Impact of the New Legislation on the Credit Union Industry

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INTRODUCTION

Credit unions urgently require updated legislation that reflects the significant changes that the credit union system and the environment in which it operates have undergone over the past decade. The difficulties with the present Act are readily apparent.

The present legislation assumes that all credit unions are and want to remain small savings and loan organizations. The trend toward larger, community-bonded credit unions and the system's clamour for new forms of capital belie this.

Federal legislation that once maintained strict distinctions among the different types of financial institutions has been radically overhauled. Credit unions in Ontario are stifled by outdated and outmoded legislation that prevents them from offering as full a range of services as their competitors. Clearly this situation must be remedied by providing credit unions with the same broad business powers as are provided other deposit-taking institutions.

AN OVERVIEW OF ONTARIO'S CREDIT UNIONS

a) The Development of Credit Unions in Ontario

Ontario's first credit unions were organized in Brantford, Welland and other industrial centres in the early 1940's by the United States National Association of Credit Unions (now the Credit Union National Association or CUNA). The Ontario credit union system became a predominantly urban phenomenon composed of a large number of credit unions organized with a common bond of occupation or association, as is the case in the United States. In contrast, credit unions in Western and Atlantic Canada found their roots within traditional agriculture and fishing communities.[1]

During the 1940's and 1950's the number of credit unions in Ontario grew exponentially. Of the 1,500 new credit unions established in Canada over this period, nearly two-thirds were in Ontario.[2] Membership in Ontario credit unions increased at an annual rate of almost 13 per cent. Despite the presence of the head offices of the banks and trust companies in Ontario, credit unions became a significant presence in the financial services market because of their emphasis on consumer lending. System expansion continued into the 1960's as a direct result of the strong demand for consumer loans fuelled by increased employment in well-paying manufacturing jobs.[3]

Higher inflation, volatile interest rates and decreased economic growth in the 1970's and the early 1980's forced a sharp contraction in Ontario's system. Growth was further eroded by the entry of banks and trust companies into the credit unions' core consumer lending business.[4] At the same time, credit unions shifted part of their focus

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[1] Ontario Legislative Assembly Select Committee on Company Law, Report on Credit Unions (Province of Ontario, 1969), page 3.

[2] Sean O'Connor, "The Evolution of the Co-operative Credit System in Canada", Bank of Canada Review (1988) 1, at 5.

[3] Sean O'Connor, "Evolution", page 9.

[4] Until the 1967 Bank Act, legislative restrictions discouraged bank participation in the consumer lending market; consequently, banks focused on lending to the business sector. Trust and loan corporations could provide mortgage credit to borrowers, but were severely limited in their consumer lending capacity until fairly recently.

from consumer lending towards residential mortgage loans because of the increased demand for house financing and the decreased profitability of intermediation spreads on consumer lending.

Credit unions also restructured their operations. Share financing was replaced by deposits, particularly term deposits, and the trend toward community bond credit unions began. These changes were needed to fund accelerating growth in mortgage loans and to provide members with higher yielding deposits as interest rates rose throughout the 1970's.

Credit unions responded to the stiffer competition with innovative products and services. Daily-interest savings accounts, direct deposit payroll services, and flexible mortgage payment plans were introduced and market positions were maintained. The success of these innovations was apparent by the end of the decade as competitors launched similar products and effectively snatched large chunks of the market.

Larger, community bond credit unions also entered the commercial lending arena, chiefly servicing small businesses and non-financial co-operative organizations. At the same time, smaller credit unions demonstrated that they could manage a portfolio of small commercial loans and Central began to offer large loan syndication.

Throughout the 1980's, Ontario's credit unions struggled to regain market share. Consumer confidence in credit unions had been undermined, to a certain extent, by a series of forced restructurings resulting from difficulties in managing the interest rate volatility which characterized the early 1980's. Membership was being further eroded by plant closures and lay-offs. Many credit unions could not recover lost market share as other financial institutions, especially the banks, resolutely set out to recapture the domestic market (which they had somewhat ignored in the mid to late-1970's in favour of international activity).

