in the opinion of the auditor, loss is likely to occur;
- any circumstances which indicate there may have been a contravention in the Act or Regulations.

The form of the section 172 report should be a letter to the board, general manager, chief financial officer and audit committee, acknowledging that section 172 of the Act had been considered in the course of the annual audit, and indicating whether there are any reportable transactions pursuant to that section. This letter is commonly known as a management letter or derivative report.

Any reportable transactions or conditions should be specified in the letter, together with recommendations for rectifying or addressing the transaction/condition. The management letter should be reviewed by the audit committee and the board of directors. Recommendations in the letter must be discussed, addressed and resolved to the satisfaction of all parties. If there are no reportable transactions or conditions, then the management letter should still be prepared, with comments to this effect.

Finally, a copy of this report should also be provided to the Superintendent of Financial Services, DICO and the stabilization authority for that credit union.

Audit Committee and Board Follow-up

To complete the function of monitoring internal controls, the audit committee and the board must review the information that it receives regarding internal controls. This information comes from a variety of sources, including:

- the report of the internal control audit;
- the external auditor's report including the section 172 management letter;
- on-site verification reports by DICO.

The board and the audit committee must ensure that recommendations in these reports are be discussed, addressed and resolved to the satisfaction of all parties. Management should be required to report back to the board when adopted recommendations are complete.

Policy Development and Review

The board is required to develop policy to manage risk within the credit union. It is also required to annually review board policies, to ensure that they are current and appropriate. The review of policy can be delegated to a sub-committee of the board. The approval of new or amended policies, however, can not be delegated, and is a function of the board.

Some credit unions may request management to draft their policies; however, the Board's analysis and final approval should always be obtained. Policies are required to be in writing so that they are not vulnerable to misinterpretation particularly as a result of staff turnover.

It is recommended that policy statements be placed in a Board Policy Manual. A Policy Log should be kept as part of the Manual, which lists all board policies, and the dates they were implemented. The Log should also be used to keep track of and administrate the review of board policies. A sample Board Policy Log is provided in Schedule 9.11.

To ensure that policies have sufficient scope and content, the board should consult appropriate sections of the Act and Regulations (specifically, sections 104, 190 and 191 of the Act, sections 50, 78 and 87 of Regulation 76/95, and FSCO's Guideline for Prudent Investment and Lending Policies and Procedures for Ontario's Credit Unions).

Schedule 9.11
SAMPLE BOARD POLICY LOG

Policy area	Created on:	Last review:	Next review:	To be reviewed by:
• Governance • Capital Management • Credit Risk Management • Market Risk Management (Investments) • Structural Risk Management (Asset/Liability) • Liquidity Risk Management • Operational Risk Management (Internal Controls)				

Technology Development

The level of technology employed should support future business and strategic plans of the organization.

New or modified systems hardware or software must be appropriately authorized and fully tested prior to going on line and should not be implemented without proper documentation and adequate training.

Institutions should establish an appropriate framework for technology development.

This framework should include processes for:

- planning for technology requirements consistent with business strategies and activity needs
- identifying and evaluating technology solutions
- development and acquisition
- documentation, testing and implementation
- delivery and support.

Changes to systems must be clearly documented and tested.

Adequate documentation should:

- provide sufficient information to understand the system
- facilitate supervisory review of proposed changes
- preserve continuity in the event of staff turnover
- provide auditors and others with an understanding of the system.

Outsourcing of Services

Outsourcing involves contracting a business function to a service provider instead of performing that function internally.

Before this occurs, the credit union must identify:

- the process for selecting capable and reliable service providers
- standards for outsourced services, including accuracy, security, privacy and confidentiality
- procedures to monitor the performance and risks related to outsourced services and service providers
- schedules for periodic reviews of outstanding contracts

Overview

Appropriate rationale and business case should be developed to support recommendations for outsourcing services. Services or functions that are typically considered for outsourcing include:

- investment management
- information systems management
- lending analysis and/or loan collection activities
- records management
- payroll administration
- internal audit.

Sufficient analysis should be undertaken to confirm that the service provider has the necessary expertise, capacity and viability to perform the functions or activities to be outsourced. Appropriate due diligence and impact analysis of non-performance by a service provider should also be undertaken.

