

Where are credit unions heading?

Legislative avenues – Analysis of Bill C-38

In 1992, the last significant review of the financial services sector, the CCA Act was drafted to accommodate the unique structure of the credit union system. While the Act was drafted specifically for the credit union system, significant sections mirror those found in the *Bank Act*. Since that time, the financial services sector has changed dramatically and the need for amendments to all acts governing the financial services sector are required. The federal government made some minor adjustments to the Acts in 1997 but held back any significant changes until after the review by the Task Force on the Future of the Financial Services Sector (MacKay Task Force).

The MacKay Task Force tabled its report in September 1998. The credit union system participated throughout the review process and was pleased with the favourable response by the MacKay Task Force, the House of Commons Finance Committee and the Senate Committee on Banking, Trade and Commerce. The federal government's White Paper of June 1999 expressed policy support for the credit union system's proposals.

This paper will outline the main features of the CCA Act today and describe the amendments that are being pursued by the credit union system.

COOPERATIVE CREDIT ASSOCIATIONS ACT - BUSINESS POWERS

The business powers of an association incorporated under the CCA Act, are outlined in Part IX of the CCA Act:

1. Members Only:

Under section 375, an association may provide “financial services” (including investment counselling and portfolio management services) to:

- (a) members¹;
- (b) subsidiaries;
- (c) centrals;
- (d) credit unions;
- (e) cooperative corporations; or
- (f) any subsidiary of a member, a subsidiary, a central, a credit union, or a cooperative corporation.

2. Technical and Consultative Services:

An association may provide administrative, technical, and consultative services and related goods to a central or a credit union.

3. Additional Powers:

Among other additional powers, an association may:

- (a) accept deposits from any level of government or government agency, regardless of whether such government or government agency is a member; and
- (b) provide information services (including information processing services, software development, and manufacture or sale of special

¹Under section 41 of the CCA Act to be a member of an association, a person must be: (a) an association; (b) a central; (c) a cooperative corporation (organized and operated on cooperative principles); or (d) with the prior approval of OSFI, a credit union.

purpose computer hardware) to any person to whom an association may provide financial services under section 375.

4. Retail Powers and Networking:

Because of the limitations in section 375 (essentially, financial services to members only), an association may not deal directly with the general public, except through subsidiaries or, in a limited way, through commercial loans.

An association, through the following subsidiaries, may provide retail financial services:

- (a) a bank;
- (b) a loan or trust company;
- (c) an insurance company;
- (d) a securities dealer;
- (e) a financial leasing corporation; or
- (f) a mutual fund distribution corporation.

Under section 377 (networking), an association may also act as an agent for a financial institution or a subsidiary in respect of a service to be provided to a person mentioned in section 375 or to a member of a central or a credit union. If taken to its fullest extent (e.g., acting as an agent for a financial institution in respect of the provision of services to a “member of a [credit union]”), the networking powers would appear to open up retail powers to an association on an agency basis.

5. Commercial Lending:

Under paragraph 376(1)(d), an association may make loans to or investments in entities that are not members. This provision effectively allows an association to direct funds deposited with it to commercial lending activity, as that activity is defined at section 386.

As most associations are expected to operate in the context of a liquidity provider to member centrals and credit unions, the CCA Act seeks to assure the liquidity of an association by limiting its commercial loan portfolio and the commercial loan portfolios of any subsidiary (including a bank) to no more than five per cent (5%) of an association's total assets without the prior approval of OSFI. It is expected that OSFI would not authorize a commercial lending portfolio at an association which played a role in liquidity management which would exceed ten (10%) to fifteen (15%) per cent of an association's total assets. See sections 398 and 399.

6. Restrictions:

The CCA Act lists the following restrictions on the business powers of an association which are similar to the restrictions found in the *Bank Act* (Canada). An association shall not:

- (a) deal in goods or engage in any trade or business;
- (b) engage in fiduciary activities;
- (c) deal in securities;
- (d) undertake the business of insurance except to the extent permitted by the regulation to the CCA Act (essentially, the restrictions under the *Bank Act* (Canada));
- (e) engage in personal property leasing of consumer goods, including motor vehicles, except that CUCC does so on a grandfathered basis through an affiliated company called Canadian Cooperative Leasing Services; or
- (f) accept deposits from non-members, except as otherwise expressly permitted.

