March 2014

# CREDIT UNION SUPERVISION IN BRITISH COLUMBIA

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The Honourable Linda Reid
Speaker of the Legislative Assembly
Province of British Columbia
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Dear Madame Speaker:

I have the honour to transmit to the Legislative Assembly of British Columbia my *Credit Union Supervision in British Columbia* report.

We conducted the audit in accordance with Section 11(8) of the *Auditor General Act* and the standards for assurance engagements established by the Chartered Professional Accountants of Canada.

At the end of June 2013, almost 1.9 million members had over $50 billion of insured deposits in British Columbia (BC) credit unions.

Credit unions have evolved to become as sophisticated and complex as banks and, therefore, require the same oversight. The Province is working towards meeting international industry standards for supervising financial institutions to ensure that the supervision of credit unions is at the same level as other major banking institutions in Canada. These global standards and best practices encourage identifying potential problems early to enable proactive intervention.

My report includes recommendations to improve the effectiveness of the credit union monitoring program, including completing an appropriate plan for insurance payments to depositors, should it be necessary. The plan would facilitate orderly and timely insurance payments and thus maintain depositor confidence across the credit union system.

My audit found that the Financial Institutions Commission (FICOM), the government arm responsible for credit union oversight, uses an appropriate supervisory framework for monitoring BC credit unions. Now they require the staff to implement the framework fully. With their shortage of staff, it would take over 14 years to review all of BC's credit unions instead of FICOM's intended target of two to three. The Ministry needs to work with FICOM to resolve this issue.

I wish to express my thanks to FICOM and its oversight panel, the Commission, and the Ministry of Finance for their cooperation and participation in this audit.

Russ Jones

Russ Jones, MBA, CA
Auditor General
Victoria, British Columbia
March 2014

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*Auditor General*

At the end of June 2013, almost 1.9 million members had over $50 billion of insured deposits in British Columbia (BC) credit unions. Government regulates and supervises BC credit unions and administers the credit union deposit insurance fund.

Credit unions have evolved to become as sophisticated and complex as banks. As such, and as recommended in the February 2014 International Monetary Fund Country Report, they require the same oversight. The Province is working towards meeting international industry standards for supervising financial institutions to ensure the supervision of credit unions is at the same level as other major banking institutions in Canada. These global standards and best practices encourage identifying potential problems early to enable proactive intervention.

Problems in even a small deposit insurance system can have "contagion effects" by spreading feelings of uncertainty and a loss of confidence in the system.[1] My report includes recommendations to improve the effectiveness of the credit union monitoring program, including completing an appropriate plan for insurance payments to depositors, should it be necessary. The plan would facilitate orderly and timely insurance payments and thus maintain depositor confidence across the credit union system.

My audit found that the Financial Institutions Commission (FICOM), the government arm responsible for credit union oversight, uses an appropriate supervisory framework for monitoring BC credit unions. Now they require the staff to implement it fully. They have been trying since the fall of 2013 to hire 17 staff (almost 25% of the division of FICOM responsible for monitoring credit unions) but without success. With this shortage of staff, it would take over 14 years to review all of BC's credit unions instead of FICOM's intended target of two to three. The Ministry needs to work with FICOM to resolve this issue.

I wish to express my thanks to FICOM and its oversight panel, the Commission, and the Ministry of Finance for their cooperation and participation in this audit.

Russ Jones, MBA, CA
Auditor General
March 2014

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1 "Canada Financial Sector Stability Assessment," *International Monetary Fund Country Report* 14/29 (February 2014).

# EXECUTIVE SUMMARY

Credit unions offer a full range of financial services, just as Canada's chartered banks do. Unlike the banks, though, credit unions are owned by their members. These institutions play an important role, particularly in smaller or more remote communities where banks are reluctant to establish branches.

British Columbia (BC) has 43 credit unions, where almost 1.9 million members have over $50 billion of insured deposits (as of June 30, 2013). The insurance for those deposits is provided by the Credit Union Deposit Insurance Corporation of British Columbia (CUDIC). If a provincial credit union were to fail, the depositors could make a claim from the insurance corporation for the full amount they had on deposit.

The Financial Institutions Commission (FICOM), an agency of the Ministry of Finance, is responsible for regulating and supervising BC's credit unions, and for overseeing CUDIC. Decisions about regulatory enforcement are made by the Superintendent and by the Commission – a panel charged with overall regulatory oversight (see page 13).