Currently, the system is growing in two very different directions. Many closed-bond credit unions are carving market niches by continuing to provide their members with traditional services largely limited to basic savings and lending. At the same time, an increasing number of community-bond credit unions are providing their members with a full and ever-expanding range of financial services. The latter often closely resemble their competition as they offer multi-branching, advanced technology, and wider product offerings.

Whether niche players or full-service operations, credit unions are competing head-to-head with the banks and trust companies operating in their communities, and there is no reason to believe that this competition will diminish.

b) The Structure of Ontario's Credit Union System

Credit Union Central of Ontario's member credit unions operate within the three-tiered national credit union system. Each credit union is an autonomous unit incorporated under the Credit Unions and Caisses Populaires Act (the "present Act") with a member-elected board of directors. There are now about 435 credit unions (approximately 70% of all Ontario credit unions) which are members of Central. Some 4,000 people volunteer as directors or committee members within the decision-making structures of these organizations.

Central is the largest of the three Ontario leagues.[5] Central provides its members with financial services (including liquidity management, member-cheque clearing, and credit card and payments-related electronic services) and trade association services (such as marketing, communications, and product development). Central and its members have combined assets of approximately $8.5 billion. Central is dually-regulated by the Province of Ontario under the present Act and by the federal government under the Cooperative Credit Associations Act.

Central, in turn, is a member of Credit Union Central of Canada, the financial intermediary and trade association for the national system. In addition to maintaining system liquidity and providing access to the Canadian payments system, Canadian Central provides non-financial services to support overall national system stability and

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[5]La Federation des caisses populaires de l'Ontario and L'Alliance des caisses populaires de l'Ontario are the other Ontario leagues. They provide liquidity and trade services to Ontario's francophone caisses populaires which represent about 10% of the overall system. There are also several independent credit unions which are not part of a formal league. These credit unions represent approximately 20% of the system. Note that proportions are based on OSDIC figures for assets.

development.

Ontario's credit unions are regulated by the Superintendent of Deposit Taking Institutions in the Ministry of Finance. Deposits in credit unions are insured up to a maximum of $60,000 by the Ontario Share and Deposit Insurance Corporation. Deposit insurance is mandatory and is funded through premiums paid by credit unions and caisses populaires.

CHALLENGES FACING ONTARIO'S CREDIT UNIONS

Central's members recently approved a strategic plan to implement a system vision statement. Some of the challenges outlined in the strategic plan are internal to a credit union system that, for example, must reconcile issues of historic autonomy with the realities of scale economies achieved by larger organizations.

However, many more of the challenges are contained within the larger operating environment:

a) Economic Restructuring

One of the most profound consequences for credit unions of the present massive restructuring of Ontario's economy is the threat to the membership base.

Ontario's credit union system is a microcosm of the provincial economy. Since the 1940's the system has been based largely on a membership working in the manufacturing plants of the industrial south and in the "company towns" of the resource-rich north. This concentration of a large portion of the credit union system's membership in increasingly mature, low-growth sectors, presents a significant risk for our regionally-based financial institutions.

While globalization causes our economy to restructure to compete at a world level, increased integration of the economy into the "Great Lakes" zone and into a North American trading block is aggravating the pressure for reorganizing production in key sectors. Ontario is now just one of several jurisdictions competing to retain its manufacturing base, however reduced or consolidated.

Entire industries are being affected by increased and accelerated technological change. Workers are being declared redundant because they cannot compete with rapidly changing technologies that never sleep and adapt to change with the turn of a screwdriver.[6]

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[6]Premier's Council. Competing in the New Global Economy (Volume 1). Queen's Printer. 1988. pp. 11 - 13.

The threat to the traditional base of Ontario's credit union system is obvious. As plants downsize or close, as members move to find employment, and as they reduce their dependence on traditional credit union products and services, membership and profitability will erode and many credit unions may be jeopardized, unless industrial bond credit unions can more easily expand to a community bond. Many have already done so but the process has been slow.