All outsourced services should be subject to standard contract terms, which may include:

- the nature and scope of the service to be outsourced
- rules and limitations concerning subcontracting
- performance measures and reporting requirements
- dispute resolution and conditions surrounding defaults and termination
- ownership of information, tools, etc., and access restrictions
- audit rights
- confidentiality, privacy and security
- pricing and insurance.

A review of the service provider's performance should occur at a minimum annually, and align with the length of the contract. Each review will ensure that the outsourcing arrangement is being carried out in accordance with all contract terms and meets all contract objectives. The review should also include an assessment of the financial strength, technical competence and continuing viability of the service provider.

Self-Assessment

Executive Summary

Each year, the board and management are required to review the credit union's compliance with sound business and financial practices.

Annually, management is required provide a representation letter to the board of directors regarding its assessment of adherence to management’s responsibilities under the standards of sound business and financial practices

Annually, member institutions are required to forward to DICO a copy of a board resolution indicating that the board is fulfilling its responsibilities under the Standards. The resolution sets out DICO’s minimum requirements although boards are free to expand on these if they wish.

DICO has developed sample assessment workbooks that may be used by member institutions to help assess its effectiveness concerning its responsibilities for governance practices as outlined in DICO By-Law No.5.

The workbooks are generally suitable for operations of all sizes and complexity[1]. Each member institution needs to satisfy the same criteria, where they apply, taking into account the scope and complexity of its own operations.

There is no requirement to complete or file the workbook with DICO. Institutions may develop their own assessment tools or modify the workbook to suit their particular requirements

[1] A modified version of this workbook has been developed for institutions with less complex operations that meet specified criteria.

Assessment Workbooks

Separate workbooks have been developed for the board of directors and management**.**

Board Workbook

Part I outlines the criteria which should be considered when addressing the fundamental elements of the governance standard. It contains a series of statements and considerations relating to the responsibilities of the board of directors.

Part II is an assessment tool for the board to help evaluate the member institution's adherence with the standards and identify any material weaknesses or deficiencies that may need to be addressed. It also provides references to DICO publications, the Act and Regulations that institutions may wish to review as part of its assessment process when evaluating the effectiveness of governance practices.

Part III contains information on the reporting requirement. Under By-law No. 5, as a condition of the renewal of the policy of deposit insurance, each member institution is required to attest annually that:

- management has provided a representation letter to the board of directors regarding its assessment of adherence to management's responsibilities under the standards of sound business and financial practices
- the board of directors is familiar with, and is acting in compliance with, the standards of sound business and financial practices

A sample management representation letter and copy of a **board resolution** is included in the workbook. The **board resolution** sets out DICO's minimum requirements although boards are free to expand on these if they wish.

Part IV provides a sample action plan that may be helpful in identifying and resolving material weaknesses.

Management Workbook

Part I is an assessment tool for management to help evaluate the member institution's adherence with the standards and identify any material weaknesses or deficiencies that may need to be addressed. It also provides references to DICO publications, the Act and Regulations that institutions may wish to review as part of its assessment process when evaluating the effectiveness of governance practices. Additional considerations are also provided for each of the risk management areas.

Part II contains information on the reporting requirement.

A sample management representation letter and is included.

Part III provides a sample action plan that may be helpful in identifying and resolving material weaknesses.

Management Representation Letter

Annually, management is required provide a representation letter to the board of directors regarding its assessment of adherence to management's responsibilities under the standards of sound business and financial practices

In order to complete the management representation letter, it is expected that senior management typically would review internal management assessments by individuals who manage the institution's operations as to whether the significant issues in their areas of responsibility are being identified and addressed. Senior management should also review periodic validations that the assessments have been conducted competently and with integrity and the significant issues are being dealt with.

The annual representation letter by management to the member institution's board of directors is to contain the statements as outlined in a sample management representation letter provided.

The board will determine when the letter should be provided and what additional evidence or documentation is required. The sample letter may be modified by institutions as appropriate, although it should:

- confirm that management is familiar with the contents of By-law No.5 and that they are fulfilling their responsibilities under the Standards
- identify any outstanding deficiencies or exceptions
- include an action plan to address to any outstanding deficiencies or exceptions

A sample management representation letter is provided below.

Sample Management Representation Letter

To: Board of Directors

This representation letter in respect of <name of member institution> (the "institution") concerns adherence to the Deposit Insurance Corporation of Ontario ("DICO") Standards of Sound Business and Financial Practices (the "Standards") as outlined in DICO By-law No.5.