The strength of the credit union deposit insurance system depends on how well it is supervised. The goal of supervision is to promote the stability and soundness of credit unions and, through the use of early intervention and problem resolution efforts, reduce the probability of any failures. FICOM's mandate is not to prevent all failures, but to reduce the likelihood of failures and, if one should fail, to minimize the negative impact on the financial sector.

## WHY AND HOW WE DID THIS AUDIT

We undertook this audit to determine whether the method and extent of the supervision of the province's credit unions are appropriate.

Specifically, we looked at whether:

- FICOM has an effective credit union monitoring program;
- the deposit insurance fund is adequate to cover a significant credit union failure; and
- a full plan is in place to ensure that payments from the insurance fund could be made to depositors promptly, should a credit union fail.

## WHAT WE FOUND AND CONCLUDED

We concluded that FICOM uses an appropriate supervisory framework for monitoring BC credit unions; however, FICOM is not currently performing timely reviews of them due to a shortage of staff. FICOM may not be able to detect a worsening situation at a credit union in time to address and reduce the risk of failure.

Among our key findings:

- FICOM is working towards meeting the international industry standards (set out by the Basel Committee on Banking Supervision and the International Association of Deposit Insurers), which it adopted in 2012. However, for some of the standards, FICOM has gone as far as it can within the existing legislation. Given that the required 10-year review of that legislation is due in 2014, government has an opportunity to consider amending the legislation so FICOM can fully adopt these standards.
- Supervision of credit unions is currently significantly constrained due to a shortage of staff. At the time of our audit, 35% of positions identified in FICOM's Financial Institutions Division were vacant. As a result, even though FICOM has developed an appropriate supervisory plan, the lack of staff is impeding its ability to carry out the full scope of the plan in a timely manner.
- Although FICOM is establishing appropriate risk ratings for credit unions (risk ratings represent the risk profile of a credit union and determine the degree of monitoring required by FICOM), again the lack of staff is stalling the effectiveness of this work. Just over half of the ratings are based on onsite reviews that were over two years old at the time of our audit.
- FICOM is using an appropriate method for determining the target size of the deposit insurance fund, and is administering the fund properly, although there are upcoming changes in international guidance that should be reviewed.
- A detailed operational plan is not yet in place for the insurance fund to pay depositors should a credit union fail, but one is currently being developed. Such a plan is important to ensure that payments would occur in an orderly and timely fashion to maintain depositor confidence across the credit union system.

## TO IMPROVE THE EFFECTIVENESS OF THE CREDIT UNION MONITORING PROGRAM:

### WE RECOMMEND THAT THE MINISTRY OF FINANCE:

**1** ensure that in its review of the *Financial Institutions Act* and the *Credit Union Incorporation Act*, it also review the standards set out in the *Core Principles for Effective Banking Supervision* and the *Core Principles for Effective Deposit Insurance Systems*.

**2** work with FICOM to find ways to enable it to hire and retain the staff it requires to fulfill its mandate.

### WE RECOMMEND THAT FICOM:

**3** improve key supervisory areas of its Financial Institutions Division by recruiting staff with the required expertise and competencies.

**4** implement policies and processes to ensure consistent documentation by staff when determining composite risk ratings.

**5** document the work processes to be used in supervising smaller credit unions.

## TO MAINTAIN AN ADEQUATE INSURANCE FUND:

### WE RECOMMEND THAT THE COMMISSION:

**6** establish policies and guidance for determining an appropriate target size for the deposit insurance fund.

**7** implement the guidance on target fund size being prepared by the International Association of Deposit Insurers, once it is available.

**8** annually review and, if needed, adjust the deposit insurance target fund size to ensure it remains sufficient for its purpose.

## TO ESTABLISH AN APPROPRIATE OPERATIONAL PLAN FOR INSURANCE FUND PAYMENTS:

## WE RECOMMEND THAT THE COMMISSION:

**9** ensure the joint FICOM and Ministry of Finance group finishes the operational plan for payments to insured depositors by an agreed-to date, and ensure that the plan includes:
- operating protocols;
- a target timeframe for reimbursing depositors; and
- formal funding mechanisms, including back-up funding options.

**10** establish a policy for reviewing the operational plan for payments to insured depositors on a regular basis once it has been prepared, and for updating the plan as needed.

**11** inform the public of the reimbursement process, explaining how, when and where depositors may file claims and receive reimbursements in the event of a credit union failure.

# JOINT RESPONSE FROM THE MINISTRY OF FINANCE, THE FINANCIAL INSTITUTIONS COMMISSION AND THE COMMISSION

The Ministry of Finance (the Ministry), the Financial Institutions Commission (FICOM) and the Commission thank the Office of the Auditor General (OAG) for its report on the oversight of British Columbia Credit Unions.