Other changes in Ontario's economy present different challenges for credit unions. The business services sector, which is largely composed of financial, insurance and legal enterprises, is displacing the traditional manufacturing and resource extraction sectors as the new growth sector. There has been an increase in the proportion of non-traditional jobs, that is, jobs that are not full-time and physically located in a plant or an office. Part-time employment, self-employment and home-based work are on the rise. Traditional concepts of lifetime tenure have eroded to the point where, at any given time, more than half of Ontario's work force has been in its current employment for six years or less.

The workforce is aging and, at the same time, there is an increase in the representation of "non-traditional" workers. Aboriginals and other visible minorities, women and the disabled now account for almost two-thirds of Ontario's workers.[7]

This means that credit unions must seek new ways to recruit and retain members and revisit the type and range of products and services they will offer. The days of close integration of a particular workforce in a community and an industrial bond credit union are rapidly disappearing. Credit unions must re-examine their purpose and forge new links to this changing community while operating in a competitive manner.

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[7]Ontario Economic Outlook - Meeting the Challenges. Ministry of Treasury and Economics. December 1991. pp. 9 - 16.

For example, credit unions will be severely tested to simultaneously develop adequate financial service responses for an older population with large savings who largely own their residences; young people needing savings and investment vehicles for home ownership, education and retirement; and small and medium-sized business lending packages to support the tremendous capital required for ongoing technology replacement, research, and training needs of the service economy.

Some change has taken place. Over the past decade there has been a marked increase in the number and relative size of community-bonded credit unions and a decline in closed-bond industrial credit unions.[8] Increased investment in technology has provided more cost effective ways of enhancing service capacities. However, the demands of a sophisticated and highly differentiated marketplace will strain the capacity of the system to reinvent itself as easily as it did, for example, in the late 1960's and 1970's when mortgage lending began to outpace consumer lending as the core credit union business.

Confronting and managing this change is crucial. Banks, trust and other financial services companies have read the same signals and are armed with new legislation that enables them to more rapidly respond to change than can credit unions operating within the constraints of the present Act.

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[8]The following chart illustrates the trend:

PRIMARY MEMBERSHIP BY BOND

	1985	1991
Primary Credit Union Members	1,352,000	1,232,000
Employer Bond Credit Unions	47%	36%
Community Bond Credit Unions	40%	54%
Associational Bond Credit Unions	13%	10%

The degree to which these competitors successfully challenge the traditional strengths of the credit union system will dictate the direction and extent of the anticipated restructuring within the credit union system.

b) The Competitive Landscape

Credit unions no longer operate --if they ever did-- in a vacuum. Banks and trust companies have long ago entered the traditional credit union core businesses, like consumer lending and mortgages. They have used their competitive advantages, including broader access to capital and national economics of scale, to erode credit union market share. We can expect that the expanded business powers gained by banks and trusts under new federal financial institutions legislation will have the following results:

1. banks and trust companies will exploit these new areas of business and increase the profitability of their operations by spreading their fixed costs across a greater range of products; and

2. banks and trust companies will use increased profitability to cross-subsidize core operations and further enhance their ability to exploit competitive advantages in those areas and vice versa.

Industry observers suggest that Canada is heading toward a universal banking system where financial institutions will provide all types of financial services.[9] This will reinforce the fundamental goal of most financial institutions --increasing the number of relationships with each client. One strategy will be to provide "one-stop-shopping" by offering packages of financial products and services.

[9] Brent Sutton and Guy Glorieux, "The Future of Financial Services: Industry and Regulator Perspectives" The Conference Board of Canada Report 89-92, at 12-13.

Strategic alliances will also broaden the range of financial products. These are most likely to be established when customers demand products outside the financial institution's core business. Financial institutions will satisfy this demand by networking the products offered by their alliance partners.

This marketplace will test the system's ability to respond to constantly shifting trends. Credit unions will need to quickly and decisively address issues such as technological sophistication and integration, capitalization, and product/service development that responds to an ever-increasingly segmented market. The capacity of legislation to adequately accommodate these competitive exigencies within a consumer protection framework will be sorely tested.

c) Balancing Margin-Based and Fee-Based Revenue

Many financial institutions experienced a decline in earnings during the past ten years. This decline was accelerated at credit unions by a number of factors:

1. deposits and loan instruments whose design exposed the institutions to interest rate risk;

2. insufficient collateral on loans;

3. sharply rising operating costs; and

4. limited access to fee-based sources of revenue.

