C R E D I T U N I O N / C A I S S E P O P U L A I R E

S T U D Y

A REPORT PREPARED
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For
Law Reform Branch
Office of the Attorney General
Province of New Brunswick

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FOREWORD

In the Fall of 1986 the Law Reform Branch of the Office of the Attorney General was requested to assume responsibility for undertaking a study of the law respecting credit unions/caisses populaires in New Brunswick. The impetus for the study came from two sources. On the one hand, the credit union movement had, for several years, been making representations to the Minister of Justice concerning proposed reform of the existing legislation and regulations. On the other hand, the Government had determined that it was appropriate and advisable to undertake a general review of the laws governing the operations of financial institutions in the province. The first phase of that review was the study of loan and trust company legislation which resulted in the enactment of a new Act in 1987. The second phase was determined to be that in relation to credit unions/caisses populaires.

The Law Reform Branch engaged the services of Professor Richard Bird of the Faculty of Law at the University of New Brunswick and Professor Norman Roy of the Administrative Sciences Research Centre at the Université de Moncton to conduct the research of credit union/caisse populaire law and operations. A committee of Law Reform and Justice Department officials was established to act in a consultative capacity to the researchers.

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The project was commenced with the preparation of a preliminary list of suggested issues to be included in the study. By letters dated November 6, 1986 the Minister of Justice provided copies of the list to La Fédération des Caisses Populaires Acadiennes, the Credit Union Central of New Brunswick, the Stabilization Boards and each credit union and caisse populaire with the invitation to suggest other issues to be added to the list. The recipients of the letters were also invited to submit written briefs concerning such matters. By subsequent letters dated January 29, 1987, the Minister provided those same parties with a final list of issues that had been revised to reflect the responses to the earlier letters. The Minister again invited the recipients to submit written briefs to assist the researchers in their work.

The Minister's invitations elicited responses from La Fédération and from several credit unions and caisses populaires. Most of the caisses populaires chose to have La Fédération represent them in the matter. La Fédération, through the instrumentality of its Legislation Committee, prepared and submitted very extensive briefs addressing most of the issues that had been identified. Those briefs, together with the ones provided by individual credit unions and caisses

.../3

populaires, were of considerable benefit to the researchers and the committee of officials. The Credit Union Central chose to restrict its brief to a criticism of the procedure governing conduct of the study.

Requests by La Fédération and La Caisse Populaire de Shippagan to be permitted to make verbal presentations in relation to their written briefs were accommodated. At the invitation of the officials committee, the President and General Manager of the Credit Union Central appeared to present the Central's brief referred to above and to answer questions concerning several of the issues under study. The views which they expressed were presented as personal opinions since the Central had not developed any policy positions to be presented.

The research conducted by Professor Bird and Professor Roy has been very extensive. The materials included in the study were voluminous and were drawn from sources within New Brunswick and from other Canadian jurisdictions. As experienced and knowledgeable researchers who have not been directly involved in either the regulation or operation of credit unions/caisses populaires, they have been able to approach the task with complete objectivity, without any preconceived solutions or biases.

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While the researchers consulted extensively with the committee of officials in the course of their research, the report which they have presented does not purport to express more than their findings and recommendations. It should not be viewed as representing official policy or recommendations of the Law Reform Branch, the Department of Justice or the Government. Such recommendations and policy will be developed only after interested parties have had an ample opportunity to study the researchers' report and to react to it.

Since there are demonstrable differences of opinion within the credit union movement in relation to several substantial issues, it is to be expected that the researchers' recommendations will not be supported by all interested parties. It is to be hoped, however, that the reasons offered by the researchers in support of their recommendations will be duly considered and addressed in the responses to the report.

Those who wish to make representations on the report are invited to do so in writing by June 1, 1988. The written brief should identify the specific recommendations to which the representations relate. Those who wish to have the opportunity to appear in person to speak in support of their written

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submissions should include that request when submitting their briefs. Arrangements will be made for personal appearances after the June 1st deadline when all such requests have been received.

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CREDIT UNION/CAISSE POPULAIRE STUDY

January 29, 1988

Richard Bird
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OUTLINE

CHAPTER I

Philosophy of the Credit Union/Caisse Populaire Movement and Direction of Report

Credit Unions and Caisses Populaires are the financial arm of the cooperative movement. Like other cooperatives, at the heart of the movement is the guiding principle of self-help. Through mutual cooperation, those members of the community (bonded together geographically or having a common bond of occupation or association) having surplus money can make it available to those in need of money. The former are encouraged to save and the latter are provided credit under mutual administration to their mutual advantage. One group is to receive a fair rate of return on their savings while the other is provided credit at reasonable rates of interest. This central idea of an organization founded on the principle of self-help rather than profit has traditionally been a primary feature of the credit union/caisse populaire movement. Should there be surplus earnings from this arrangement, they are distributed back to those that created them in the form of patronage refunds to the borrowers and patronage dividends to the lenders. Either way, any surplus belongs to the members.

Management and membership in credit unions and caisses populaires are strictly along democratic principles. Share capital requirements are usually kept at a minimum to encourage individuals to join the movement. Thus, for a nominal amount (usually $5) one can become a member of a credit union or caisse populaire. Through the rule of one person/one vote rather than control based on investment, management along democratic principles is assured.

Sometimes credit unions and caisses populaires extend cooperative principles into the community through education. As such, the movement often plays an important social role in the community, not only in the financial field, but in all aspects of life. This has been particularly true in the Acadian sector of the Province.

While credit unions and caisses populaires are part of the cooperative movement, they are also a significant part of Canada's financial system. They compete with the "four pillars" of the system. The four pillars have been identified as the chartered banks, insurance companies, trust companies, and securities firms. The differences between the four pillars and credit unions and caisses populaires have, with time, become less and less clear and the latter are sometimes referred to as "near-banks". The more that these institutions offer similar services and actively compete with one another, the more arguments that can be made for a similar legislative framework. Credit unions and caisses populaires as deposit-taking institutions often resemble their branch bank counterpart with chequing accounts, daily interest savings, and automated teller machines. In fact, it appears that the latter two originated in the credit union/caisse populaire movement. Just as there has been concern to protect depositors in the other financial pillars, similar concern has existed in the credit union/caisse populaire movement. In addition, as the competitive element has spread among the four pillars, so too has it affected the credit unions and caisses populaires. To some extent they are competing for the same deposits and, to be competitive, they must be able to offer competitive services at competitive prices. Such competition often influences attitudes towards such topics as investment powers, loan policies, patronage dividends, liquidity and deposit insurance.

While credit unions and caisses populaires have much in common with the other financial pillars, there are important differences. In the case of the other financial pillars, the services are provided by the owners of capital who put their money at risk to provide services to others for profit. For example, in the case of loan companies, New Brunswick legislation requires the minimum paid up capital to be $3 million. The purpose of such a requirement is to provide a measure of protection to depositors. That protection results from the rule that should some of the loan company's investments and loans prove to be bad or uncollectible, it is the shareholders who will first suffer, not the depositors for, in the case of liquidation, the depositors will be paid back before the shareholders. On the other hand, should there remain a surplus, it will belong to the shareholders. In the case of credit unions and caisses populaires, the depositors are also the shareholders. Here it is somewhat artificial to think of a person's share capital or surplus earnings as providing a measure of protection for one's deposits. If a member has $5 in share capital, $95 on deposit and if his share of the undivided surplus is $5, the member has $105 at risk no matter what nomenclature is used. As long as the shareholder and depositor is the same person, share capital requirements do not serve the same purposes as in many other institutions. This aspect, that the depositors are also the owners of the share capital and surplus, creates the greatest problem and, concurrently, the greatest challenge to the credit union/caisse populaire movement in meeting the competition of the other financial "pillars".

The philosophy of the cooperative movement and its position in the financial system is also relevant when considering the regulatory framework in which it is to operate. On the one side there is the argument that credit

unions and caisses populaires, as self help organizations that are owned by the lenders and borrowers and managed by them should, for the most part, be free to act in their own self interest. Any regulation should be facilitative rather than restrictive so that they may grow and develop as their members best see fit. From this viewpoint, credit unions and caisses populaires are like any other cooperative and if one followed this philosophy completely, one might even make a case for bringing credit unions and caisses populaires under the more general Cooperative Associations Act.

However, most agree that any deposit-taking institution should be subject to greater regulation and more stringent control than other organizations. The main reason is to assure, as much as possible, that the savings of an individual that are put on deposit will be there when that individual would like their return. In one sense, because there is no separate fund of owner's capital to protect depositors in credit unions and caisses populaires, control of the use of funds put on deposit is all the more important. On the other hand, one can argue that since every member has an equal say in the management of the credit union or caisse populaire he should be allowed to decide, in his own self interest, how the funds are to be managed.

In the past, the approach has been, and should continue to be, to allow credit unions and caisses populaires as much as possible to develop in the manner they think best in the cooperative tradition. Pursuant to this philosophy, unless there is a good reason to the contrary, the principle of personal freedom to decide one's own destiny should prevail. The case to the contrary to this approach appears to be based on the growth of some credit unions to near bank status. It would appear that some view their deposits with

a credit union as an alternative to a bank and the share requirements a mere technical formality. Such depositors are willing to leave the matter of management to professionals hired by the credit union or caisse populaire and have come to expect dividends as a matter of right, whether profits are earned or not, just like the interest one would receive at a bank and also to have their deposits and share capital fully insured. To be competitive with other financial institutions, this attitude may require that credit unions and caisses populaires offer services that are as equally attractive, in other words, as much depositor protection as their competitors. The expectations of and the role to be played by government depends in large part, on which view one holds of the movement. In a truly cooperative setting, little regulation may be necessary for the movement to flourish. From the near bank view, substantial regulation (and possibly deposit guarantee) may be necessary to maintain depositor confidence. In either case, there are limits which no prudent credit union or caisse populaire would go beyond. In the interest of the movement, it is proposed to define those limits as much as possible and maintain supervision of them to assure the public that these limits are not exceeded. Apart from those limits, it is recommended that the credit union/caisse populaire movement be encouraged and permitted to provide and develop financial services for its members in the cooperative tradition.

CHAPTER 2

Protection of Deposits

I. Loan Policies

The primary objective of credit unions and caisses populaires is to provide a means of savings and to provide loans to their members at reasonable rates of interest. These funds are obtained from a variety of sources, including loans made to the credit union or caisse, share capital and most importantly, from deposits made by members. The desire to accommodate the needs of members requiring a loan must be weighed by the credit union or caisse against its obligation to protect the assets of depositors. A good loan portfolio will provide a return for depositors, a bad portfolio could mean the loss of a depositor's savings. In fact, the loan portfolio is the single most important asset of the credit union or caisse populaire. In 1986 loans accounted for 79% of all credit union and caisse populaire assets or 86% of share capital and deposits in New Brunswick. (New Brunswick Credit Unions, Annual Report, 1986) By comparison, all other controls and regulations designed to protect depositors are of relatively minor importance. In theory, a sound loan portfolio should make most other regulatory restrictions superfluous.