Management are familiar with the contents of the DICO By-law No. 5 as it applies to the institution and acknowledge their responsibilities under the Standards, which include:

- implementing appropriate and prudent risk management policies, procedures and controls for each of the Standards
- developing and implementing an appropriate and prudent business strategy and business plans
- providing the board of directors with timely, relevant and accurate reports on the implementation of the institution's business strategy and business plans and any material risk that may affect business objectives

Management confirms that they are fulfilling their responsibilities under the Standards [*if applicable, add*: "except as indicated below"].

After careful consideration, management have concluded that to the best of their knowledge [*if applicable, add*: "except as indicated below"] the operations of the member institution are being managed in accordance with the DICO Standards.

[*If applicable, add:* "The following deficiency(ies) or exception(s) are outstanding: <provide description or reference an appended document to the same effect>"]

[*If applicable, add:* "The action plan(s) have not been met to date in that: <provide description or reference appended document to the same effect>."]

In arriving at our conclusions we have exercised prudent judgment and have caused the appropriate amount of testing and/or review (both through internal management assessments and internal reporting) to take place.

Dated at <insert place> <month> <day>, <year>.

Board Resolution

Annually, member institutions are required to forward to DICO a copy of a board resolution indicating that the board is fulfilling its responsibilities under the Standards. The resolution sets out DICO's minimum requirements although boards are free to expand on these if they wish.

In coming to a conclusion on whether the institution is following the Standards, a board of directors needs to assess its own governance effectiveness as well as to understand and assess how management determine that significant issues at different levels in the organization are identified and addressed. In turn, a board assessment of managements' assertions could include some confirmation against periodic observations received from external sources (such as external auditors, etc.).

The board workbook has been designed to help directors in obtaining reasonable assurance that their member institution is following the Standards, except as identified.

A copy of the resolution is to be forwarded to DICO along with the Annual Member Institution Return within 75 days of the institution's fiscal year end.

An action plan should include a description of any significant or material issue being addressed, the manner of addressing it, designated responsibility for corrective action and appropriate timeframes for completion.

A sample board resolution is provided below.

Sample Resolution of the Board of Directors

It is resolved that:

This resolution is made in respect of <name of member institution> (the “member institution”) and concerns its adherence to the Deposit Insurance Corporation of Ontario ("DICO") Standards of Sound Business and Financial Practices (the "Standards") as outlined in DICO By-law No.5.

The board of directors (the “board “) of the member institution is familiar with the contents of the Standards By-law and acknowledges its responsibilities under the Standards, which include:

- establishing appropriate and prudent risk management policies for each of the Standards and obtaining reasonable assurance that the institution is adhering to its risk management policies for significant risks
- establishing the responsibilities, accountability and authority of board committees
- establishing standards of business conduct and ethical behaviour
- appointing appropriately skilled and experienced management to implement the board’s objectives
- establishing the business objectives of the institution consistent with cooperative principles and approving the institution’s business strategy and business plans
- evaluating the institution’s actual operating and financial results against business plans
- evaluating the effectiveness of management

The board of directors of the member institution is, to the best of its knowledge and abilities, fulfilling its responsibilities under the Standards [*if applicable, add:* "except as indicated below"].

The board has carefully considered the management representation letter dated <month> <day>, <year> addressed to the board concerning adherence to the Standards. The board has also carefully considered other information, and made such inquiries as it deems appropriate, relevant to the forming of its opinion on whether the member is following the Standards.

It is the opinion of the board that to the best of its knowledge, it has obtained reasonable assurance that the member institution is following the Standards [*add, if applicable:* "except as indicated in the representation letter and/or below"].

[*If applicable, add:* "With respect to the deficiency (ies) or exception(s) not indicated in the representation letter, the board of directors confirms that an action plan(plans) addressing their correction has(have) been prepared and is(are) being implemented. A copy of the action plan(s) is being (has been) submitted to DICO and/or the Financial Services Commission of Ontario."]

****

The foregoing is certified as a true copy of a resolution of the board of directors of <name of member institution> passed at a meeting of the board held on the <day> of <month>, <year>. Dated at <insert place> this <day>of<month>, <year>.

____

Corporate Secretary

Filing Dates

A copy of the board resolution confirming that the board is fulfilling its responsibilities under the standards of By-Law No.5 is to be forwarded to DICO within 75 days of the member institution's fiscal year end.

The following table provides details of the filing requirements for different fiscal year ends.