As interest rates began to rise sharply through the 1970's, the net intermediation spread at all financial institutions, including credit unions, declined as borrowers held onto their fixed-rate loans and depositors reinvested their lower-yielding deposits at higher rates. Consequently, by the late 1970's, net interest returns on assets were declining while loan losses were beginning to rise and the rate of personal and commercial bankruptcies grew. In some cases, particularly during the early 1980's, these losses were magnified by a drop in the market value of mortgaged property to less than the remaining value of the loan. The late 1980's and early 1990's have seen a return of this broad trend in real estate.

Traditionally, credit unions have not derived significant proportions of their revenue from fee-based activities. User fees have often been waived on services such as chequing privileges, travellers' cheques and loan insurance.[10] Service fees were raised and stiffer penalties were levied for the pre-encashment of term deposits and the prepayment of mortgage loans by the late 1970s but fee income still remained a minor source of revenue.

Through the 1980's and early 1990's, increasingly, credit unions and caisses populaires charge user fees on a broader range of service including electronic banking operations, credit cards and credit lines, foreign currency deposits, guarantees and letters of credit. They also receive fees from sales of securities and insurance through networking arrangements. Consequently, fee income has doubled from 0.2 per cent of assets in 1981 to 0.4 per cent in 1987.[11]

The statistics in Figure 1 show the contrast between the income mixes of banks, trusts and credit unions. Although, credit unions Other Income has risen to almost 0.6 per cent, that income still represents only 14.5 per cent of Total Income. For banks and trusts Other Income represents almost approximately one-third of Total Income.

Although credit unions still aim to provide financial services to their members at a reasonable cost, they have increasingly recognized that the short-term benefits to members from not charging for certain services may threaten the long-term viability of the institution.

The trend toward charging additional user fees on traditional banking operations will be introduced into new lines of business like mutual funds, direct payment and possibly insurance retailing --mostly from products which credit unions will network.

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[10] Sean O'Connor and Ed Fine, "New Directions for the Cooperative Credit System in Canada", Bank of Canada Review (1989) at 8.

[11] Sean O'Connor and Ed Fine, "New Directions" at 12.

In addition, with increased commercial lending powers, credit unions will be able to increase Other Income by imposing on commercial borrowers the kinds of commitment and stand-by fees they have been paying to the banks over the years.

We can expect the proportion of credit unions' revenues derived from fees and shared commissions to increase significantly.

FIGURE 1

ONTARIO'S CREDIT UNIONS AND CAISSES POPULAIRES

COMPARISON OF NET INTEREST INCOME AND OTHER INCOME TRENDS

(% of Average Assets)

		4 Q 1990		4 Q 1991		4 Q 1992		4 Q 1993	
Net Interest Income									
Ontario System	(1)	3.76%	87.9%	3.41%	86.5%	3.43%	85.1%	3.35%	85.5%
Large Domestic Banks	(2)	2.80%	69.1%	2.90%	69.9%	2.89%	69.0%	2.83%	67.7%
Trust Companies	(3)	1.89%	62.2%	1.84%	65.7%	1.65%	68.5%	1.73%	59.5%
Other Income									
Ontario System	(1)	0.52%	12.1%	0.53%	13.5%	0.60%	14.9%	0.57%	14.5%
Large Domestic Banks	(2)	1.25%	30.9%	1.25%	30.1%	1.30%	31.0%	1.35%	32.3%
Trust Companies	(3)	1.15%	37.8%	0.96%	34.3%	0.76%	31.5%	1.18%	40.5%
Total Income									
Ontario System	(1)	4.28%	100.0%	3.94%	100.0%	4.03%	100.0%	3.92%	100.0%
Large Domestic Banks	(2)	4.05%	100.0%	4.15%	100.0%	4.19%	100.0%	4.18%	100.0%
Trust Companies	(3)	3.04%	100.0%	2.80%	100.0%	2.41%	100.0%	2.91%	100.0%