Credit union depositors have never experienced a loss in the 75 years that credit unions have operated in British Columbia (BC), and there is no reason for concern that BC credit union depositors are at risk. In Canada and in BC the financial sector proved more resilient through the global financial crisis of 2008 and 2009 than those in most other industrialized countries. Throughout the crisis and today, each of BC's 43 credit unions maintains capital and liquidity levels above minimum statutory requirements.

Deposit insurance for BC credit unions dates back to 1968, shortly after the federal government established the Canada Deposit Insurance Corporation (CDIC) as the deposit insurance program for banks and other federally regulated deposit-taking institutions. For most of the time since its inception, the deposit insurance program provided by the Credit Union Deposit Insurance Corporation (CUDIC) has offered higher levels of coverage to credit union depositors than that provided to depositors of federal institutions.

From 1990 until 2005, CUDIC provided $100,000 of coverage to credit union deposits while CDIC provided $60,000 of coverage to deposits held by federally regulated deposit-taking institutions. In 2005, CDIC raised its coverage limit to $100,000. In 2008, as part of a broader plan to respond to the destabilizing impacts of the global financial crisis, the BC government removed the limit on provincial deposit insurance coverage. At the same time, the Commission was given increased regulatory powers to intervene when a credit union demonstrates deteriorating financial stability.

The 2008 financial crisis highlighted weaknesses in financial institutions and regulatory frameworks of many countries around the world. In response standard setting bodies for financial regulators have issued extensive new and revised standards in recent years. The standards used by the OAG in its review, the International Association of Deposit Insurers (IADI) *Core Principles for Effective Deposit Insurance* and the Basel Committee on Banking Supervision (BCBS) *Core Principles for Effective Banking Supervision*, were issued in 2009 and 2012 respectively.

As the OAG noted FICOM, like many financial regulators around the world, is still working toward implementing the changes necessary to meet these new standards. This transition is a significant undertaking not only for FICOM but also for the credit unions it regulates. FICOM began this transition, as the OAG noted in its report, in 2012 with the adoption of a new Supervisory Framework. That same year the Commission approved changes to the deposit insurance assessment framework to more closely align with IADI standards and in 2013 FICOM issued guidelines to BC credit unions to strengthen governance and capital management.

In early 2013 the Ministry and FICOM undertook a preliminary analysis of the regulatory and supervisory framework for BC credit unions. This work was undertaken as background research in anticipation of the upcoming review of the *Financial Institutions Act* (FIA) and *Credit Union Incorporation Act* (CUIA). The results of this analysis were shared with the OAG as part of their audit. Not surprisingly, given the degree of change in the financial sector and in financial regulation in recent years, the current legislation is not completely consistent with new and revised international standards.

The government will be initiating its planned review of the FIA and CUIA in 2014. As is normal practice for a review of this nature, consideration will be given to the changing landscape including new and emerging standards such as those set out by IADI and BCBS. The review will give consideration to the degree to which these standards should apply to the BC credit union system. The Ministry agrees with Recommendation 1 in the OAG's report.

The transition to a new supervisory framework undertaken by FICOM has changed the nature of its work significantly and as a result, the skills required by its staff have also changed significantly. The staff shortages noted by the OAG in its audit are primarily in more senior and specialized roles and difficulty attracting and retaining people to these roles results from a range of factors including a highly competitive environment for skills in financial sector risk management.

The Ministry and FICOM are working together to address the current staffing shortage noted by the OAG in its report. FICOM is funded by the sectors it regulates and therefore, in 2012 and 2013, was partially exempted from the public sector staffing management strategy and permitted to recruit for certain critical vacancies. However, as the OAG noted, notwithstanding this exemption FICOM has been unsuccessful in filling many of its vacant positions. As a result, in November of last year, the Ministry of Finance requested that the Public Service Agency work with FICOM on developing a more strategic solution to its staffing challenges. Recommendations arising from this work are expected in April 2014 and decisions on implementation will be made soon after.

As an interim measure, in order to improve the coverage and maintain the quality of its supervisory work, FICOM will supplement its current staffing complement with contract resources. This will ensure that an onsite examination can occur for all 43 credit unions within the next 24 months. Over this period FICOM expects that it can implement a long term staffing strategy that will ensure it can reduce its reliance on contractors as recommended by the OAG's report.

In summary, the Ministry and FICOM agree with Recommendations 2 and 3 in the OAG's report and intend to continue to work together to identify and implement a strategy that will enable FICOM to attract and retain the staff necessary to fulfil its mandate.