A Diversification

In general, the granting of loans is a policy decision that should be left to the individual credit unions and caisses populaires. Proper training and good management practices are more likely to bring about the success of a credit union or caisse populaire than anything else. However, it is not

inappropriate to establish the outer limits that no credit union or caisse populaire would prudently go beyond if the best interests of depositors are to be taken into consideration. The current philosophy towards prudent management is to maintain a diversified portfolio so that should a certain category of loans prove to be uncollectible, it will not cause the insolvency of the credit union or caisse. This diversification is effected by limiting the size of loans to any one member (limitations both in absolute terms as well as a percentage of assets); by limiting the size of loans that can be made without security (presently referred to as character loans); by restricting the size of certain types of loans and the total amount of loans of that type that can be made (e.g., business loans).

The reason for maintaining a policy of diversification becomes obvious when one considers that if members are going to receive their full deposits and share capital back, losses can only be made good from profits. Consider 10 loans of $100 each made from deposits and share capital totalling $1000 where the borrowers are each charged interest at the rate of 10%. Assuming the credit union or caisse has no expenses and one loan proves to be uncollectible in total during the year, the credit union will only have 9 loans x $100 + 10% = $990 to meet the claims of deposits that still total $1000. The credit union is $10 short because the loss has exceeded revenue by that amount. Diversification spreads this risk and in doing so reduces the impact of any one default. The security of the members' deposits is essential to the health and success of the credit union/caisse populaire movement. Here the best interests of the depositors and the movement merge and thus it is proposed that the rules requiring diversification continue to be required by law.

At present, pursuant to section 44 of the Act, the Regulations divide permitted loans into three classes: personal loans, real estate mortgage loans and business loans. The first category has four sub-categories, three of which relate to the manner of repayment. The fourth sub-category of personal loan, "a loan made in connnection with farming, fishing or forestry", may be viewed as being closer to a business loan than a personal loan (N.B. Reg. s.11). No more than 50% of the assets of a credit union or caisse populaire can be placed in mortgage loans (N.B. Regs. s.12(4)), no more than 60% in mortgage and business loans combined (N.B. Regs. s.12(5)); no more than 20% in business loans alone (N.B. Regs. s.13(3)), no one individual business loan may exceed 5% of assets (N.B. Reg. s.13(4)) and no unsecured personal loan ("character" loan) may exceed $5000. (N.B. Reg. 14(3)).

It is recommended that new limits be enacted that would ensure at least à minimum diversification of the loan portfolio of each credit union and caisse populaire. Because these limits are likely to change over time, they are best handled by regulation. It is also hoped that these limits will be recognized by individual credit unions and caisses populaires as the outer extremes and that each individual credit union and caisse populaire will develop policies that will surpass these limits towards even greater diversification.

Any limitations are somewhat arbitrary. However, tying loan limits to equity, whether share capital or surplus has some justification provided that one is justified in distinguishing between deposits on the one hand and share capital or surplus on the other. For example, if one objective is to maintain a ratio of deposits to equity of 20:1 or, put another way, equity should be at least 5% of total assets,then prohibiting any single loan from exceeding 5% of assets would mean that if that one loan should prove a total loss, repayment of deposits is still possible. The previous example

illustrates the tenuousness of the system more than it reflects the wisdom of choosing a figure as high as 5%. On the other hand, a lower figure may be impractical for small credit unions or caisses. Hopefully larger ones would always want even greater diversification and would never loan 5% of assets to one member as a prudent management philosophy. In addition, appropriate security should mean that a total loss should seldom occur. There is another way of looking at the limitation as well. If deposits, share capital and surplus are looked upon as, in reality, one account, at interest rates of 10%, one total loss of 5% of assets wipes out about 50% of operating revenue for the year. Either way the question is approached, the 5% test as a minimum standard is justified. The position of the chartered banks on this issue is informative:

> The size of individual loans is another factor in solvency problems. In the 1970s, many institutions granted individual loans that were very large. The Inspector General of Banks, in 1982 testimony to the House of Commons Standing Committee on Finance, Trade and Economic Affairs, revealed that there were four loans outstanding to a single borrower that exceeded $500 million and 15 other loans also in excess of $500 million to connected companies with closely related risks. He observed that such large loans created "fragility within the banking system," adding that he was "concerned that the system was running ahead of what [he] considered to be prudential limits." He also indicated that he had informed the banks that total loans to any borrower should not exceed 50 per cent of a bank's shareholders' equity and preferred shares. In some cases, the amount of the loans had been equivalent to 75 to 100 per cent of the lending bank's capital. (The major banks subsequently announced that they were restricting loans to a single borrower to 15 per cent, and those to associated borrowers to 25 per cent, of the bank's total capital.) "A Framework for Financial Regulation", 1987 at p. 48).

It is therefore proposed that credit unions and caisses populaires not be permitted to loan more than 5% of their assets to any one member.

The question must also be asked whether prudent management would dictate that under any loan policy, a credit union or caisse populaire should not make loans to any one member exceeding a specified monetary amount. For example, should credit unions and caisses populaires be prohibited from making real estate mortgage loans to any one member exceeding, say, $100,000? Most people would say "no" provided that the credit union or caisse populaire received adequate security and concluded that it was reasonable to expect that the mortgagor would make the necessary payments to retire the loan. Unless such a limitation were abnormally high, it might force some of the more affluent members to take their business elsewhere. Thus, it is not proposed to establish any general monetary limits on loan policies.

In the interests of the movement, two general points remain. Credit unions and caisses populaires vary greatly in size, experience, personnel, and services offered. Because they are so varied, it is virtually impossible to draft one set of rules that will adequately serve all credit unions and caisses. It is therefore proposed that while each credit union and caisse have the power to draw up their own lending policies within the limits described (for example, the lending limits imposed on managers or loan committees) these policies should be subject to the approval of the new proposed deposit insurance corporation. The second point that must be reinforced is that legislation cannot replace good management. It is hoped that the federations will continue to provide training and assistance in the management of credit unions and caisses with particular reference to loan policies.

The one exception to the current rule regarding monetary limits is unsecured ("character") loans. The present limit is $5000 (N.B. Reg. s.14).

In at least one brief to the committee it has been suggested that this limitation should be replaced by a discretionary power vested in the federation to which the credit union or caisse populaire belongs to limit the maximum amount permitted under this category on an individual basis. Complete statistics regarding loan losses by category are not available but it appears that character loans have not created the major problems. It is proposed to increase the monetary maximum to $20,000. Of course,the 5% control test will also apply so that only credit unions and caisses populaires having assets of at least $400,000 would be able to make loans of this size. In addition, it is recommended that with such an increase that some limitation should be placed on the smaller credit unions and caisses populaires. To maintain maximum flexibility, the proposal that a discretionary power to approve individual loan policies be vested in the new deposit insurance corporation should provide sufficient flexibility to balance the needs of borrowers and depositors. It should be emphasized that even though it is recommended that an individual credit union or caisse populaire be permitted to make unsecured loans up to $20,000, there may be circumstances where individual credit unions and caisses populaires would not be acting prudently in doing so. It is reemphasized that outer limits are being proposed that are not to be exceeded. Prudent credit committees will not consider these limits as a norm.

As has been already pointed out, credit unions and caisses populaires are currently restricted by three controls with regard to business loans. Business loans present the greatest challenge and the greatest risks for credit unions and caisses populaires. By entering the business loan field they are able to fulfill a major financial service required by their members. However, in the past, business loans have been the source of the greatest losses. It

has been estimated, for example, that in Saskatchewan, 90% of all bad debt write-offs are for business loans (Schroeder, Dennis, Deposits Fully Guaranteed, 1983, p. 103). In the analysis of two specific instances in New Brunswick, business loan losses accounted for 77% and 85% of the total losses. The reason for this high ratio to other types of loans probably relates to the low level of recovery on the bankruptcy of businesses. Because of this risk, credit unions and caisses populaires must proceed cautiously in the commercial lending field.

In the interests of depositors, it might be argued that business loans should be prohibited outright. Evaluating the risk is difficult. Many jurisdictions have required special approval procedures with the intent of giving commercial loans close scrutiny by knowledgeable individuals. Even then some might question whether the expertise is available to evaluate the risk. Also, a major business failure could have a major impact on the financial stability of a credit union or caisse populaire. The more general solution, however, is often to legislate a maximum percentage of commercial loans permitted in the loan portfolio. The Alberta Task Force on Credit Unions recommended the maximum aggregate of the commercial loan portfolio not exceed 25% of the total loan portfolio (Alberta Task Force Report p. 61). New Brunswick already restricts business loans to 20% of assets and it is recommended that this restriction be continued but also add to the category, the present fourth sub-category of personal loans, i.e., loans made in connection with "farming, fishing or forestry". There is the possibility that the transfer of farming, fishing or forestry category to the business loan category may cause the commercial loan portfolio of some credit unions and caisses populaires to exceed the 20% limit. Thus, credit unions and caisses

populaires must be given some time to bring their loan portfolios within the new guidelines. It is recommended that if the new proposals put any credit union or caisse populaire over the new limits that they be given a one year exemption from the new requirements. Even that may not be necessary, the one caisse populaire that was thought most likely to have a problem with the proposed change still would be 2 percentage points under the maximum acceptable based on its December 31, 1986 unaudited financial statement.

As the Regulations require that loans be classified as previously noted, by implication, only those classes of loans are permitted. One brief has recommended that a new category be authorized, "institutional" loans. Proposed for inclusion in this category were, among others, municipalities, non-profit corporations, crown corporations connected to hospitals, health care institutions, school boards, senior citizen homes, nursing homes, government agencies and religious organizations. The proposed broadening of lending powers as suggested is informative of the development that has occurred in the credit union/caisse populaire movement. Whereas formerly the movement aimed at providing services to individuals, it is gradually moving toward a more general mandate and more permanent social position. It is doubtful that many of these loans would involve any more risk than business loans (and it is obvious that many are much less risky) and, therefore, it is recommended that two new categories, rather than one, be created. One category, the less riskier group, would include, for example, municipalities and school districts. There is no need for special controls on lending to this group. Section 46(1)(a) of the Loan and Trust Companies Act could serve as a guide to define this category. The second category would include those institutions that are not government guaranteed. For this group it is recommended they be subject to the same

overall controls as business loans until more experience is gained in this area. It must also be remembered that these institutions must be able to become members of the credit union or caisse populaire to qualify for the loan.

There is a trend elsewhere in Canada to require large loans and specific kinds of loans to be approved by either a stabilization board, a federation or a deposit insurance corporation. This requirement can be justified on two grounds. First, this second tier organization may be required to come to the rescue of the individual credit union or caisse populaire should that organization find itself in financial difficulty. This is most likely to happen if loans prove to be uncollectible and large loans and business loans are most likely to cause that problem. Thus, as the ultimate organization responsible, it is often given some control over the operations of the individual credit unions and caisses populaires. Second, many individual credit unions and caisses populaires do not have the resources to adequately analyze the risk of certain kinds of loans and the centralization of those responsibilities produces some economies of scale. On the other side, such a requirement takes away from the local autonomy of the individual credit unions and caisses populaires. There is a possibility that the movement, in reality, is becoming one organization of which the individual credit unions and caisses populaires are being reduced to the status of branches. This may be seen as a fundamental change away from the co-operative principles of self-help and democratic control. The first step in this evolution may have been the earlier imposition of the requirement that each credit union and caisse populaire must belong to a federation, a move to which at least one caisse populaire has strenuously objected.