(1) Source: Ontario Share & Deposit Insurance Corporation, System Report

(2) Source: Canadian Bankers Association, Detailed Financial Statistics

(3) Source: Statistics Canada, Quarterly Financial Statistics for Enterprises

d) Capital

A Conference Board of Canada report identified the need for a strong capital base as one of the most pressing challenges to Canada's financial institutions. According to the Conference Board, this base is needed primarily because of:

1. increasing attention to capital adequacy by regulators. This means that ongoing access to capital is crucial for growth. A strong capital base is the first line of defence in securing members deposits; and

2. increasing need for large expenditures on technology innovation and new product development.[12]

These considerations apply equally to Ontario's credit unions. Accordingly, current restrictions on the ability of credit unions to raise capital must be reconsidered. Credit unions must be permitted greater flexibility in issuing a variety of types of share capital and to encourage members to purchase share capital offerings, in addition to shares required as a condition of membership.

Figure 2 shows the capital (share capital) and surplus (retained earnings) trends for credit unions over the past four years. While the ability of credit unions to generate earnings to contribute to capitalization by increasing surplus shows an overall positive trend, overall credit union capitalization has been hindered by the system's inability to raise new share capital. The trend for share capital raised by the system is virtually flat. This is primarily because credit unions can only offer one form of share ("member shares") into which each member/investor must have an equal investment.

[12] Brent Sutton and Guy Glorieux, "The Future of Financial Services".

FIGURE 2

ONTARIO'S CREDIT UNIONS AND CAISSES POPULAIRES

COMPARISON OF CAPITAL AND SURPLUS TRENDS

	4 Q 1990 ($000)		4 Q 1991 ($000)		4 Q 1992 ($000)		4 Q 1993 ($000)	
CAPITAL	$58,680	13.4%	$63,446	14.8%	$70,404	14.3%	$77,285	14.7%
% of Total Assets	0.5%		0.5%		0.6%		0.6%	
SURPLUS	$379,917	86.6%	$366,546	85.2%	$420,929	85.7%	$448,055	85.3%
% of Total Assets	3.5%		3.1%		3.4%		3.6%	
TOTAL	$438,597	100.0%	$429,992	100.0%	$491,328	100.0%	$525,340	100.0%
% of Total Assets	4.0%		3.7%		4.0%		4.2%	
TOTAL ASSETS ($000)	$10,897,063		$11,702,787		$12,220,722		$12,578,699	

Figure 3 projects increased credit union capitalization once credit unions are enabled by the new legislation to offer to members and the public various forms of capital. Based on anecdotal evidence from Central's member credit unions, a flurry of share offerings to members can be expected when the Bill becomes law. Over time, credit unions will continue to tap members and potentially the public for capital. Ultimately, the level of credit union capitalization should climb substantially, fuelled mostly by these new shares. [13]

[13] Percentages shown are not calculated according to the BIS standard. The proposed legislation will impose a BIS standard. However, to achieve an "apples-to-apples" comparison, capital percentages were left as a flat percentage of assets without "risk-weighting".

FIGURE 3

ONTARIO'S CREDIT UNIONS AND CAISSES POPULAIRES

PROJECTED CAPITAL AND SURPLUS TRENDS

	4 Q 1994 ($000)		4 Q 1995 ($000)		4 Q 1996 ($000)		4 Q 1997 ($000)	
CAPITAL	$85,030	14.7%	$148,803	21.5%	$260,404	30.4%	$455,708	41.0%
% of Total Assets	0.6%		1.0%		1.6%		2.5%	
SURPLUS	$492,910	85.3%	$542,201	78.5%	$596,421	69.6%	$656,063	59.0%
% of Total Assets	3.6%		3.6%		3.6%		3.6%	
TOTAL	$577,940	100%	$691,004	100.0%	$856,825	100.0%	$1,111,771	100.0%
% of Total Assets	4.2%		4.5%		5.1%		6.0%	
TOTAL ASSETS ($000)	$13,860,000		$15,246,000		$16,770,600		$18,447,660	