Member Institution Fiscal Year End	Copy of Board Resolution to be submitted to DICO by:
July 31st	October 15th
August 31st	November 15th
September 30th	December 15th
October 31st	January 15th
November 30th	February 15th
December 31st	March 15th
January 31st	April 15th
February 28th	May 15th
March 31st	June 15th
April 30th	July 15th
May 31st	August 15th
June 30th	September 15th

Glossary

Act, the - The Ontario *Credit Unions and Caisses Populaires Act, 1994.*

Administration - A depositor protection program prescribed in section 294 of the Act. The objective of the program is to enable the deposit insurer to assume control of a credit union where institutional failure is imminent, in order to protect depositors and minimizing the risk of any future loss to DICO's deposit insurance reserve fund.

Aged receivables - Monies owing to a company which are "aged" by the number of days outstanding, i.e., 30, 60, 90, and 120 days and over. Depending upon the credit worthiness of the debtor, receivables are usually valued based on the aging. For example, receivables outstanding up to 90 days may be valued from 50 per cent to 75 per cent, 90 to 120 days from 25 per cent to 50 per cent and over 120 days 0 per cent.

Balloon payments - Contractual lump sum payments made on an outstanding debt, usually at the end of the term.

Bankers Acceptance Notes - Commercial debt that has been guaranteed by the corporate borrowers' bank, issued into the money market, on a discount basis, maturing at par value, with terms of 30 days to 1 year. Sellable early through the secondary market.

Basis point - One one hundredth of a per cent, i.e., 100 basis points is one per cent.

Bond rating service - An external service that provides ratings on most government bonds, corporate bonds, commercial paper, and financial institutions by measuring the financial instrument's quality and return. Two companies that offer this type of service are the Dominion Bond Rating Service and Canadian Bond Rating Service.

Bridge Loans - A loan of a temporary nature, usually three months or less, that is repaid from a distinct source, for example the sale of a house. The term "bridge loan" is most commonly used to mean temporary funding to purchase a home that is repaid from the sale of another which closes a short period of time later. The loan "bridges" the time between the purchase and sale of the two homes.

By-law - A regulation governing the objects and powers of an organization, the authority of its officers and the conditions and privileges of its members.

By-laws No. 3, 5 and 6 - see "DICO By-laws"

Caisse populaire - The French language equivalent of a credit union. In Ontario, caisses populaires are incorporated under the same Act as credit unions and are subject to the same regulations. Caisses populaires conduct business primarily in French. For purposes of this Handbook, credit union is defined to mean a credit union or caisse populaire.

Callable deposits - Deposits that may be "called" or withdrawn upon demand by the depositor subject to limitations specified in the deposit contract. A callable deposit may or may not have an early redemption penalty, for example, a reduced interest rate.

Capital - Capital represents the difference in value between a credit union's assets (such as its loans and fixed assets), and its liabilities (such as deposits by its members and debts owed to its creditors). Capital fills this gap, providing a buffer against losses, and provides room for growth.

CBRS - Canadian Bond Rating Service. A company that provides ratings on most government bonds, corporate bonds, commercial paper, and financial institutions by measuring the financial instrument's quality and return.

Chattel - Personal property such as furniture, clothing or a car.

Chattel security - Personal property such as furniture, clothing or a car that has been pledged as security.

Cheque kiting - Fraudulent activity whereby a cheque is deposited to an account which is drawn on an account which has non-sufficient funds.

Commercial paper - Notes with maturities ranging from 2 to 270 days, issued by corporations and other borrowers to short-term investors.

Connected party loans - A loan made to two members who are considered to be connected, pursuant to section 73 of Regulation 76/95.

Connected parties - Defined in section 73 of Regulation 76/95.

Consolidation Loan - A loan that is written to combine several debts into one. For example, a consolidation loan might be granted to pay off credit card bills, a line of credit, and a loan at another institution. Generally, a consolidation loan results in a lower effective interest rate and reduced monthly payments for the borrower.

Core capital - Tier 1 capital as defined in FSCO's *Capital Adequacy Guideline*. Generally, core capital is characterized by relative permanence and freedom from mandatory fixed charges. Examples of tier 1 capital include membership shares and retained earnings.

Credit Administration Diary - an information system which keeps track of dates which are significant in the credit monitoring process (e.g. loan renewal and review dates, fire insurance expiry dates, etc.). These systems can be quite sophisticated (computerized), or can be simple (card catalogue), depending on the needs and size of the loan portfolio.