Elsewhere it is proposed to require each credit union and caisse populaire to contribute to a deposit insurance scheme that would replace the stabilization funds. While we are conscious of the desirability of maintaining local autonomy, the area of business and institutional loans is of sufficient concern that overall direction by another level in the movement is warranted. Such overall supervision should be to the mutual advantage of the individual depositors, individual credit union or caisse populaire and to the new deposit insurance corporation. It is proposed to delegate to the deposit insurance corporation broad supervisory powers regarding commercial and institutional lending. Lending powers of each credit union and caisse would be subject to the approval of the new deposit insurance corporation. Lending limits of each credit union and caisse can thus be varied depending on the expertise of the lending officers, general manager, loan committee and board of directors of each unit. Authority can then, if desired, be varied also by type and size of loan.

The Gunn Report suggested that in order to further diversify risk, particularly for business loans, that credit unions and caisses populaires should consider syndication of such loans. Not only does this have the effect of diversification but where a federation or one credit union or caisse populaire takes the lead, it also produces economies of scale and utilizes the expertise of that organization in the commercial lending field that might not be available at the individual credit union and caisse populaire level. We understand that some syndication now takes place. It is proposed to continue to permit such syndication but not to require it. This will permit the movement to continue to develop in a manner it determines to be in its best

interest. On a technical note, such loans should not require the borrower to obtain membership in every credit union and caisse participating in the syndicate.

B Overdrafts

The provision by credit unions and caisses populaires of chequing account services has led to the, probably inevitable, problem of overdrafts. Some jurisdictions have taken the "hard" line and prohibit them (see Manitoba, The Credit Unions and Caisses Populaires Act, Man. Stats. 1986-87, ch.5, s.45 and Nova Scotia, Credit Union Act, s.42). But even in these two jurisdictions, exceptions are provided. Practicality and consistency are best maintained if overdrafts are treated as unsecured (character) loans and only permitted under the same circumstances and subject to the same conditions as unsecured loans. Thus it is recommended that section 23.1 of the Credit Unions Act be amended to put the approval of overdrafts on the same basis as unsecured loans.

C Prepayment of Loans

In the cooperative spirit of promoting thrift and encouraging members to save, it is almost axiomatic that borrowers should be permitted to repay their loans at anytime. This right may, however, create a major (and maybe even, the classic) problem for any financial institution. Successful management requires matching the return on loans made with the returns expected on deposits. In a market of falling interest rates, there will be an incentive for borrowers to repay their loans to the credit union or caisse populaire and reborrow at the lower rates. At the same time, if the credit union or caisse has borrowed elsewhere, it may be locked-in at the higher interest rate. A

drop in interest rates below the borrowing costs of the credit union or caisse could obviously put it in a deficit position. Borrowers of money secured by mortgage of real estate for terms in excess of 5 years now have the right to repay their loans with a 3-month interest penalty. However, loans in excess of 5 years are not common.

At present, by Regulation 10(5) New Brunswick permits the prepayment of loans without penalty, in full or in part on any day that the credit union or caisse populaire is open for business. Manitoba has a similar provision but with an express obligation on the part of the credit union or caisse populaire to match the term and return of investments and loans with the term and return of member deposits (The Credit Unions and Caisses Populaires Act, ss.42(2), 49)). Alberta, on the other hand, has recommended that their provision permitting repayment be repealed. (Task Force Study, September 1985, p.60). In one brief, it has been suggested that if the right to prepayment is to be continued that the member at least be responsible for the administrative costs. Most lending institutions deduct the direct costs of loans at the time of their making and thus it is not necessary to enact any special provisions regarding costs at the time of prepayment. In any event, any such legislation should be part of the general law relating to interest and credit and not part of credit union/caisse populaire legislation.

In the cooperative tradition, it is proposed to continue to permit members to prepay loans but it is proposed to give each credit union and caisse populaire the opportunity to control this right with or without penalty through their by-laws, subject to any applicable general rules of law.

II Capitalization, Liquidity & Reserves

A. Capitalization & Surplus

Traditionally, share capital is intended to provide a margin of protection for creditors of corporations against losses. In theory, if a corporation whose financial position is properly balanced incurs a loss, the share capital should provide a sufficient cushion against the loss so that the claims of creditors can still be met by the corporation. Put another way, in the case of a loss, the share capital is the first to go. In the case of credit unions and caisses populaires, the theory (and purpose) has become somewhat obscured. First, because depositors must be members (and thus shareholders) each depositor has at least two accounts with the credit union or caisse populaire. There is his share capital account (which he might view as also including a proportionate share of any surplus) as well as his deposit account. It would appear that some depositors see this distinction as a mere technicality, even to the point where they would like to have both accounts insured. Second, even if the distinction is made and maintained, it is artificial to say to a depositor that his share capital account provides some protection for his deposit account. For example, if one were to require share capital to be at least 5% of assets, this is really just saying, as a practical matter, that for every $100 advanced by a member, only $95 can be placed in the deposit account and the other $5 must be placed in the share capital account. Of course, it must be recognized that some share capital comes from members who are borrowers instead of lenders.

The distinction between share capital and deposit accounts is theoretically difficult to justify. One might argue that the share capital account does provide some protection for creditors of the credit union or caisse populaire who are not depositors. Two points are relevant here. First this is not the group with whom we are primarily concerned. The availability of equity may, however, be important to obtain external borrowings. Second, they may be able to have their debts paid in priority to depositors under the Bankruptcy Act in any event. (see Laronge Realty Ltd. v. Golands Investments Ltd. et al. (1986), 7 B.C.L.R. (2d) 90 (B.C.C.A.) In summary the only protection that a depositor receives from the share capital account is to the extent that the proportion between his deposit account and his share capital account is not the same as other members. The less the member has in the share capital account relative to other members, the more protection he is afforded.

For profit making institutions this is not the case. Share capital of owners does provide a measure of protection to depositors. There appears to be a general trend towards the objective that share capital equal, at a minimum, 5% of assets for such financial institutions. The popular view of the proper relationship between debt and equity for financial institutions is 20:1, or, in other words, equity of 5% (See Canadian Bankers Association Brief, Jan. 23, 1987). This ratio is thought to create some confidence in the public that upon making a deposit, the deposit has a measure of protection. To ask a credit union member to, in some fashion or another, put up that 5% equity is, in reality, another way of saying that we want to use $5 of every $100 of member's assets to protect the other $95. Unless the $5 comes from some source external to the member, the protection is illusory. To the extent a member

does not see a proportionate share of the surplus account as his own, the retention of these funds can provide a measure of protection. This is the compromise approach taken or recommended by most other jurisdictions. Both Ontario and Manitoba have set an objective of capital and surplus constituting 5% of assets for credit unions in those jurisdictions (See Ontario, Program for Change, August 1986, p. 5; Manitoba Discussion Paper, Manitoba Cooperative Development Issues and Recommendations, N.D., p. 22).

The practical difficulty such an objective creates is that the retention of such surplus can only come at the expense of patronage dividends and patronage refunds. Thus it is not uncommon to give individual credit unions and caisses populaires considerable time to build the reserves. The Ontario Report, Program for Change, August 1986 proposed to build the capital and surplus of credit unions and caisses populaires to 5% of assets over a five year span (Report p.5). Following consultation with the movement, the plan has been modified to aim for capital to constitute 2% and surplus to be 3% no later than 1997. The proposal also "includes an exemption clause to use when the required level is unattainable" within the 10 year time period. (Modification to Proposal for Change, March 27, 1987, p.2). Until such levels are reached 20% of net earnings before dividends will be required to be contributed to surplus each year in order to attain surplus levels in accordance with regulations. (Ibid., p. 2) In conjunction with this, Ontario has proposed that share capital not be covered by deposit insurance. To augment this position, Ontario intends to define capital as shares held as a condition of membership.

Since share capital can be withdrawn at any time by the members, we have questioned the wisdom of including such capital as part of the protection reserve requirements. It has been suggested that the reserve requirements be

made up solely from surplus. Such a practice might limit the payment of dividends and patronage refunds, but would certainly increase confidence in the protection offered to members with regards to their deposits.

As of December 31, 1986, the surplus accounts of all of credit unions and caisses populaires in New Brunswick were 4.02% and 4.17% of total assets respectively. These figures include the guarantee reserves, undistributed surplus and advances to the mutual aid fund, but do not include the current surplus accounts, since these amounts are reported on a before dividend basis. However, since these funds were probably not wholly distributed in the form of dividends or rebates, the above percentages could be slightly higher. We should also point out that allowances for doubtful loans are included in the guarantee reserve accounts. In the future, we recommend that such allowances be accounted for as direct charges against current income and thus will not be considered as part of the guarantee reserve. We think that, since the amounts which have been advanced to the mutual aid fund are completely recoverable, and in fact will be returned over time (see recommendation re contributions to the Deposit Insurance Corporation), these amounts should also be considered as part of the surplus.

Given the above figures, we think that an objective of building the surplus accounts of credit unions and caisses populaires to 5% of assets over a reasonable time span (i.e., 5 years) seems realistic, and such a requirement should not impose unreasonable restrictions on the payment of patronage dividends and patronage refunds to the members.

What the objective means in reality is that in the self-help tradition, the movement collectively should use some of their undistributed earnings to protect the actual savings (i.e., deposits) of all members. It

means that in good times members must forego some dividends so that if there should be bad times, their savings have some shield of protection. This shield would be that the first 5% decrease in assets (i.e., losses) would come from capital and surplus rather than deposits. This would help to put credit unions and caisses populaires on a similar basis in meeting competition from other financial institutions for deposits.

It is recommended that New Brunswick credit unions and caisses populaires be required to build their undistributed surplus to 5% of assets over a five year span. Until such levels are reached, it will be necessary to require that credit unions and caisses populaires contribute a certain amount of their net earnings before dividends to surplus each year in order to attain the required reserves. The aforementioned Ontario requirement that an amount equal to 20% of net earnings before dividends be contributed appears, at first glance, adequate. However, the 20% contribution will only attain the required 5% level under certain specific circumstances. For example, if we consider the case of a credit union or caisse which has $1,000,000 of assets, the 20% requirement will only achieve the required 5% level within the five year limit if the following two conditions exist.

1 - The credit union or caisse earns a net return before dividends of at least 5% of total assets (i.e., $50,000 of net earnings).

2 - The assets of the credit union or caisse do not increase.

In such a case, the 20% yearly contribution of $10,000 will enable surplus to attain the required 5% of assets level (i.e., $50,000) within the five year limit. Of course, any credit union or caisse whose net earnings before dividends are greater than 5% of assets, and, whose asset growth is static or minimal, can attain the 5% required surplus level well within the five year limit. However, such would not be the case for credit unions or

caisses populaires whose net earnings before dividends were less than 5% of total assets, or, who are experiencing asset growth.

Contributions to surplus based on total asset value rather than net earnings would eliminate most of the problems referred to, for example, a yearly contribution of 1% of total assets will achieve the same result as the 20% of net earnings approach for any credit union or caisse whose asset growth is static or minimal. However, unlike the 20% of net earnings approach, a simple model can be devised for those credit unions and caisses populaires whose asset growth is more than minimal. The model is illustrated by the following Table I and further confirmed by Table II in Appendix A.