RECOMMENDED REGULATORY RESPONSES

In Central's view, there are a number of key regulatory changes required to create the conditions necessary for credit unions to be able to respond to the above-noted competitive challenges.[14] These changes include:

a) Regulatory Principles

Reform of the present Act should be undertaken with several objectives in mind. First, the protection of consumer interests must be paramount. Regulation provides the only means to balance the information assymmetries which exist between institutions and their clients. We may like to believe that credit union members are not as powerless as bank customers. But, the proliferation of financial products and the complexity of choices demands that consumers of financial services, regardless of institution, be protected, even if the means for protection prove inconvenient for the institutions.

Equally important is the preservation of the co-operative aspect of the credit union system. This means that the proposed legislation should ensure that democratic decision-making is supported in legislation, that managers and directors are given appropriate direction regarding their respective obligations and responsibilities, and that the mutual self-help aspect of the co-operative movement is recognized in, for example, incentives to join liquidity pools.

Regulatory policy should place a premium on flexibility and adaptability. Innovations should be acceptable unless they can be demonstrated to run counter to the public interest. Reforms must be forward thinking if Ontario is to be a leader. The frame of reference for meeting new challenges cannot be limited to what the banks or trust companies can and cannot do.

b) Networking

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[14]This section of the paper is based on the key regulatory changes articulated in a resolution passed at Central's 1992 Annual General Meeting.

Networking describes the arrangements between financial institutions under which one institution provides its customers with access to products or services issued by the other. The ability to "network" financial services is essential to credit unions. In fact, to achieve a level playing field, there must be fewer restrictions on networking for credit unions than any other type of financial institution currently faces. Networking provides an opportunity for independent and small financial institutions to offer a broader range of financial services than they could otherwise.

Credit unions have provided access to certain insurance services through their insurance affiliates, CUMIS and The Co-operators, for many years. The proposed legislation must enable credit unions to maintain and even expand their business opportunities in this area.

Regulations must provide for networking a full-range of financial products which could be sold by properly trained employees directly on the premises of credit unions. Central believes that the "two-hat" model should be employed. Credit union employees should be permitted to become licensed to sell the financial services of a networking company, like a mutual fund company, and work for both the credit union and the networking company as their dually-employed representative in the credit union.

As consumers, credit union members will benefit from the ability to satisfy their total financial needs in one location. Appropriate licensing and "know-your-client" rules, and regulations to prevent tied-selling and protect confidential information, can ensure member protection.

c) Self-Regulation of Liquidity

Liquidity, or the ability to provide cash when it is required, is an important element in the financial soundness of credit unions. The majority of credit unions in Canada pool their liquidity. In Ontario, most credit unions and caisses populaires pool their liquidity in their league which is a member of a Group Clearer (either Credit Union Central of

Canada or Groupe Desjardins) in the Canadian Payments Association (CPA).[15] As such, the leagues act as central bankers through their ability to move cash from cash-surplus credit unions to credit unions requiring cash.

Membership in a league which is a member of the CPA is central to the practical advantages enjoyed by credit unions which pool their liquidity. As a member of a Group Clearer in the CPA, a credit union's access to liquidity is protected by the Group Clearer's obligation to settle for items drawn on members of the group for 30 days and contractual arrangements from the Group Clearer and down through the leagues to the credit union level which mirror the 30-day obligations.[16]

Leagues also protect a credit union's access to liquidity by providing lines of credit which are secured by general security agreements against the assets of the credit unions. As well, mandatory liquidity by-laws force member credit unions to maintain the deposits which create the pool.

The pooling of liquidity offers three other general advantages:

1. To the extent the CPA-member, league-managed liquidity pool is willing to advance more funds to an individual credit union than the credit union has on deposit, the individual credit union is in a stronger position to meet withdrawals and other cash demands than it would be on its own.