BILL C-38 AMENDMENTS

Among the most important improvements to the CCA Act are the following:

- ❏ Improved Business Powers for Associations and Part XVI Centrals.
- ❏ New Retail Powers in the National Marketplace.
- ❏ Restructuring Flexibility.
- ❏ Customizable Powers for Associations.

These improvements will enhance the ability of associations and the Part XVI Centrals to provide support to credit unions as they strive to meet the financial services needs of their members and will enhance the competitiveness of credit unions in the Canadian financial services marketplace.

1. Improved Business Powers for Associations and Part XVI Centrals:

Bill C-38 permits associations and the Part XVI Centrals to make their services available to a broader range of users of such services.

Firstly, an amendment to section 375(1) and changes to the definition of the term “service corporation”, as that term is used in the CCA Act, will give associations and the Part XVI Centrals improved statutory capacity (although not yet complete capacity) to serve the full cooperative system, including financial cooperatives and commercial cooperatives and their related companies.

Secondly, a new section 375.1 (in addition to providing for the new retail association powers) adds the potential for increasing the scope of services that an association or the Part XVI Centrals may provide and for expanding the potential users of such services. The new section 375.1 provides a mechanism by which the credit union system and the Minister can negotiate these expanded business powers, which are most likely to relate to the provision of clearing settlement, and payment services to members of the *Canadian Payments Association*, including the many new entities that will be eligible to be members of the *Canadian Payments Association* under Bill C-38.

Thirdly, associations and the Part XVI Centrals are given broader powers to:

?? expand electronic banking services (section 376); and

?? network financial products and services under a revised section 377.

Finally, investment powers for associations and the Part XVI Centrals are expanded or enhanced:

?? control over banks and other financial institutions need no longer be *de jure* (i.e., 50% plus one of the voting shares owned by one interest), but could be *de facto* (i.e., one controlling member is nominated for regulatory purposes, regardless of how capital is structured)(section 390(1));

?? expanded investments in financial service services entities are permitted (section 390(2));

?? association group investments can be transferred within the group without control.

And, to help make these rules work for the credit union system, control concepts which recognize group ownership are expected to be provided in minority investment regulations. Such rules will assist the centrals in working together through ventures that are co-owned.

In sum, these amendments will enhance the ability of associations and the Part XVI Centrals to provide support to credit unions in providing full financial services to their members and enhance the competitiveness of credit unions in the Canadian financial services marketplace².

² Attached as Schedule A to this memorandum is a point-form comparison of the business power provisions as they apply to associations, trust companies, and banks. This point-form comparison was prepared by my

2. New Retail Powers in the National Marketplace:

Bill C-38 expands the CCA Act to permit, for the first time, the delivery of financial services to the general public by a federally-regulated, cooperatively-owned and cooperatively-governed financial institution. This new type of association will be defined in the CCA Act as a “retail association”.

Under new section 375.1, the specific business powers of a retail association will be determined by the Minister after consultation with the proposed incorporators and federal regulators. This will allow the incorporators to tailor the retail association’s business powers to suit their business case needs and for the regulators to design a regulatory framework to apply specifically to address the prudential concerns associated with such a retail association.

In this context, because a retail association may take deposits from the general public, Bill C-38 amends the *Canada Deposit Insurance Corporation Act* to allow a retail association to become a member of the Canada Deposit Insurance Corporation and provide its depositors with federal deposit insurance coverage in accordance with Canada Deposit Insurance Corporation’s deposit insurance terms and conditions.

The ability to provide retail financial services to all Canadians through a federally-chartered, co-operatively-owned and governed financial institution on a basis that will complement existing credit union products and services is seen by the credit union system as an important step in allowing credit unions to continue to meet the needs of their members.