TABLE I Yearly percentage contribution (Percent of total assets) required in order to attain a surplus level equal to 5% of total assets within five years

% Asset Growth	% contribution to surplus	% asset growth	% contribution to surplus
0 - 2.5%	1.0%	25.01% - 30.0%	1.6%
2.51% - 5.0%	1.1%	30.01% - 35.0%	1.7%
5.01% - 10.0%	1.2%	35.01% - 40.0%	1.8%
10.01% - 15.0%	1.3%	40.01% - 45.0%	1.9%
15.01% - 20.0%	1.4%	45.01% - 50.0%	2.0%
20.01% - 25.0%	1.5%		

We therefore, recommend that until the undistributed surplus attains 5% of assets, every credit union and caisse populaire be required to contribute

from their yearly net earnings before dividends, to their undistributed surplus account, an amount equal to at least 1% of total assets.

The actual percentage contribution would be determined in compliance with Table I, subject to exemption by the Registrar, based on the percentage growth in assets for each credit union and caisse populaire. (For a more detailed illustration of the model, see Appendix A).

Concern was expressed that the 5% requirement for some caisses populaires and credit unions is not attainable within the five year limit and that for others, it would seriously limit the rate of dividend that they could pay to members. Based on the information contained in Table II as of December 31, 1986, 28% of the caisses populaires and 30% of the credit unions had reserve accounts that were equal to approximately 5% of their total assets. Table II further indicates that 80% of the caisses populaires and 65% of the credit unions had reserve accounts equal to at least 3% of total assets. It is understood that the implementation of the recommendation with respect to doubtful accounts would result in a reflection of lower percentages of reserve levels than those set out in Table II. Nevertheless, even when one takes into account that the percentages reflected in Table II include the Guarantee Reserves for doubtful accounts without a concurrent adjustment for doubtful accounts, for those credit unions just referred to, a reserve account equal to 5% of assets within five years would seem attainable without imposing undue hardship on their ability to distribute adequate returns to their members. It has been suggested to us that the portion of undistributed surplus that is required to be placed in the reserve account may be circumvented by a credit union or caisse populaire avoiding having any surplus by paying interest on deposits rather than patronage dividends and thus not included in the calculation of surplus for the purpose of determining the required contribution to the reserve account.

Table II. Caisses Populaires and Credit Unions Reserve accounts as a Percentage of total assets as at December 31, 1986, including the guarantee reserve. 1

		5% +	4-4.9%	3-3.9%	2-2.9%	1-1.9%	0-0.9%	Deficit	Total
Caisses Populaires	Number	24	21	25	10	7			87
	Percentage	27.58	24.14	28.74	11.49	8.04			100%
Credit Unions	Number	11	9	4	7		5	1	37
	Percentage	29.73	24.32	10.81	18.92		13.51	2.70	100%

1. The data appearing in this table was collected from December 31, 1986 unaudited financial statements. It should be noted that the data includes the Mutual Aid reserves, undivided earnings and other reserves, and includes the Guarantee reserves for doubtful accounts without any adjustments for doubtful accounts, and does not include current surplus for the year.

For some caisses populaires and credit unions, it may be difficult to attain the required 5% of assets level within the five year limit. It is recommended that the registrar be authorized to permit a caisse populaire or credit union to defer making any or all of the allocation to surplus if undue hardship is established. Any such deferral should be noted in the financial statements.

It should also be noted that the 5% capitalization requirement would mean that a credit union or caisse populaire would not be permitted to pay dividends where by borrowing funds or accepting new deposits it would not be maintaining the required 5% capitalization level.

B. Share Capital and Membership

It has been suggested that the movement might be better served if individual membership in a credit union or caisse populaire were increased from the traditional $5 share to $50 or $100 and that a credit union or caisse populaire be required to have 500 members before it be permitted to carry on business. This proposal has merit if share capital is seen as providing depositors some protection from losses. It has particular advantages where the credit union or caisse populaire has no surplus in the initial year of operations. We think, however, that the protection is illusory if the persons providing the capital are the same as the ones making the deposits. We therefore do not recommend requiring such but the law should be clear that individual credit unions and caisses populaires can impose such terms if they should so desire. By not imposing a membership requirement greater than the present 10 members possible further expansion of the movement is encouraged. It is recommended that if a credit union or caisse populaire chooses, it can have its share capital included in the calculation of the proposed 5% reserve requirements. However, should it so choose, the share capital should not be paid back to the members until it is replaced by other share capital (by new memberships) or by the allocation of surplus to the reserve account.

One brief also recommended that the legislation should permit an associate class of membership. The purpose of such a class is to allow

individuals who at one time met but no longer meet the membership requirement of residence or common bond of occupation or association (see Credit Unions Act s.18). It has been said that some persons who leave the territory or bond are no longer eligible for membership but would like to continue their affiliation. Some jurisdictions (Manitoba for instance) permit such individuals to maintain associate membership. They are given all the privileges of members except voting and holding office. In Manitoba the number of associates may not exceed 1/4 of the number of full members. In our opinion, the problem can just as easily be handled by making it clear that the membership requirement must be met at the time of taking out the membership and not a continuing one and thus enabling the credit union or caisse to grant every member the right to participate in the management of the credit union or caisse. However, if a credit union or caisse wants to require resignation when a member leaves the common bond, it should be permitted to do so by by-law.

C. Patronage Dividends

Patronage dividends have been the traditional way that the cooperative movement has rewarded those who have taken part in the system. Where operations produce a surplus, it can be shared in the form of a rebate of charges levied and as a dividend for those who have provided funds for operations. One difficulty that has arisen is that some credit union members have viewed the dividend as a substitute for interest that they would have received as a matter of right had they made their deposit at a bank. With this attitude, some members have come to expect "their dividends" whether the credit union or caisse has had a profitable year or not. Some credit unions or caisses have argued that the "dividends' must be paid in such circumstances in order to keep the depositors. The pressure to pay such dividends hinders the

accumulation of surplus and, at times, has even eroded capital.

At present, the distribution of surplus, declaration and payment of dividends is regulated by section 26(3) of the Act and section 19 of the Regulations, enacted pursuant to section 44(n) of the Act. It appears that these provisions were intended to restrict the payment of dividends out of net surplus. However, it appears that some credit unions and caisses populaires have interpreted the provisions as not imposing limitations but only as an authorization and concluded that other dividends are permitted. The result has been the payment of dividends while in a deficit position. Sometimes a stabilization board has made a contingent loan or a grant to enable the credit union or caisse populaire to pay a dividend. Sometimes it has merely condoned the payment. It is recommended the legislation be clarified to make it clear that dividends are only to be paid out of surplus. To pay dividends out of capital is an illusion. In effect the member is receiving a return of capital, or worse, a portion of his deposit back as a dividend. If the credit union or caisse populaire should be wound up, it would mean that those who withdrew their share capital and deposits first would profit at the expense of others or, more likely, a stabilization board would cover the deficit and, in effect, underwrite the dividend. Either scenario is contrary to the fundamental principles of financial cooperatives.

D. Liquidity and Reserves

As a deposit taking institution, credit unions and caisses populaires must always be cognizant of the fact that at any moment in time some depositors will want to withdraw some or all of their deposits. Obviously if all of the depositors' money has been loaned to other members, the credit union or caisse

populaire will not be able to meet the demand of the depositor. The movement, however, operates on the assumption that not all of the members will want all of their deposits at the same time. To safeguard against the possibility of a run on deposits there is general agreement at the national level that at least 10% of deposits, share capital and borrowings should be held in cash or in a form readily convertible into cash to meet withdrawals. One brief, however, received suggested a figure of 8%. At present, the rules regarding liquidity in New Brunswick vary depending on the type of deposit made by the member. At present, the actual liquidity rates maintained by the movement in New Brunswick overall may be closer to 18%. Some may see this as an overly conservative management of credit union and caisse populaire assets.

Within most jurisdictions, the assets that qualify as liquidity investments include cash on hand, cash deposits with other financial institutions such as chartered banks, and cash deposits with a central or federation. In fact, one of the major functions that has been assumed by centrals and federations is to provide a liquidity service. The Brunswick Central has joined the Canadian Cooperative Credit Society (CCCS) which provides even greater diversification of the liquidity function. The CCCS has introduced a policy whereby each individual credit union is supposed to keep 2% of its assets in liquid form to meet daily needs, the remaining 8% is to be forwarded to the Central which in turn forwards at least 2% to CCCS. In return, CCCS provides the Central with a line of credit for liquidity purposes. It has been represented to the committee that the 10% requirement has worked well but that not all members of the Central have advanced 8% of their assets to the Central but have opted to use other investments to meet their minimum liquidity requirements. It was suggested that the 2%-6%-2% formula should be

legislated. We recommend against this approach on two grounds. First, La Federation is not a member of CCCS and thus the formula is inappropriate for that branch of the movement. Second, in the cooperative tradition the Central can, if it wishes, impose as a condition of membership, that each credit union and caisse populaire comply with the 2%-6%-2% policy. We think that it is sufficient to legislate the overall liquidity requirements and leave it to the individual centrals and federations to decide for themselves if they want to impose further restrictions. We, therefore, recommend that liquidity reserves amounting to 10% of deposits, share capital and external borrowings be required.

Currently, the New Brunswick Credit Union Federations Act, section 25(3) requires "that a federation, which is not a member of C.C.C.S. shall, for the purpose of meeting withdrawals, maintain a reserve in cash or in readily convertible investments equal to at least 20% of all money deposited with it. We recommend that this requirement be increased to 25% in order to correspond to the 2% that will be forwarded to C.C.C.S. by a Central that is a member of this national third tier organization. For example, where a credit union or caisse has $1,000 of assets, it is required to maintain $100 (10%) in liquid assets. In compliance with C.C.C.S. and its Central's requirements, it forwards $80 (8%) to Central, which forwards $20 (2%) to C.C.C.S. The $20 forwarded to C.C.C.S. represents an investment, equal to 25% of the money deposited in the Central. We also recommend that regulation of the investment of the remaining 75% of the liquidity funds be provided for. We view it as inappropriate to require a credit union or caisse to keep its liquidity funds in cash and investments readily convertible into cash but permit the federation and central to invest 75% of these funds without any control. Consideration

may also have to be given to regulating the circumstances when deposits of these funds in the third tier will be permitted.

The availability of this 10% liquidity reserve to the individual credit unions and caisses populaires seems to be in doubt. One view is that this money can never be used to meet a run on deposits because to do so would immediately put the credit union or caisse in violation of the requirement. The "solution" that appears to be in vogue at the moment is for the central to grant the credit union or caisse populaire a line of credit. Apparently, drawings on the line of credit are not considered by the movement as a return of liquidity funds but treated as an independent loan and to emphasize the distinction, credit unions and caisses populaires must often give an assignment of some of their accounts receivable to secure the drawings on the line of credit. We find this distinction somewhat artificial. In our view, the intention of the liquidity requirement is to create a pool of funds that is available as a source of funds to meet withdrawals of members of credit unions and caisses populaires beyond normal cash flow requirements. However, once any of the 10% liquidity requirement of an individual credit union or caisse is used to meet withdrawals of its members, then that individual credit union or caisse populaire must then use all available assets as they come in to replenish its liquidity level to the required 10%. For example, if a Central advances funds to a credit union or caisse populaire on a line of credit, the advance should be regarded as a return of deposits. Consequently, if as a result of using the line of credit the individual credit union or caisse falls below the 10% liquidity requirement, it should not be permitted without the consent of the proposed deposit insurer to make any new loans until the liquidity reserve have been replaced. In Alberta, the reserve requirement is

calculated once a month by dividing the aggregate of the credit union's assets at the end of each Wednesday in the month by the number of Wednesdays in the month and taking 10% of the quotient. This determines the reserve requirement for the following month. We recommend New Brunswick adopt a similar procedure.