We are pleased that the OAG's findings noted improvement in the quality of FICOM's supervisory work since the adoption of the new Supervisory Framework in 2012. This reflects the considerable effort that is ongoing in this area. The policies and processes noted in Recommendations 4 and 5 in the OAG's report will be implemented by FICOM in 2014 as part of our continuous effort to improve the quality and consistency of our supervisory practices.

Recommendations 6, 7 and 8 are also well on their way to being addressed. In 2013 the Commission directed staff to undertake a review of the target size for the deposit insurance fund, including a review of the actuarial model and funding guidelines against those set out by IADI. The final funding guidelines from IADI were released in draft to member organizations (CUDIC is a member organization of IADI) in late 2013 and are expected to be finalized and made public later this year. The Commission expects to review and approve any resulting changes to its target fund size and funding policies by September 2014. The Commission agrees with the recommendations set out in the OAG's report and will be including them as part of this comprehensive review.

The Ministry and the Commission also agree with Recommendations 9 through 11 pertaining to the completion and communication of an operational plan for reimbursing depositors. As noted earlier, not a single credit union depositor has ever suffered a loss in the 45 years since deposit insurance was introduced. Notwithstanding this strong track record, the financial crisis reminded regulators and deposit insurers of the value of being prepared, even for events that appear very unlikely. We agree that consumer confidence is critical to the stability of even the strongest financial sector and being prepared for all events is part of ensuring that confidence remains intact, even in times of financial stress.

As noted by the OAG, a joint working group of the Ministry and FICOM staff initiated this work in 2012. It is a complex project requiring involvement of several divisions with a range of expertise. A plan is in place and the Commission and Ministry have agreed to complete the plan before the end of March 2015. Once complete the Commission will ensure relevant details of the plan are made available to credit union depositors on FICOM's website and an annual review of the plan will be included in the Commission's governance policies.

# BACKGROUND

**Credit unions began** establishing in Canada many years ago as an alternative to the federally chartered banks. They occupy a unique place in the Canadian financial services industry. They offer a full range of financial services just as chartered banks do, but – unlike banks – they are owned by their members. Credit unions have long played an essential role in serving smaller and remote communities and other markets the banks did not serve.

All credit unions in the country are incorporated provincially, and can have branches only in the province in which they are incorporated (although in some circumstances a BC credit union can do business outside the province).

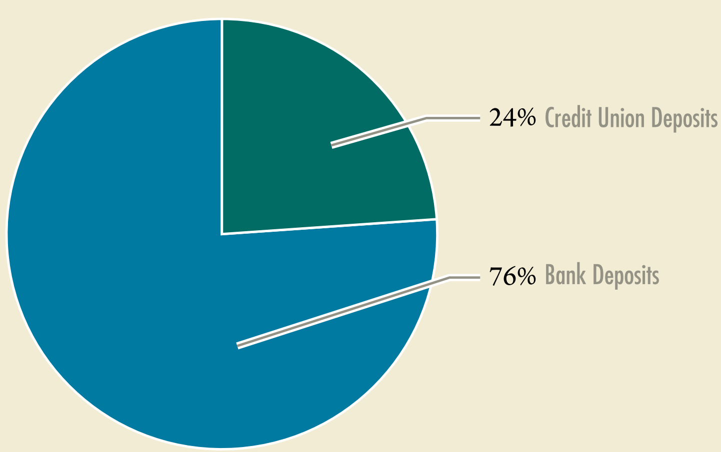
The regulation of credit unions in BC is guided by the *Financial Institutions Act* and the *Credit Union Incorporation Act*.

## The significance of credit unions in British Columbia

BC's 43 credit unions together have almost 1.9 million members and hold over $50 billion of insured deposits (as of June 30, 2013). The two largest credit unions, Coast Capital and Vancity, have a combined membership of just over 1 million and hold over 50% of these deposits. The 10 largest together have more than 1.5 million members and hold more than 80% of these deposits.

By comparison, BC's federally regulated banks hold approximately $160 billion of deposits (see Exhibit 1).

**Exhibit 1:** Comparison of total credit union deposits and total bank deposits, as a percentage of total financial institution deposits in British Columbia




Sources: Financial Institutions Commission of British Columbia; Bank of Canada Banking and Financial Statistics report

When the global financial crisis hit in 2008, the BC government responded with 10 initiatives, one of which was to change legislation to provide for unlimited deposit insurance coverage for deposits in the province's credit unions.[2] Previously, the insurance was limited to $100,000, the same as it still is in Canadian banks.