3. Restructuring Flexibility:

The credit union system is reviewing its existing structure. Many of the proposals that have been studied involve a restructuring of those parts of the credit union system (including associations and the Part XVI Centrals) that are under federal regulation. Potential credit union system restructuring proposals could require the flexibility to transfer assets among associations and centrals or amalgamate associations, centrals or other financial institutions owned and controlled by the credit union system. Bill C-38 adds to the CCA Act several important restructuring options that were not previously available to the credit union system, including:

- ?? The ability for one association to own and control another association (section 52). This change will allow the credit union system to establish holding company structures.
- ?? Non-financial centrals/trade associations (referred to in the proposed amendments to the CCA Act as “leagues”) are given the power to incorporate and own an association. This change will allow provincial credit union systems to act collectively through provincial institutions that could represent their interests in the governance structure of a federal association.
- ?? Federal and provincial corporations, including centrals, that meet qualifications of incorporation, may continue as an association or amalgamate with an association. This innovation could make restructuring transactions more efficient.
- ?? If considered desirable by the credit union system, associations will have the power to continue as other federal financial institutions (including a bank under the *Bank Act*), a bank holding company or as federal business corporations or cooperatives.

- ?? Associations may amalgamate with each other and associations may amalgamate with federal corporations, including federal financial institutions such as banks and trusts. *Bank Act* security rights can be maintained on an amalgamation with a bank.

- ?? New asset purchase and sale rules are set out in sections 74 and 75, including new flexibility in designing share consideration and tax rollovers in asset transactions (section 75(2.1)) and provisions that would permit streamlining of asset transactions through recognition of bylaw formulae for valuing assets (section 74(3)).

- ?? An amendment to section 41 of the CCA Act eliminates existing barriers to credit union membership in associations. This measure would permit the reorganization of the credit union system from three tiers to two tiers, if and when credit unions decide that is what they want to do with their system.

- ?? Barriers to providing payments and settlements in a possible two-tier environment are eliminated by an amendment to subsection 379(3), that would allow an association to act as guarantor to the payment system for credit unions, and an amendment to the definition of “commercial loan” in section 386 to provide for a power to prescribe association loans to credit union as non-commercial loans.

4. Customizable Powers for Associations

One of the key elements of the amendments to the CCA Act under Bill C-38 is its legislative approach. The proposed amendments to the CCA Act provide for a regime that allows the credit union system and federal regulators to design customized charters for carrying on financial services businesses through associations. For instance, and in addition to comments made earlier in this Part about section 375.1, classes of associations

can be exempted from portfolio limits, including commercial lending rules and maximum equity investments.

In an environment where business needs can change quickly, this customizable-powers approach will work best for the credit union system in both the short-term and the long-term.

In the short-term, the legislative approach allows the credit union system to consider innovative solutions for its structure. In relation to possible business models and structures, many new doors are opened by the proposed amendments to the CCA Act. In the long term, the flexibility of the customizable-powers approach may mean that the CCA Act can continue to be adaptable to the credit union system's needs even in the face of issues or solutions that cannot be foreseen at this time.

Finally, the application of the new *de facto* control principles in section 390 will allow associations, the Part XVI Centrals, credit unions and non-credit union system entities to enter into much needed co-ownership arrangements for the provision of products and services. The ability to use holding company structures and the maintenance of widely-held status for associations and the Part XVI Centrals contribute even greater flexibility for co-ownership interests.

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SCHEDULE A

BANK	TRUST	ASSOCIATION
<p>Commercial Loans</p> <ul style="list-style-type: none"> ?? No limit ?? Business plan 	<p>Commercial Loans</p> <ul style="list-style-type: none"> ?? 5% increases with approval ?? no regulatory exemption ?? loans to credit unions included 	<p>Commercial Loans</p> <ul style="list-style-type: none"> ?? 5% increases with approval ?? regulatory exemption for specific loans ?? regulatory exemption for specific associations ?? loans to associations exempt ?? loans to Part XVI Centrals exempt
<p>Capital</p> <ul style="list-style-type: none"> ?? one class common share with governance ?? no limit preferred shares 	<p>Capital</p> <ul style="list-style-type: none"> ?? one class common shares with governance ?? no limit preferred shares 	<p>Capital</p> <ul style="list-style-type: none"> ?? Membership shares cooperatives and credit unions ?? Bylaw governance ?? Investment shares no limit
<p>Capital Adequacy</p> <ul style="list-style-type: none"> ?? BIS rule ?? Leverage rule 	<p>Capital Adequacy</p> <ul style="list-style-type: none"> ?? BIS rule ?? Leverage rule 	<p>Capital Adequacy</p> <ul style="list-style-type: none"> ?? Wholesale Association Leverage rule ?? Liquidity Association Negotiable leverage rule ?? Retail Association BIS rule Leverage rule
<p>Tax</p> <ul style="list-style-type: none"> ?? Corporate rate ?? Capital tax ?? Mark to market ?? Dividend ?? Integration ?? GST 	<p>Tax</p> <ul style="list-style-type: none"> ?? Corporate rate ?? Capital tax ?? Mark to market ?? Dividend ?? Integration ?? GST 	<p>Tax</p> <ul style="list-style-type: none"> ?? Credit union integration ?? Dividends deductible ?? Capital gains dividend flow through election ?? Capital tax