Credit quality - Refers to the level of credit risk of a loan or portfolio of loans.

Credit risk - The risk that promised cash flows on a loan, mortgage or other financial instrument may not be paid in full.

Credit Union - A co-operative financial institution, that provides financial services exclusively to its membership. For purposes of this Handbook, credit union is defined to mean a credit union or caisse populaire.

Credit Union Institute of Canada (CUIC) - Provides professional development programs in conjunction with Dalhousie University leading to accreditation. Consists of existing college/university courses, plus credit union specific courses at a university level.

Credit Union Managers Association (CUMA) - An association of credit union managers formed to promote excellence in credit union management through training, information sharing and conferences. Hosts biannual forums on management skills and relevant issues.

Credit Unions and Caisses Populaires Act, 1994 - The legislation enacted by provincial parliament that applies to credit unions and caisses populaires.

DBRS - Dominion Bond Rating Service. A company that provides ratings on most government bonds, corporate bonds, commercial paper, and financial institutions by measuring the financial instrument's quality and return.

Deposit Insurance Corporation of Ontario (DICO) - DICO is an "Operational Enterprise" Agency of the Province of Ontario without share capital established under the provisions of the Credit Unions and Caisses Populaires Act. It is responsible to the Ontario government for protecting the deposits of members of the credit union and caisse populaire sector. DICO provides deposit insurance for all Ontario credit unions and caisses populaires.

Derivative instrument - A financial contract whose value fluctuates in relation to the performance of an underlying asset or market index, such as an interest rate swap. Derivatives may be used by credit unions for hedging purposes only.

Derivative report - see "Management letter"

Derivatives - see "Derivative instrument"

DICO - Deposit Insurance Corporation of Ontario

DICO By-law No. 3 - A by-law of the Deposit Insurance Corporation of Ontario relating generally to its deposit insurance coverage.

DICO By-law No. 5 - A by-law of the Deposit Insurance Corporation of Ontario relating to the minimum standards of Sound Business and Financial Practices prescribed for credit unions.

DICO By-law No. 6 - A by-law of the Deposit Insurance Corporation of Ontario relating to the application of allowances for impaired loans.

Disaster recover plan - A contingency plan for the recovery of data processing facilities, and for the protection of financial data caused by short, medium and long-term system interruptions.

EFT/POS - Electronic Funds Transfer/Point of Sale. An electronic debit system that enables members to pay for goods purchased through merchants which offer this payment option. Members accounts are debited automatically and the merchant's account is credited under this arrangement.

Fair Value of Security (FVS) - Management's reasonable estimate of how much cash the credit union can realize from the disposal of security underlying a loan, after paying real estate or legal/court fees, taxes and holding costs for management and preservation of property.

Financial derivative instrument - see "Derivative instrument"

Financial Services Commission of Ontario - FSCO is a provincial government commission. It regulates financial institutions that are provincially incorporated, such as credit unions. FSCO issues lending licences and approves incorporations, amalgamations and by-law amendments. The head of the Financial Services Commission of Ontario is the Superintendent of Financial Services. The head of the Credit Unions Branch of FSCO is the Director who exercises his power under the supervision of the Superintendent.

Formally Restructured Loan - A formally restructured loan is a loan rewrite where a portion of the principal or interest is written off in exchange for the borrower's full co-operation to repay the residual debt without further collection efforts.

FSCO - Financial Services Commission of Ontario

Gap - The extent of interest rate mismatch calculated by subtracting, for each time bucket, the volume of liabilities subject to repricing from the volume of assets subject to repricing.

Gap ratio - Defined as the ratio of net assets (or liabilities) within a particular time bucket divided by the greater of their two amounts.

Gap schedule - The most common method of measuring interest rate risk. In a gap schedule, all of the institution's balance sheet items (both on and off) are placed into a series of time buckets. which correspond to the amount of time remaining before the interest rates on that item are re-priced.

General security agreement (GSA) - An agreement which allows a lender to obtain a security interest in the non real estate assets of a borrower.

Hedging - engaging in financial transactions to reduce risk.

Hypothecation - An assignment of negotiable securities or other financial instruments, such as deposits or receivable instruments, to secure a loan.

Impaired loan - A loan for which, as a result of a deterioration in credit quality, there is no reasonable assurance of the timely and full collection of principal and interest. Under DICO by-law No. 6, such loans should have their carrying value reduced.