2. Short-term investments (the type required for liquidity reserves) usually have a low rate of return. If, by pooling, a group is permitted to keep a lower percentage of these assets in short-term investments, the pool may be able to earn a better rate of return.

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[15]Throughout the remainder of this text, the term "CPA member, league-managed liquidity pool" will be used to identify the arrangements we believe constitute a legitimate self-regulated regime for liquidity management.

[16]Canadian Payments Association. By-Law No. 3, Section 13.04.

3. The strength of the movement lies in the joining together of the individual credit unions to provide the movement with a large co-operative financial base that can meet the challenges of a rapidly evolving financial institutions sector.[17]

The advantages of liquidity pooling raise the issue of mandatory membership in a Canadian Payments Association-member, league-managed liquidity pool. In considering this question, Central has been sensitive to the following concerns:

1. Regardless of the obligations of a Canadian Payments Association-member, league-managed liquidity pool, it may be hesitant to assist an individual credit union beyond the deposits made by that credit union, if this would deplete the deposits of the other credit unions. It is obvious, that which side of the liquidity/insolvency line a credit union falls may be difficult to determine. Insolvency problems are traditionally the purview of stabilization funds and deposit insurers.

2. Compulsory membership in a Canadian Payments Association-member, league-managed liquidity pool violates one of the essential principles of a co-operative organization: open and voluntary membership. Voluntary membership gives individual credit unions a democratic right to decide their own destiny.

Nevertheless, Central contends that credit unions which belong to a Canadian Payments Association-member, league-managed liquidity pool are potentially less at risk than credit unions which do not. Credit unions which participate in a liquidity pool are more readily stabilized and less likely to require emergency stabilization or deposit insurance assistance.

Credit unions which pool and collectively regulate their liquidity should be entitled to determine the levels of liquidity which are appropriate for their circumstances. In other

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[17] Richard Bird and Norman Roy, "Credit Union and Caisse Populaire Study", (Research Paper on the New Brunswick credit union system), 1988, pp. 36-37.

words, credit unions which pool their liquidity funds in a Canadian Payments Association-member, league-managed liquidity pool should be exempt from any legislated liquidity requirement provided the Director of Credit Unions is satisfied with the pooling arrangement.

d) Commercial Lending

Subject to overriding standards of financial prudence, all types of lending and investment activities should be open to credit unions, including commercial lending, pursuant to Ministry-issued licences.

A lending license system would provide a workable method of permitting credit unions to engage in commercial lending, while preventing unqualified credit unions from entering that field. There should be a tiered licensing system, and some licenses could be limited to particular types of lending (e.g., real estate, small business, agricultural). The risks, income streams, types of security and asset values of different types of business vary, sometimes significantly. For instance, a credit union with real estate development expertise may not be qualified to engage in agricultural lending.

e) Capital Adequacy

There have been a number of methods used by financial institutions and regulatory bodies to create capital ratio standards: capital to liabilities, capital to total assets, capital to risk assets and capital to risk-weighted assets.

The Bank for International Settlement ("BIS") has adopted a risk-weighted asset capital formula for all internationally active banks. The BIS proposal represents two major shifts in the approach for establishing capital adequacy standards:

1. capital is measured as a percentage of assets rather than liabilities; and

2. assets are weighted on the basis of the risk they represent to financial performance. (Assets include both on and off-balance sheet items).

Adoption of the BIS rules is a key aspect of the federal financial services reform package. Risk-weighting of capital to determine capital adequacy will result in many competitive pressures, whether or not the credit union system follows suit. Risk-weighted returns will become increasingly important to banks and trust companies and pricing policies will be adopted to reflect this.

Financial institutions around the world are moving toward the BIS approach. While it may not prove to be the best method of regulating capital, it is the best option available for measuring capital. Credit unions should be prepared to similarly measure their capital adequacy, subject to certain modifications to accommodate our tiered capital structure.

f) Capital Formation

At present, credit unions face a number of obstacles to raising new capital. Constraints include:

1. the legal restriction on the issuance of non-voting shares;

2. the mandatory redemption of capital on demand; and

3. the minimal share capital received from membership growth.