Owners/Members ?? No limit	Owners/Members ?? No limit	Owners/Members ?? Cooperative/credit union system ?? Investment shares any one
Permitted Substantial Investment ?? National/international FIs ?? Financial service entities ?? Holdcos ?? Service companies ?? Financial agents ?? Mutual funds ?? Real property ?? Prescribed	Permitted Substantial Investment ?? National/international FIs ?? Financial service entities ?? Holdcos ?? Service companies ?? Financial agents ?? Mutual funds ?? Real property ?? Prescribed	Permitted Investment ?? National/international FIs ?? Financial service entities ?? Holdcos ?? Service companies ?? Financial agents ?? Mutual funds ?? Real property ?? Prescribed
10/50 Rule ?? Applies to FIs ?? Applies to non-FIs engaged in intermediation ?? Bank/holdco de juris control ?? Others de facto control	10/50 Rule ?? Applies to FIs ?? Applies to non-FIS engaged in intermediation ?? De facto control	10/50 Rule ?? Applies to FIs ?? Applies to non-FIS engaged in intermediation ?? De facto control
Minority Investment ?? Single entity rule	Minority Investment ?? Single entity rule	Minority Investment ?? Group investment with <i>de facto</i> control for equity ?? Group investment for debt
Significant Interest ?? Control	Significant Interest ?? Control	Significant Interest ?? No control required ?? Association may control

<p>Holding Company Structure</p> <ul style="list-style-type: none"> ?? Special regulatory structure ?? Widely held for big banks ?? Flexible bank/bank Holdco ownership transfer/group rules ?? Permitted investments parallel trust 	<p>Holding Company Structure</p> <ul style="list-style-type: none"> ?? Non-regulated ?? 35% public issue if over 1 billion capital 	<p>Holding Company Structure</p> <ul style="list-style-type: none"> ?? must be another association under CCAA ?? holding association not controlled, owned by credit union/cooperatives ?? holding association permitted investments as any association
<p>Related Party</p> <ul style="list-style-type: none"> ?? includes: <ul style="list-style-type: none"> ☞officers/directors ☞entities owning 10% of a class of shares ☞extended family owners ☞entities controlled by related parties ?? transfers of assets limited ?? transfers to financial institutions with OSFI approval OK ?? cross service supply is OK ?? flexibility in transfers within the bank group (subsidiary) ?? flexibility in transfers to bank holdco ?? possible regulatory exemption for classes of transaction 	<p>Related Party</p> <ul style="list-style-type: none"> ?? includes: <ul style="list-style-type: none"> ☞officers/directors ☞entities owning 10% of a class of shares ☞extended family owners ☞entities controlled by related parties ?? transfer of assets limited ?? transfers to financial institutions with OSFI approval OK ?? cross service supply is OK ?? flexibility in transfers in trust group (subsidiary) ?? possible regulatory exemption for classes of transactions 	<p>Related Party</p> <ul style="list-style-type: none"> ?? Wholesale Association <ul style="list-style-type: none"> ☞Related parties are limited to officers/directors and 10% or more owners of investment shares ☞General related party rules apply except group transfer rules ?? Retail Association <ul style="list-style-type: none"> ☞Subject to regulations related parties includes <ul style="list-style-type: none"> - all members - any person that is a member of any entity that has a 10% ownership of membership or investment shares ☞General related party rules apply other than group transfer rules

<p>Securities Laws ?? Broad exemption for deposits, private placements and corporate reorganizations</p>	<p>Securities Laws ?? Broad exemption for deposits, private placements and corporate reorganizations</p>	<p>Securities Laws ?? In some provinces will require amendments to <i>Securities Acts</i> especially for retail deposits</p>
<p>Provincial Compliance ?? Not an issue</p>	<p>Provincial Compliance ?? Requires compliance</p>	<p>Provincial Compliance ?? Requires compliance, may be modified in some provinces</p>