Insolvent/Insolvency - Unable to meet or discharge a financial obligation.

Interest rate swaps - A type of financial derivative. A contract between two parties; one party agrees to pay a fixed rate of interest for a specific term in exchange for the other party paying a variable or floating rate of interest.

IRR - interest rate risk - The risk that a change in interest rates (both higher or lower) will affect a credit union's financial margin.

Key man life insurance - A life insurance policy taken out on an individual considered to be critical to the continued success of the business. The policy is then usually assigned to the lender to ensure payout of any borrowings in the event of the sudden demise of the person covered by the policy.

Large deposits - Defined as a deposit of such a size that its sudden withdrawal might cause liquidity problems. When determining what qualifies as a large deposit, management should consider the total amount of deposits that belong to an individual or group of connected persons.

Leagues - Leagues are provincially incorporated institutions that act as central bankers and trade associations for their members. They also provide members with access to liquidity pools, training, consulting and other services. The three leagues in Ontario are Credit Union Central of Ontario (Ontario Central), L'Alliance des caisses populaires de l'Ontario (L'Alliance), and La Fédération des caisses populaires de l'Ontario (La Fédération).

Lending licence - A credit union's lending powers are formally defined by its lending licence, which it obtains either by designation under the Act, or through an application to FSCO.

Liquidity - Defined as the amount of liquid assets available to service the cashflow needs of the day to day operation of the credit union. Sections 16 to 18 of Ontario Regulation 76/95 detail legislated minimum liquidity requirements.

Loan co-maker - A person who signs the promissory note with the principal borrower, thereby assuming responsibility for the loan. In the case of a co-maker, the individual also receives some benefit from the loan.

Loan Rewrites - A loan rewrite involves changing any of several conditions of the loan, such as the maturity date, the amount of the monthly payments, or the security taken. For example, the credit union may wish to reduce the size of monthly payments to accommodate a permanent decline in the borrower's cashflow (e.g. borrower has taken a part-time job at a lower salary), thereby lengthening the loan's repayment period.

Management letter - A letter prepared by a credit union's auditor, written to the board, general manager, chief financial officer and audit committee of a credit union, acknowledging that section 172 of the Act had been considered in the course of the annual audit, and indicating whether there are any questionable transactions pursuant to that section. This letter is also known as a derivative report or as a section 172 letter.

Matching - "Matching" refers to the process of structuring the balance sheet so that maturities of interest rate sensitive assets correspond closely to the maturities of interest rate sensitive liabilities. If the balance sheet is well-matched, a change in interest rates will have little or no impact on margin, because assets and liabilities re-price at the same time.

Maturity calendar - A maturity calendar is a daily diary which contains information regarding any securities that may be maturing, the rate at which they were purchased, the principal amount of the security, and where they were purchased.

Membership shares - Equity interests in a credit union held as a condition of membership. Membership shares provide the shareholder with the right to receive dividends on those shares when declared by the board, the right to receive the remaining property of the credit union upon dissolution, and the right to vote at general meetings and special meetings of the membership.

Ministry of Finance - The Ministry of Finance regulates Ontario's credit unions. By developing legislation, (i.e., regulations, directives, and amendments to the Act) the Ministry ensures that both the public and the industry's interests are protected.

MIS - management information system - A system of reporting to the board and management that provides quantitative and qualitative information about the credit union.

MISAR - see "Member Institution Self-Assessment Report"

Money laundering - defined as a criminal process whereby the existence of an illegal source, or illegal application of income is concealed by the re-circulation (laundering) of that income through legal deposit taking institutions. Money laundering makes illegal cash appear legitimate. Under Canada's *Criminal Code*, it is a criminal offence for anyone, including credit union staff, to knowingly assist in laundering the proceeds of crime.

Non-callable deposits - A deposit that may not be withdrawn by the depositor until maturity.

Non-membership shares - Equity interests in a credit union that members hold not as a condition of membership, but for other purposes; such as for investment purposes.

OHOSP's - Ontario Home Ownership Savings Plans. A registered savings plan that encourages members to save for their first home by providing a tax credit for funds deposited in the OHOSP. The plan is subject to certain limitations as to the amount that may be deposited annually, the total amount that may be deposited, and the life of the plan. Funds may be withdrawn tax free if used to purchase a home. At times, the Ontario Government may, on a short-term program basis, detail other purposes for which the funds may be used, for example, home improvements.