E. Allowance for Doubtful Accounts

In the past, attempts have been made to legislate the size of deduction that must be taken to account for the eventuality of bad debts in the calculation of surplus. The deduction being a non-cash outlay also has the effect of increasing the reserves of the credit union or caisse populaire, at least on a temporary basis. In the past, similar legislation under the Income Tax Act has also been tried. Under that Act, a credit union or caisse populaire could claim a reserve deduction of 1 1/2% of the first $2 billion of loans, plus 1% of any excess (Income Tax Act, s.137; Reg. 600). Under the Regulations enacted pursuant to the Credit Unions Act, the credit union or caisse populaire must deduct as a reserve 1 1/2% of all loans or an amount determined by their delinquency ranging from 25% for loans 6 months in arrears to 100% for loans more than 24 months in arrears. (Regulation 23). There has been some dissatisfaction with a regimented reserve system. It has been suggested that for some credit unions and caisses populaires, the deduction is too large in that their losses do not meet the level of the reserves required while for others it is too small. In one discussion paper (Credit Union Financial Standards, Third Draft, September 20, 1986 at p. 8) it was proposed that the reserve be based on the average of actual losses on loans and investments over the past five years with a provision for extra-ordinary losses. This proposal was apparently defeated at the Credit Union

Stabilization Funds of Canada Third Policy Conference, May 6, 1987. The precise reason for the rejection was not given in the chairman's summary of the proceedings but it appears that there was agreement that the past five years experience is not necessarily a good predictor of the next five years because of the important role that the general economic climate plays in determining losses.

The Tax Reform 1987 package proposes to repeal that part of section 137 of the Income Tax Act that outlines the 1 1/2% and 1% deductions and place all financial institutions on a similar basis.

> The proposed changes to the tax treatment of doubtful debts place all financial institutions (and others part of whose ordinary business includes the lending of money) on a consistent basis. The permitted reserve deduction in respect of doubtful debts arising from loans made in the ordinary course of business will now be related to the actual loan loss experience of the financial intermediary. The formula provision for trust and loan companies (section 33 of the Income Tax Act), credit unions (section 137) and life insurance companies (section 138) will be repealed.
>
> Doubtful debts may be established, depending upon the nature of a loan, on the basis of a loan-by-loan examination, or, where this is not feasible, on a pooled basis.
>
> Where a financial intermediary establishes a doubtful debt reserve in respect of aged pools of non-performing loans taking into account historical recovery rates, a full doubtful debt reserve will be permitted provided the criteria set out by Revenue Canada in Interpretation Bulletin 442 are met and the amounts are reasonable. Similarly, a full deduction will be allowed for the general provisions required by the Inspector General of Banks with respect to loans made to borrowers in a group of 34 heavily indebted countries.
>
> In cases where the reserves are based on an analysis of individual loans with unique characteristics and circumstances, it may not be possible to use a pooling

> approach to take into account an historical recovery rate. In such cases, the full deduction of a reserve for any particular loan can provide, in aggregate, a reserve in excess of eventual losses experienced, even though the deduction taken in each particular case is reasonable in the circumstances. Though subsequent recoveries are included in income for tax purposes, the taxpayer may have benefited from a tax deferral. A prescribed recovery rate will be established to reflect the average rates that have been observed historically, in order to provide a mechanism for eliminating the deferral of tax while taking into account differing circumstances in an administratively manageable manner.
>
> The proposals apply with respect to taxation years beginning after June 17, 1987 and ending after December 31, 1987. Income Tax Reform, 1987, June 18, 1987, p. 122-3.

The general requirement under the Income Tax Act in the future will be to permit a deduction that more accurately reflects losses. This is in accordance with generally accepted accounting principles. We recommend that this be a requirement under the Regulations of the Credit Union Act rather than the current requirement providing a formulated allowance to be allocated to the Guarantee Reserve. The allowance for doubtful accounts would, therefore, be subtracted from the value of the loan portfolio. Paragraphs 22 and 23 of Interpretation Bulletin IT-442, February 11, 1980 gives some guidance as to what is, and what is not acceptable in making this determination:

> 22. The requirements in respect of a reserve for doubtful debts claimed under paragraph 20(1)(l) are the same as those specified in paragraph 20(1)(p) for bad debts as summarized in 1 above, except as to the degree of doubt concerning the collectibility of the debts. For a debt to be classed as a bad debt there must be evidence that it has in fact become uncollectible. For a debt to be included in a reserve for doubtful debts it is sufficient that there may be reasonable doubt about the collectibility of it. Many of the comments in 1 to 13 above regarding bad debts, appropriately interpreted, apply equally to a reserve for doubtful debts.

> 23. For a taxpayer to establish that a reserve for doubtful debts is reasonable in amount it is necessary to identify the debts that are doubtful of collection, having regard for such indications as the period of arrears or default, the financial status and prospects of the debtor, the debtor's past credit record both with the taxpayer and, if available, with other creditors, the value of any security taken and any other factor that is relevant in judging the debtor's ability or willingness to pay. Once having identified which debts are doubtful, the maximum amount of the reserve should be calculated based on an estimate as to what percentage of the doubtful debts will probably not be collected. This calculation should preferably be based on the taxpayer's past history of bad debts, the experience in the industry if that information is available, general and local economic conditions, costs of collection, etc. This procedure may result in a reserve being calculated as a percentage of the total amount of the doubtful debts or a series of percentages relating to an age-analysis of those debts. However, a reserve that is merely based on a percentage of all debts, whether doubtful or not, a percentage of gross sales or some similar calculation is not considered to be a reserve determined on a reasonable basis as required by paragraph 20(1)(1).

III. The Second and Third Tiers

A. Centrals and Federations

Over time, a second level of organization has evolved in the credit union/caisse populaire movement. Today individual credit unions and caisses populaires are required to join an association of credit unions and caisses populaires known as a Central or Federation. (See Credit Unions Act, s.4) There are two such organizations in New Brunswick. La Federation des Caisses Populaires Acadiennes Limitee and the Credit Union Central of New Brunswick Limited. Federations or centrals have evolved to serve three main purposes. First, by joining together, most credit unions and caisses populaires have found that such an association can provide services to the credit unions and

caisses that they could not have afforded individually or, at least, provided at lower cost.

Second, the federations and centrals have served as an organization in which the credit unions and caisses can pool funds necessary to meet their liquidity requirements. In this regard Brunswick Central belongs to a national (the third tier) organization, the Canadian Cooperative Credit Society (CCCS), where provincial organizations further pool their resources to maintain an even larger liquidity pool. La Federation does not belong to a similar organization. In most Canadian jurisdictions there appears to be agreement that a prudent credit union should have 10% of its assets in liquid form in order to meet withdrawals. As discussed earlier, under this policy, individual credit unions and caisses populaires that are members of a federation that is a member of CCCS are expected to maintain 2% of their assets within their own organization and place the remainder with the central or federation. The central or federation holds 6% of all provincial assets and forwards the remaining 2% to CCCS. The pooling of liquidity is thought to have two advantages. To the extent the Central or Federation is willing to advance more funds to an individual credit union or caisse than it has on deposit with the central or federation, the individual credit union or caisse is in a stronger position to meet withdrawals than it would be on its own. Of course, it should be noted that it is axiomatic that every dollar advanced to a credit union or caisse over its liquidity deposits and share capital in the central or federation reduces the cash available to other credit unions and caisses in the central or federation. There is a second potential advantage to pooling. 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. In fact, if the pool of assets is large enough, it may be able to borrow even more money in the market at a rate low enough to enable it to loan it to others at a profit and still meet the liquidity requirements of the movement. Much of this depends on the success of the investment policy of the central, federation, and CCCS.

The advantages of pooling of liquidity raises the question as to whether a credit union or caisse should, on this ground alone, be required to be a member of a central or federation. In our view, they do not. First, a central or federation cannot be legislated to come to the assistance of an individual credit union or caisse beyond the deposits made by that credit union or caisse without impinging on the deposits of other credit unions and caisses. Thus, assistance cannot be guaranteed by this means. In fact it has been represented to us that in times of crisis, it has been the federations that have come to the rescue while others have denied this. No matter who is right, a problem of illiquidity will lead to insolvency if an institution is forced to sell off its assets at prices below book value to meet withdrawals. "It may indeed be hard to dispose of commercial and personal loans at book value, since it would be more difficult for another institution to evaluate those loans over the short period of time available before the liquidity crisis turns into insolvency." ("A Framework for Financial Regulation", 1987, Economic Council of Canada, at p.46.) Insolvency problems have traditionally been left by the centrals and federations to the domain of stabilization boards and deposit insurers. It is obvious that on which side of the illiquidity/insolvency line one falls may be difficult to determine. Provided the stabilization board or deposit insurer is willing to come to the rescue, usually as a lender of last

resort, a liquidity crisis can be averted and public confidence maintained. This is how we think the system should operate and would thus require participation in a stabilization fund but not require membership in a central or federation.

A third function served by membership in a federation is that it qualifies the credit union or caisse as a "bank" under section 164.1 of the Bills of Exchange Act:

> 164.1 In this Part, "bank" includes every member of the Canadian Payments Association established under the Canadian Payments Association Act and every local cooperative credit society, as defined in that Act, that is a member of a central, as defined in that Act, that is a member of the Canadian Payments Association

A credit union or caisse populaire must be a member of the association or belong to a central or federation that is as member of the association to come within the definition of "bank" to have the chequing provisions of the Bills of Exchange Act apply to instruments drawn on it. It should be pointed out that under the Canadian Payments Association Act, a credit union or caisse populaire that is not a member of a central or federation may still be able to make a private clearing arrangement with another member institution but instruments drawn on such a credit union or caisse populaire are not "cheques" and the rules that apply to them are unclear. (See Canadian Pioneer v. Labour Relations Board (1980), 31 N.R. 361 (S.C.C.); La Caisse Populaire Notre Dame Limitee v. Moyen (1967), 61 D.L.R. (2d) 118 (Sask.Q.B.)). The aspect of chequing privileges that are now granted by credit unions and caisses populaires carries with it a concurrent obligation to see that the public is properly protected. This includes bringing itself within section 164.1 of the

Bills of Exchange Act. The difficulty of not coming within section 164.1 of the Bills of Exchange Act is discussed in Crawford & Falconbridge, Banking and Bills of Exchange, Vol.2, 8th ed., 1986 at p.1739-40:

> In addition to being a bill, however, a cheque must be drawn upon a bank. The definition of "bank" for this purpose was enlarged in 1980 to include every member of the Canadian Payments Association. Prior to that time the definition of the term "bank" in s.2 of the Act had caused an inordinate amount of difficulty with respect to instruments drawn on incorporated deposit-taking enterprises other than chartered banks. We have expressed the opinion in 4801.3 that this was unnecessary from the beginning, but even if it was an error, it cannot be denied that it was a very common error. A dozen courts and even Parliament itself struggled with the proper characterization of demand payment instruments drawn on banking businesses other than Bank Act banks, and with the attendant problems of ascertaining the rights of parties to them, without the assistance of the Bills of Exchange Act. There were various approaches to the problem. Trunkfield v. Proctor, decided in 1901, proposed that such instruments be treated simply as bills of exchange. That proposal attracted adherents but led to certain disadvantages, such as the loss of the customer's power of countermand which was thought to apply only to "cheques". Dean Falconbridge was critical of this approach, suggesting instead that the instruments should be regarded as "common law cheques", outside the Act but continued from pre-Act precedents by virtue of s.10. That approach also found adherents but was also found to involve hidden disadvantages for the parties due to the supposed inapplicability of sections of the Act that were remedial of deficiencies in the old pre-Act common law. Some courts remained unaware of, and some sought to ignore the problem, but that was technically difficult when the Supreme Court of Canada had officially recognized its existence.
>
> The cases are of no further practical significance and are unlikely to be, so long as the economy does not encourage the development of a class of unincorporated deposit-taking businesses not qualifying for or electing to hold the membership in the Canadian Payments Association.