One option for increasing credit union equity levels is to allow credit unions to become more aggressive in attracting member capital. This could be achieved by offering members the opportunity to invest in a greater range of non-voting capital instruments. This would offer the following benefits:

1. Credit unions would be able to accelerate their capital building program and so reduce the potential need for stabilization and deposit insurance.

2. Deposit insurance premiums could be stabilized and, potentially reduced. Marginal credit unions could rehabilitate themselves through building capital before a deficit situation occurred.

3. Control of credit unions would remain in the hands of the members; they would remain sheltered from the influence of external parties such as the general public.

4. Credit unions would be able to expand and compete more effectively with better capitalized banks and trust companies.

g) Sunset Clause

In order to ensure that credit union legislation will not hinder the competitiveness of credit unions in the financial services marketplace, Central has argued that the proposed legislation must be enabling and flexible. Nevertheless, industry leaders and policy makers could never foresee all of the possible developments which might occur in a quickly changing environment. Central believes that the proposed legislation and the Regulations must be reviewed and updated by the Legislature every five years.

h) Deposit Insurance

The Canada Deposit Insurance Corporation ("CDIC") insures the deposits of the banks and trusts. CDIC has the right, under statute, to borrow from the Consolidated Revenue Fund.

At its inception, CDIC's authorized borrowing limit was $500 million. In a series of amendments to the Canada Deposit Insurance Act (Canada) since 1983, CDIC's authorized borrowings were increased first to $1.5 billion, then to $3 billion and finally, in 1992, to $6 billion.

Central has argued that there must be a legislative solution to the issue of the Province's support for the credit union deposit insurer, Ontario Share and Deposit Insurance Corporation ("OSDIC") to permit credit unions to compete with other financial institutions on an equal footing.

Appendix "B" to the June 1993 Report of the Standing Senate Committee on Banking, Trade and Commerce entitled, "Monitoring and Protection of Clients of Financial

Institutions" canvassed all forms of financial product protection schemes (CDIC [deposits], CompCorp [insurance], CIPF [securities]) and, essentially, supported the argument that the sources of funds upon which these schemes may draw is a basic issue of competitiveness in the financial services industry.

To quote the Report:

> Many witnesses have pointed out that the Consolidated Revenue Fund supports CDIC but no other consumer protection funds. CDIC therefore has a cost advantage over the other compensation plans which must pay full market rates and must pay a service fee to maintain their line of credit with the banks.
>
> The Committee once again considers that competition among products should be encouraged. Therefore, access to the CRF should be granted to products that call for protection from the consumers' point of view and for which protection would not be offered otherwise. Segregated funds could be set up to provide coverage, if so wished, by CDIC's member institutions engaged in various businesses. (at 42B:23,24) (emphasis added)

The Committee's Report and recommendation are consistent with the proposal that OSDIC, like CDIC, be granted, by statute, access to the provincial government's general revenues in order for credit unions' deposit insurance to be equivalent to and competitive with the deposit insurance provided to the banks and trusts.

CONCLUSION

The urgent need for fundamental reform of Ontario's Credit Unions and Caisses Populaires Act cannot be overstated. The present Act cannot and, frankly has not for some time, been able to meet our credit unions' needs in a rapidly evolving financial institutions marketplace. The present Act is inadequate from a variety of perspectives.

Our present legislation restricts competition in financial services by prohibiting credit unions from operating as full-service financial institutions. This means that members have had to go to other financial institutions to get some of their financial services. We have lost members as a result.

The present Act lags behind the revised federal financial institutions legislation. The new federal regulatory regime alters the historic relationships among Canada's financial pillars. Ontario's current credit union legislation does not reflect the philosophy nor the specifics of these changes. This places credit unions at a serious disadvantage.

Neither does the present Act reflect the profound changes the system has gone through in the past decade. The increase in number of community credit unions shows the need for legislation to provide credit unions with the ability to constantly innovate in order to meet the requirements of an ever more demanding membership.

In short, the present Act is out of date and out of step with the financial services marketplace. If Ontario's credit unions are to build on their strengths they must have new legislation.

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