Personal Property Security Act - Governs the taking of security against personal property in Ontario. The Act also establishes a registry whereby priorities in rights to security are established and notice to third parties of security interests in a debtors assets is given.

Pledging - An assignment of negotiable securities or other financial instruments, such as deposits or receivable instruments, to secure a loan.

Policies - A set of documented prudent strategies or philosophies approved by the board of directors, adopted and implemented by management of a credit union, that promote sound business and financial practices. Policies put limits on the amount of business risk a credit union can assume. They also summarize the organization's rational for each of its key activities.

Procedures - A set of documented courses of action which support the policies of the credit union. Procedures are specific and detailed and differ from policies which are broad and conceptual in nature.

Receiver - A receiver is a firm or person appointed to liquidate a business or parts of a business as a going concern in order to satisfy the borrower's debts.

Receiver-manager - See "receiver"

Regulations - The regulations proclaimed under the Ontario *Credit Unions and Caisses Populaires Act, 1994*.

Restricted party loans - A loan granted to a restricted party. Restricted parties, which, include all directors, officers and committee members are defined in sections 81 to 87 of Regulation 76/95.

Retained Earnings - Accumulated earnings from current and previous years.

Reverse Mortgage Line of Credit - A unique type of credit facility which involves the conveyance of an interest in land (real property) as security for debt, in particular a line of credit permitting demand drawings. A reverse mortgage differs principally from a conventional mortgage, in that there are no loan payments until maturity, at which time the original principal advanced plus all compounded interest must be repaid.

Right of set-off - A legal right of a financial institution to set-off the balances of mutual debts between itself and a debtor, without prior notice. The right of set-off cannot legally be exercised on a member's RRSP deposits, deposits held in trust for a designated beneficiary or deposits held jointly with another member.

RRIF's - Registered Retirements Income Funds

RRSP's - Registered Retirement Savings Plans

Section 172 letter - see "Management letter"

Liquidity pools - A fund established for the purpose of enabling the pool's members to obtain sufficient cash or the equivalent to meet their commitments as they arise and to do so in a timely manner and at a reasonable cost.

Short term debt - Debt or investments with a maturity of less than three years.

Skip tracing - The process of locating a borrower that has failed to make payments, moved and left their employment, and who has left no forwarding address.

Stabilization fund - A fund that is established and maintained to provide liquidity and stability for the benefit of its member institutions.

Subordinated debt - Debt that is legally subordinated to the rights of depositors and other creditors of the credit union.

Superintendent of Financial Services - the head of the Financial Services Commission of Ontario.

Supervision - A depositor protection program prescribed in section 285 of the Act, and managed by the Deposit Insurance Corporation of Ontario. The purpose of the program is to provide mandatory assistance to financial institutions that are operating at unacceptable levels of risk. DICO works closely with the board of a credit union to correct the specific operational problems which necessitate intervention. DICO, in its role as a stabilization authority, may request FSCO to order a credit union into DICO's Supervision Program.

Supplemental lines of credit - Loans extended by a league or chartered bank to a credit union that provide a revolving sum of money up to a maximum limit.

Supplementary capital - Tier 2 capital as defined in FSCO's *Capital Adequacy Guideline.* A capital instrument will qualify as tier 2 if it has an element of permanence and characteristics of both debt and equity. Examples of tier 2 capital include the redeemable portion of non-membership shares and subordinated debt.

T-Bill Accounts - A type of savings account that offers superior rates of interest on larger balances (usually $10,000 or more) and may offer chequing privileges.

The Act - The Ontario *Credit Unions and Caisses Populaires Act, 1994.*

Time bucket - A period of time, for example, 30 days, during which certain assets and liabilities may mature and the interest rate on them is then repriced. Time buckets are used for GAP analysis and interest rate risk measurement.

Tort - An injury to one person for which the person who caused the injury is legally responsible.

Variable cost analysis - Profit contribution analysis that quantifies the net dollar benefit of a product/service based on its revenues versus its variable cost.

Variance order - An order given by the Superintendent allowing a credit union to continue operations while failing to comply with a specific requirement of the Act or Regulations. A variance order will usually be subject to restrictive terms, such as prohibiting the payment of cash dividends to members, or requiring the credit union to raise additional capital.

Zero coupon bond - A bond sold at a discount from its face value that pays no interest until maturity, when it is redeemable for its face value.