Some credit unions have been able to obtain membership in the Canadian Payments Association in order to meet this requirement even though they do not clear

their own cheques.

The provision of services, liquidity and cheque clearing by federations raises the question of whether individual credit unions and caisses populaires should be required to maintain membership in a federation. At present, section 4 of the Credit Unions Act makes membership mandatory. It has been argued by New Brunswick's largest caisse populaire that this should be changed. It argues that compulsory membership violates one of the essential principles of co-operative organizations; open and voluntary membership. Voluntary membership gives individual credit unions and caisses the democratic right to decide their own destiny. On the other side, it is argued that the strength of the movement lies in the joining together of the individual credit unions and caisses to provide the movement with a large cooperative financial base that can meet the needs of today's modern society. In fact, La Federation would go so far as to require any institution using the words "caisse populaire" to be required to be a member of La Federation. La Federation cites the Manitoba legislation in support of its position (see 3, The Credit Unions and Caisses Populaires Act. (Manitoba, 1986-87, ch.5) s.178)) The arguments have been raised and debated before (see, for example, Poapst, Studies for Decision Making: Towards the Development of Credit Unions in the Atlantic Provinces (1979)) at p. 137 and Report & Recommendations of the Minister's Task Force on Credit Unions, Alberta, September,1985, p. 109.) Because of its size, La Caisse Populaire de Shippagan Limitee has said that it has not been able to find much advantage to belonging to a central or federation. With assets over $58 million, compared with $89 million for all other 36 credit unions belonging to the Brunswick Central, there is some truth to the argument.

Elsewhere we have recommended that a provincial deposit insurance corporation be established that will assume the functions of the stabilization boards which are currently adjuncts of the federations and all credit unions and caisses populaires will be required to contribute to it. With this change, compulsory membership in a federation is not as essential. Large credit unions can obtain elsewhere, or even in-house, services that are provided by federations. Also liquidity requirements need not be met by deposits (See Credit Unions Act, Regs. S.24(1)) with a federation (although with economies of size, a federation should be able to provide individual credit unions and caisses with a better return on their liquidity reserves than they could obtain individually and maybe even greater resources to meet liquidity demands). Finally, if a credit union or caisse populaire wants to provide chequing privileges, private arrangements appear to be possible provided they meet the definiton of "bank" in the Bills of Exchange Act. Thus compulsory membership does not appear to be necessary. We would hope, however, that in the cooperative spirit, each credit union and caisse populaire would want to belong to a federation and, in turn, the federations would be able to offer such services that each credit union and caisse would benefit from membership. Again we refer to the essential principles of cooperative organizations, "All cooperative organizations, in order to best serve the interests of their members and their communities, should actively co-operate in every practical way with other co-operatives at local, national, and international levels". (The Essential Principles of Co-operative Organizations as approved by International Co-operative Alliance, September, 1966). Open and voluntary membership may be the best way to achieve that objective. The ability to withdraw may constitute the best incentive for the federations to serve

individual credit unions and caisses populaires. In addition, in the cooperative spirit, there is no reason to give the Central and La Federation a monopoly control over credit unions and caisses populaires along linguistic lines. Federations should function on the same open and voluntary basis as their underlying members. It should also be noted that the intent of the present Credit Union Federations Act was not to create only two federations but to provide any ten or more credit unions and caisses populaires the opportunity to form a federation. (Credit Unions Federation Act, S.2) We think that principle should be a guide in determining the direction of any future legislation. However, it is recommended that a credit union or caisse not be permitted to grant chequing privileges unless it is a member of a federation or the Canadian Payments Association.

One corollary problem has been brought to our attention. We understand that at present, the by-laws of one of the second tier organizations are such that it may be difficult for a credit union or caisse populaire to leave it. This is because the central or federation may be entitled to hold the share capital invested by the credit union or caisse for some time after it has withdrawn its membership. It has been suggested that the maximum period that a central or federation should be allowed to keep the share capital of a withdrawing credit union or caisse populaire be one year. We concur with this position.

Most other jurisdictions do not appear to require compulsory membership in a federation but they do require individual credit unions and caisses populaires to participate in either a stabilization fund or a deposit insurance scheme. (See Table 3) One major exception appears to be Manitoba's new Act which requires each credit union and caisse to join either the Co-oporative Credit Society of Manitoba Limited or La Federation des Caisses

Populaires du Manitoba. (See Man. Stats. 1986-87, ch.5, s.178). Saskatchewan may have achieved a similar result by requiring credit unions to maintain an account with Credit Union Central (See The Credit Union Regulations of Saskatchewan, Ch. C-45.1,Reg. 1, s.4(3)). On balance, however, we would recommend voluntary membership.

Table 3. Summary of legislative requirements or regulations re compulsory participation of caisses populaires and credit unions to stabilization funds and federations or centrals in the jurisdictions of Canada

JURISDICTION	CONTRIBUTION TO STABILIZATION FUNDS OR DEPOSIT INSURANCE CORP.	MEMBERSHIP IN CENTRAL OR FEDERATION
Newfoundland	Yes (Reg. 57)	No (Sec. 72)
Nova Scotia	Yes (Sec.84(2))	No (Sec.111, 112)
Prince Edward Island [1]	Yes (Sec.42(1))	No (Sec. 37)
Quebec	Yes (Sec.40(2))	Yes (Sec.12)
Ontario	Yes (Sec.12(6)) (Sec.96(3))	(Sec.115) No (Sec.12)
Manitoba	Yes (Sec.158)	Yes (Sec.178)
Saskatchewan [2]	Yes (Sec.249(2)(h))	Yes(Reg.1(54)(3))
Alberta [3]	Yes (Sec.102)	No (Sec.86)
British Columbia	Yes (Sec.141)	No (Sec.125)

1. S.6 of the Act provides that the Rules & Regulations of the Central are applicable to all credit unions whether or not they are a member of the Central.
2. The Act specifically requires that all credit unions must deposit their liquidity investments with the Central. In turn, the Central by-laws provide that in order to use the "deposit services" of the Central, a credit union must be a member of the Central. The practical effect is that all credit unions must be a member of the Central, although the Act does not require it directly.
3. It is understood that consideration is being given to provide for compulsory membership but with regulatory authority to permit a credit union to opt out pursuant to conditions to be set out in the regulations.

At present membership in the second tier carries with it the right to vote on the basis of one credit union or caisse populaire, one vote. It has been suggested that this should be changed to reflect the size of the credit union or caisse populaire. The credit union/caisse populaire movement was founded on principles of cooperation and democracy that included the principle of one person, one vote. At the central and federation level, this has been translated to mean one credit union or caisse populaire, one vote. This policy is more in keeping with cooperative principles than a voting scheme weighted in relation to the size of the members of the central or federation.

B. Stabilization Boards vs. Deposit Insurance

While the Central and La Federation have played a major role in providing service, liquidity and cheque clearing, the task of meeting insolvency problems has become the responsibility of the stabilization boards. At present, each central or federation has under its direction a stabilization fund that is intended to be used to meet any financial difficulties that an individual credit union or caisse populaire might encounter. It is intended that the fund ultimately be used to protect deposits and share capital of members. (See Credit Unions Act, s.47(1). While the movement perceives philosophical differences,it is comparable to a deposit insurance scheme.

In the past, stabilization boards have concentrated on promoting the financial stability of credit unions and caisses by taking over the administration of unsound units, providing managerial assistance, and providing financial assistance to rehabilitate individual credit unions and caisses as well as facilitating mergers of units in financial difficulty. All of these

methods have the result of ultimately protecting depositors. This is sometimes contrasted with the perceived role of an insurer who merely pays out any deficiency to depositors on the liquidation of an institution. It should be noted, however, that this need not be the only role of an insurer and, in fact, the Annual Report 1986 of the Canada Deposit Insurance Corporation indicates that, "The ongoing role of CDIC as an insurer with respect to troubled members must be preventive and timely. In plain language, the Corporation's role is moving from that of an undertaker to that of doctor" (p.6). It appears that CDIC has borrowed a page from the credit union/caisse populaire movement. As deposit insurers and stabilization boards have matured, they have grown in similarities. It is not surprising that Saskatchewan's Mutual Aid Board has been renamed the "Credit Union Deposit Guarantee Corporation".

It is our view that consumers would prefer and be better served by formalizing a deposit insurance system in New Brunswick and that this can be accommodated without sacrificing the advances made in the past by the two stabilization boards. We think the public would be better served if the two stabilization funds were to become the New Brunswick Credit Union Deposit Insurance Corporation/La Corporation de Assurance Depots des Caisses Populaires du Nouveau-Brunswick. If we were starting the movement from the beginning, we would go even further and recommend that the liquidity and solvency reserves be under the supervision of only one organization. It is obvious that a liquidity crisis can lead to a solvency problem and "jurisdictional" problems between two separate organizations would be solved with only one organization. However, we recognize the tradition that has developed and recommend that the separation of functions continue. However, we recommend one corporation to succeed the two boards for several reasons. One main goal of insurance is risk spreading. In

the past the credit union/caisse populaire movement in other provinces has, on occasion encountered financial difficulties. Experience has shown that the greater the diversification, the better able one is to meet any regional economic downturns. We also think that one organization would create greater public confidence. In this regard, the Canada Deposit Insurance Corporation is instructive. CDIC is intended to be an industry financed, deposit insurance system. In fact, with premiums at the rate of only 1/10 of 1% of insured deposits the CDIC deficit was $1.2 billion at the end of 1986. (Canada Deposit Insurance Corporation, Annual Report, 1986 at p. 10.) However, Federal Government loans have enabled it to meet its obligations. In spite of this, it has been said that CDIC is perceived as providing depositors with stability and security, and substantial experience in financial supervision. (See Addendum to the Brief submitted by Co-operative Financial Institutions to the Submission by the Canadian Credit Union System on The Wyman Report: The Final Report on the Working Committee on the Canada Deposit Insurance Corporation to the House of Commons Standing Committee on Finance, Trade and Economic Affairs, September, 1985) CDIC is aiming to eliminate the deficit and creating a fund that would constitute 0.75% of insured deposits. In contrast, the two stabilization funds in New Brunswick are in a surplus position and presently the surplus exceeds 1.5% of deposits and the provincial objective is to reach 3% (See Credit Unions Act Regulations, s.22(3)). This has been achieved by levying a fee of 1/4 of 1% of deposits and share capital. The ideal rate and size for a secure deposit insurance system is virtually impossible to predict. As the Brief previously referred to indicated with regard to a target of 1.25% - 1.50% for a credit union fund, "No reasonable projection can be made, however, to cover the severe regional economic downturns experienced from time

to time in Canada". It is clear, however, that New Brunswick's stabilization boards have a better track record than CDIC. Yet it is thought by some that CDIC would be the ideal solution.

The funding of deposit insurance presents great challenges to the movement. The maximum premium rate at present appears to be 1/4 of 1% of insured deposits (See McGuinness and Abrams, Deposit Protection: Lessons Learned from Recent Experience (1986), 12 Can. Bus. L.J. 185; (1987), 12 Can. Bus. L.J. 312). Saskatchewan hopes to build their fund to 1% of insured deposits (Schroeder, Deposits Fully Insured (1983) p.88) and at least one study has indicated this may be too low. (Ibid., p.89). The basic problem is classic. The more charges that a credit union or caisse populaire incurs, the less surplus available to its members and the less attractive the movement is to the public. At the same time the public wants security and this can only be provided with money. Even a premium of 1/4 of 1% of insured deposits only provides the movement with fractional coverage. Such insurance is founded on the assumption that not all credit unions and caisses populaires will find themselves in difficulty but only a small fraction of them and, of those, not all of their loans will prove uncollectible. In fact, ignoring for a moment the investment income that the insurer would earn on premiums, the assumption is that, on average, the problem cases will not exceed 1/4 of 1% of insured deposits in any one year. One must not lose sight of the fact that insurance or a guarantee is only as good as the financial resources of the insurer or guarantor. One deposit insurer in New Brunswick does not make it a certainty that depositors will always receive 100% of their deposits and share capital but it tends to reduce the risk of loss. This is even more so if the insurer has the ability to borrow from the Province or CDIC.

CDIC only insures deposits to a maximum of $60,000. Saskatchewan's Credit Union Deposit Guarantee Corporation fully guarantees all deposits. The matter raises some fundamental issues. If deposits and share capital are fully insured, the members only have their surplus at risk. One might restrict insurance to deposits so that share capital is also at risk but this would probably lead to members maintaining the minimum share capital requirement of $5.

Alternatively, a scheme that insured a percentage (for example, 95%) of a member's total deposits and share capital could be viewed as the best compromise. It would recognize the reality that there is not a great deal of difference between share capital and deposits and at the same time reinforce that, as an institution, the credit union or caisse populaire is owned by the members and they are to the extent of 5%, at risk. To this extent the market place would also encourage prudency on the part of the membership in the management of the credit union or caisse, especially if such a scheme were designed to ensure that the member's 5% was a first loss and not co-insurance. This would also maintain the "market discipline" recommended by the Wyman Committee on the Canada Deposit Insurance Corporation (1985). They recommended all depositors should be exposed to some risk (suggesting 10%).

To be competitive with the other financial institutions, the Wyman proposal is probably not acceptable. Insuring to $60,000 would put credit unions and caisses populaires on a similar basis and full insurance, like Saskatchewan, would give credit unions and caisses populaires an advantage over their competitors. Capping deposit insurance at $60,000 has the appearance of being less expensive but if the traditional methods of stabilization are continued by the new corporation, members will receive 100% insurance in any

event and therefore the Saskatchewan model of deposits fully guaranteed is proposed for New Brunswick's credit unions and caisses populaires. In addition to deposits and share capital being at risk, it must be remembered that collectively the members also have any surplus left in the credit union or caisse at risk. Thus, to this extent they are not only co-insurers but also are the first losers in the event of losses. Thus, indirectly, the Wyman proposals would apply to credit unions and caisses populaires.

To be effective, we believe that the corporation, like the stabilization boards, must have borrowing authority from the Province and likewise, the Lieutenant-Governor-in-Council should be authorized to lend to the deposit insurance corporation. If the recommendation for a deposit insurance corporation is accepted, it is suggested that the corporation pursue the opportunity to also borrow from CDIC as, for example, the Credit Union Stabilization Corporation (Alberta), Credit Union Deposit Insurance Corporation of British Columbia and the Saskatchewan Credit Union Deposit Guarantee Corporation have done. (See CDIC Annual Report, 1986, p. 4.)

Since the movement has been successful in managing its own affairs in the past, we believe that, as long as they continue to show good judgment, they should be primarily responsible for their own destiny in the future. Therefore it is recommended that management of the deposit insurance corporation rest primarily with the movement. It is suggested that a board of directors of six could be put in place with two members appointed by each federation and two by the government. Some of the functions presently performed by the federations as well as those of the stabilization boards would be assumed by the new deposit insurance corporation. Needless to say, this will require that some realignment of staffing between the federations and the deposit insurance

corporation.

Funds presently held by the stabilization boards would be transferred to the new corporation. The mutual aid fund (See Credit Unions Act Regulations, s.22(1)) would also be transferred and held on the same basis that it is presently held by the stabilization boards and subject to withdrawal by credit unions and caisses populaires when the deposit insurance corporation's funds reach 3% of total deposits (See present Regulation 22(3)).

We recommend that all credit unions and caisses populaires be required to contribute to the deposit insurance scheme. The power to set premiums should be vested in the corporation. We would anticipate that a premium of 1/4 of 1% of insured deposits would be the norm, consideration should be given to providing discounts to those credit unions and caisses that have surplus accounts totalling at least 5% of assets. This would provide each credit union and caisse an additional incentive to meet the surplus objective.

Chapter 3

The General Regulatory Structure

The general regulatory structure of the credit union/caisse populaire movement is presently provided for by two statutes (Credit Unions Act and Credit Union Federations Act) and the Regulations thereunder. Through control of the By-Laws of individual credit unions and caisses, another level of regulation is also provided. As credit unions and caisses populaires have grown and developed, their needs have changed as well as their problems. Saskatchewan (The Credit Union Act, 1985, chapter c-45.1) and (Manitoba 1986-87, Ch.5) have recently enacted new statutes. The central feature of both pieces of legislation is that they are similar to the Business Corporations Acts for those provinces. This should not be surprising. It appears that the original credit union/caisse populaire legislation used the old Companies Acts as their model. It must be remembered that all of these legislative provisions have as their objective the facilitation and control of organizations and the relationship of the members of those organizations. The rules are also often picked up by charitable organizations as well. This is, in part, because they have worked reasonably well, are reasonably definitive, and are reasonably understood. The present Business Corporations Act model, has the further attraction that it is a recent attempt to solve the administrative problems that business organizations generally have faced and have been adopted nationally because of their simplicity and clarity. Many of the issues dealt with therein are facilitative and more technical in nature than of substantive policy and thus have not

generated much debate. From a legal point of view, however, the approach taken by the business corporations acts should clarify a number of potential problems. Further, judicial decisions in other areas of the law will serve as useful guidelines for credit unions and caisses populaires. This is is particularly true if any new legislation is expressed in similar legislative language. In the trust and loan company field, it has been proposed to bring those companies under the Business Corporations Act rules by requiring them to apply for a certificate of continuance under that legislation. (See Bill 96, Loan and Trust Companies Act, s.3).

The credit union/caisse populaire legislation in both Manitoba and Saskatchewan have modelled the part dealing with incorporation, including the application, registration, name, seal and pre-incorporation contracts on their respective Business Corporations Act and it is proposed to do the same for New Brunswick. There are no major policy issues that have been identified in this area. Like the present Act and unlike the Business Corporations Act, it is proposed that the Minister will continue to have the discretionary power to approve incorporation of credit unions and caisses populaires.

It is also proposed that credit unions and caisses populaires have capacities and powers comparable to other business corporations. This includes clarifying the law with regard to ultra vires transactions, abolition of constructive notice doctrine and clarifying the authority of agents, the designation of head office, clarifying the lack of necessity of a corporate seal and the right of access by members to credit union and caisse populaire documents. The corporate finance, security certificates, registers and transfers parts of the business corporations statute and is not as completely applicable to credit unions and caisses populaires as many other areas but there

are areas of mutual concern and applicability. The matter of loans and deposits will require a separate part in the Act and these matters have been dealt with in the preceding chapter.

The general rules regarding management and, in particular, matters dealing with directors and officers including organizational meetings, meetings generally, indemnification, standard of care, and conflict of interest guidelines are as of much relevance to credit unions and caisses populaires as they are other business corporations and it is proposed to use the Business Corporations Act as the model for the new Act. There are areas that it is proposed to not include: e.g., qualification of directors; it is proposed to require membership as a condition to being a director; it is not proposed to introduce cumulative voting provisions, nor any insider trading provisions.

It is proposed to update the rules regarding the meetings of members along the lines of the Business Corporations Act, but this will not include the right to vote by proxy or unanimous shareholder agreements.

Financial Disclosure and Audit

In evaluating what the financial disclosure and audit requirements should be for credit unions and caisses populaires in New Brunswick, it became evident that most of the other jurisdictions have adopted the requirements found in the Business Corporations Act. The "Loan and Trust Companies Act" of New Brunswick has also adopted these requirements (sec. 137 to 148). Therefore, to be consistent, similar requirements are recommended for credit unions and caisses populaires.

The modifications are minor and involve mostly the substituting of words, where applicable, such as "credit union" for "company"; "caisse populaire" for "compagnie"; "member" for "shareholder"; and "Registrar" for "Superintendent".

In our opinion, there is one major modification which is required. Most jurisdictions require that credit unions and caisses populaires appoint professionally accredited auditors. We recommend that this requirement be adopted in New Brunswick. If such is the case, section 140(4) of the "Loan and Trust Companies Act" which reads as follows, "A person is disqualified from being an auditor of a provincial company if the person is not an accountant...", would have to be modified to read as follows: "A person is disqualified from being an auditor of a provincial credit union if the person is not a member of a certified accounting association...".

It is not necessary that the actual audit be performed by a member of a certified accounting association, but the audit procedure should be prepared by, and the audit supervision should be carried out by one.

It has been suggested that the audit procedures appropriate for credit unions and caisses populaires be defined. We think that such a task should be left to the auditors themselves. However, since it has been pointed out earlier that the loan portfolio is the single most important asset of the credit union or caisse populaire, heavy emphasis should be placed on an in depth examination of the loan portfolio in determining what should be the generally accepted auditing procedures. Section 146(2) of the "Loan and Trust Companies Act" would accommodate such procedures:

> "The Superintendent (Registrar) may at any time in writing, and shall when so required by the Minister, require that the scope of an annual audit of a provincial company (credit union) be enlarged or extended in any manner that the Superintendent (Registrar) thinks fit".

Such procedures would not be inconsistent with generally accepted auditing standards as defined in the Canadian Institute of Chartered Accountants Handbook (Section 5000):

> 01. The objective of an audit of financial statements is to express an opinion on the fairness with which they present the financial position, results of operations and changes in financial position in accordance with generally accepted accounting principles, or in special circumstances another appropriate disclosed basis of accounting, consistently applied. Such an opinion is not an assurance as to the future viability of an enterprise nor an opinion as to the efficiency or effectiveness with which its operations, including internal control, have been conducted.
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> 03. In the performance of an audit of financial statements, the auditor complies with generally accepted auditing standards, which relate to the auditor's qualifications, the performance of his examination and the preparation of his report.

With regard to the appointment of auditors, we would emphasize the following recommendations:

1. That only members or firms of a certified accounting association be appointed as auditors of any credit union, caisse populaire, Central or Federation. This requirement does not mean that the audit must be performed by a professionally accredited accountant. Preparation of the audit procedures, supervision of the audit process and accepting responsibility for the audit report by a professionally accredited accountant would be sufficient.

   We think that affiliates of a Central or Federation, such as Services Unis de Verification et D'Inspection Inc. (SUVI) could qualify for appointment as auditors of any credit union or caisse populaire, provided such an affiliate has at least one member of a certified accounting association on staff, whose functions would include those previously mentioned.

2. That the auditors appointed be independent of the credit unions, caisses populaires, Centrals or Federations being audited. Again, we feel that, in the case of credit unions and caisses populaires, affiliates of a Central or Federation, such as SUVI, qualify as independent. The reason being that each credit union and caisses populaire is a separate corporate entity, independent of the Central or Federation. Their relationship will be, as per our recommendation, one of voluntary membership in order to avail itself of the independent services provided by the Central or Federation.

   Furthermore, section 140(9) of the "Loan and Trust Companies Act" of New Brunswick states: "An interested person or the Superintendent may apply to the Court for an order exempting an auditor from disqualification under this section and the Court may, if it is satisfied that an exemption would not unfairly prejudice the shareholders or the depositors, make an exemption order on such terms as it thinks fit, which order may have retrospective effect". A similar section has been recommended for the credit union/caisse populaire act, therefore, the appointment of an audit firm which is an affiliate of a Central or Federation, such as SUVI would be justifiable, if necessary, through an exemption granted by the Court.

3. That similar to Section 117(1) of the "Loan and Trust Companies Act" of New Brunswic, the directors of a provincial credit union or caisse populaire appoint from among their number a committee to be known as the audit committee to be composed of not fewer than three directors.

Other parts of the Business Corporations Act that are of relevance to credit unions and caisses populaires include the part on fundamental changes including amalgamation, investigations and remedies.

Chapter 4

Summary of the Recommendations

Chapter 2 - Protection of Deposits

I - Loan Policies

A. Diversification

1. We recommend that the rules requiring diversification of the loan portfolio continue to be imposed by law. However, we recommend that new limits be enacted that would ensure adequate diversification of the loan portfolio of each credit union and caisse populaire.

2. We recommend against any general monetary limits on loan policies. It is recommended that a discretionary power to approve individual loan limits be vested in a new Deposit Insurance Corporation.

3. We recommend the creation of two new loan categories, both related to institutional organizations; one category for those institutional organizations whose debts are guaranteed by government, and a second category for those institutional organizations whose debts are not guaranteed by government.

4. We recommend that syndication of loans be permitted but do not propose that syndication be required.

5. We recommend that a credit union or caisse populaire not be permitted to loan more than 5% of its assets to any one member.

6. Subject to recommendation 5, it is recommended that a monetary maximum of $20,000 be placed on unsecured "character" loans.

7. It is recommended that business loans and non-government guaranteed institutional loans be restricted to 20% of the assets of any credit union or caisse populaire. Business loans would be defined to include loans made in connection with farming, fishing

or forestry.

B Overdrafts:

We recommend that overdrafts be permitted, but that approval of overdrafts be on the same basis as unsecured loans.

C Loan Prepayments:

We recommend that members be permitted to prepay their loans, however, it is proposed to give each credit union and caisse populaire the opportunity to determine the prepayment penalty through their individual by-laws.

II Capitalization, Liquidity and Reserves

A Capitalization and Surplus:

1. We recommend that each credit union and caisse populaire be required to maintain an undistributed surplus account (contingency reserve account) equal to at least 5% of its total assets at year end.

2. For those credit unions and caisses populaires whose undistributed surplus account has not yet attained 5% of total assets, they be required to build up their surplus account to the 5% level over five years.

3. We recommend that until the undistributed surplus attains a level of at least 5% of total assets, each credit union and caisse populaire be required to contribute to surplus, from their net earnings before dividends, an amount equal to at least 1% of their total assets at year end. However, for those caisses populaires and credit unions who

have achieved asset growth, the amount required be determined as per table 1.

4. Should it become evident that for some caisses populaires or credit unions, it would be very difficult to attain the required 5% of assets level within the five year limit, or if net earnings are not sufficient to contribute the required 1% of assets (or more) into the reserve account, we recommend that the Registrar be empowered to permit the caisse populaire or credit union to defer making all or any of the allocation to surplus. Any such deferral should be pointed out in notes to the financial statements.

5. We recommend that credit unions and caisses populaires be prohibited from paying dividends when in a deficit position.

B. Share Capital and Membership:

1. We recommend that if a credit union or caisse populaire chooses, it can have its share capital included in the calculation of the proposed 5% reserve requirements.

2. We recommend that membership requirements must be met at the time of taking out membership and not be a continuing one.

C. Patronage Dividends:

We recommend that the legislation be clarified to make it clear that dividends are only to be paid out of surplus.

D. Liquidity and Reserves:

1. It is recommended that each credit union and caisse be required to maintain a reserve in cash or in readily convertible investments equal to at least 10% of its total deposits, capital and external borrowings.

2. It is recommended that each Central or Federation be required to maintain a reserve in cash or in readily convertible investments equal to at least 25% of all money deposited with it and consideration be given to regulation of the remaining 75%.

3. We recommend that if a credit union or caisse populaire does not meet the liquidity requirements, it not be permitted to make any new loans until the reserves have been replaced.

E. Allowance for Doubtful Accounts:

We recommend that an allowance for doubtful accounts be maintained by the credit unions and caisses populaires. Determination of this allowance should be similar to the general Income Tax Act requirements and based on generally accepted accounting principles rather than the current requirement providing for a formulated allowance to be allocated to the Guarantee Reserve. The allowance for doubtful accounts would be subtracted from the value of the loan portfolio. (Paragraphs 22 and 23 of Interpretation Bulletin IT-442, Feb. 11, 1980).

III. The Second and Third Tiers

A. Centrals and Federations:

1. If a Deposit Insurance Corporation is established pursuant to our recommendation, we recommend that compulsory membership in a Central

or Federation not be required.

2. We recommend that the maximum period a Central or Federation may keep the share capital of a credit union or caisse populaire be limited to 1 year.

3. However, it is recommended that a credit union or caisse not be permitted to grant chequing privileges unless it is a member of a federation or the Canadian Payments Association.

4. We recommend that the voting rights remain along co-operative lines which would continue to be equal voting rights for each member credit union or caisse populaire.

B. Deposit Insurance Corporation

1. We recommend that the two stabilization boards be merged to form a new deposit insurance corporation.

2. It is recommended that each credit union and caisse populaire be required to contribute to the insurance fund.

3. The corporation will be authorized to determine premiums with authority to establish variable rates.

4. The new deposit insurance corporation fully guarantee deposits.

5. The corporation be managed by a board of directors, 2 appointed by La Federation, 2 by the Central and 2 by the government.

Chapter 3 - The General Regulatory Structure

A. General Structure.

1. With respect to issues concerning the general regulatory

structure we recommend legislation similar to the Business Corporations Act of New Brunswick be adapted for credit unions and caisses populaires.

2. We recommend that the Minister continue to have the discretionary power to approve incorporation of credit unions and caisses populaires.

3. We recommend that credit unions and caisses populaires have capacities and powers comparable to other business corporations. This includes clarifying the laws regarding: ultra vires transactions; abolition of constructive notice doctrine; clarifying the authority of agents, the designation of head office; lack of necessity of a corporate seal; and, right of access by members to credit union and caisse populaire documents.

4. We recommend the use of the Business Corporations Act as the model for determining the general rules regarding management, in particular, matters dealing with directors and officers such as: meetings; idemnification; standard of care, and conflict of interest guidelines.

B. Financial Disclosure and Audit:

1. It is recommended that requirements regarding financial disclosure and audit procedures be legislated in a similar manner as the "Loan and Trust Companies Act" of New Brunswick (Section 137 to 148).

2. It is recommended that only members or firms of a certified accounting association be appointed as auditors of the credit unions, caisses populaires, Centrals and Federations. An affiliate firm of a

Central or Federation may be appointed as auditor of any credit union or caisse populaire, provided the audit procedure is prepared by, and the audit process supervised by a member of a certified accounting association.

3. It is recommended that the auditors be independent of the credit unions, caisses populaires, Centrals or Federations being audited.

4. It is recommended that audit committees be required for the individual credit unions and caisses populaires, similar to Section 117(1) of the Loan and Trust Companies Act of New Brunswick.

C. Other

We recommend that regulations similar to the Business Corporations Act be established with regards to fundamental changes including amalgamation, investigations and remedies.

APPENDIX A

Table II

An illustrated model showing the contributions required to attain a level of surplus equal to 5% of total assets within five years at various growth rates in assets for a credit union/caisse whose asset base is $1,000,000.

GROWTH RATE	5%	10%	15%	20%	25%	30%	40%	50%
Total Assets Year 1	$1,050,000	$1,100,000	$1,150,000	$1,200,000	$1,250,000	$1,300,000	$1,400,000	$1,500,000
2	1,102,500	1,210,000	1,322,500	1,440,000	1,562,500	1,690,000	1,960,000	2,250,000
3	1,157,625	1,337,000	1,520,875	1,728,000	1,953,125	2,197,000	2,744,000	3,375,000
4	1,215,506	1,470,700	1,749,006	2,073,600	2,441,406	2,856,100	3,841,600	5,062,500
5	1,276,287	1,617,770	2,011,357	2,488,320	3,051,758	3,712,930	5,378,240	7,593,750
5% of Total Assets	$ 63,814	$ 80,888	$ 100,567	$ 124,416	$ 152,588	$ 185,646	$ 268,912	$ 379,680
% Contribution to Surplus	1.1%	1.2%	1.3%	1.4%	1.5%	1.6%	1.8%	2.0%
Year 1	$ 11,550	$ 13,200	$ 14,950	$ 16,800	$ 18,750	$ 20,800	$ 25,200	$ 30,000
2	12,127	14,520	17,192	20,160	23,437	27,040	35,280	45,000
3	12,734	15,972	19,777	24,192	29,297	35,752	49,392	67,500
4	13,370	17,648	22,737	29,030	36,621	45,698	69,149	101,250
5	14,039	19,413	26,148	34,836	45,776	59,407	96,808	151,870
Total	$ 63,820	$ 80,753	$ 100,804	$ 125,018	$ 153,887	$ 188,696	$ 275,829	$ 395,620