## Responsibility for credit unions

Three main players are responsible for the management of credit unions in BC:

- The **Credit Union Deposit Insurance Corporation of British Columbia (CUDIC)** provides credit union deposit insurance and administers a credit union deposit insurance fund. CUDIC is administered by FICOM, which allocates a percentage of its salaries, occupancy costs and other expenses to CUDIC based on the proportionate share of activities.
- The **Financial Institutions Commission (FICOM)**, an agency that is part of the Ministry of Finance, regulates the credit unions and administers CUDIC. **The Superintendent**, appointed by the Lieutenant Governor in Council, is the Chief Executive Officer of FICOM. The **Financial Institutions Division** within FICOM is responsible for carrying out the supervisory program for credit unions. FICOM also has other responsibilities: it regulates other financial institutions carrying on business in BC, (e.g., trust companies and insurance companies), real estate, mortgage brokers, strata property and pension plans.
- **The Commission**, a panel charged with overall regulatory oversight, and comprising a group of individuals (currently seven in number, but up to nine may be appointed) appointed by government through a merit process based on their expertise in the areas of business, finance, regulation and administrative law. Members of the Commission are all independent of government with the exception of the Deputy Minister of Finance who is an ex-officio member. The Commission is only involved in the regulation of credit unions and other financial institutions, and does not have any role relating to the other areas (e.g., real estate and mortgage brokers) that FICOM is responsible for. As well, the Commission has no operational control over FICOM, for example its staffing.

In this report, "FICOM" refers to the agency that is part of the Ministry of Finance; the "Commission" refers only to the panel charged with overall regulatory oversight; the "Superintendent" refers to the Superintendent of Financial Institutions; and the "Financial Institutions Division" refers to the division within FICOM that is responsible for carrying out the supervisory program for credit unions.

## Supervision of insured deposits

The strength of any deposit insurance system depends on the effective supervision of the financial institutions where the deposits are insured. Global standards and best practice for the supervision of financial institutions encourage a risk-based approach (meaning more time and resources are devoted to the larger, more complex or riskier institutions). This approach is intended to identify potential problems early, allowing proactive intervention by the regulator.

2 For what the unlimited deposit insurance covers, see Frequently Asked Questions under the CUDIC tab on FICOM's website: www.cudicbc.ca/faq/faq.pdf.

Important to understand about this approach is that the primary objective is ensuring the safety and soundness of financial institutions and the stability of the system overall. Prevention of all failures is not an objective of supervision. Rather, supervision aims to reduce the risk of failure occurring – and, if a failure does occur, to minimize its impact and ensure resolution is orderly and depositors are protected.

FICOM's supervisory framework is based on standards set out in the *Core Principles for Effective Banking Supervision* published by the Basel Committee on Banking Supervision. These minimum standards for sound supervisory practices were originally established in 1997 and most recently updated in 2012. They are considered universally applicable and have been adopted by Canada's Office of the Superintendent of Financial Institutions (the federal regulator of banks and other federally incorporated financial institutions). They are also in use in countries around the world, as well as by the World Bank and the International Monetary Fund.

Although these standards were originally developed with banks and banking systems in mind, the revised core principles can be used on financial institutions ranging from large internationally active banks to small, non–complex deposit taking institutions. Almost all of them are applicable to credit unions in BC.

FICOM's approach to supervising credit unions and other financial institutions is detailed in FICOM's Supervisory Framework.

### Management of the deposit insurance fund

A strong deposit insurance system not only requires effective supervision, but also sound management of an insurance fund, if one is used. Some countries maintain insurance funds while others opt to cover losses by borrowing the funds to pay out insured depositors and then repay the borrowing later.

An insurance fund has been established in BC and is funded by the credit unions through an annual assessment by CUDIC, which also holds the money in trust. FICOM is responsible for the management of the deposit insurance fund which is based on international standards set out in the *Core Principles for Effective Deposit Insurance Systems*. These standards were developed by the International Association of Deposit Insurers, and updated jointly with the Basel Committee on Banking Supervision in 2009. They are considered to be adaptable to a broad range of country circumstances, settings and structures.

## AUDIT OBJECTIVES AND SCOPE

We conducted this audit to determine whether the method and extent of the supervision of the province's credit unions are appropriate. Our focus was on assessing whether FICOM was following best practices in its supervision of credit unions. In particular, we wanted to determine whether:

- FICOM has an effective credit union monitoring program;
- the deposit insurance fund is adequate to cover a significant credit union failure; and
- a full plan is in place to ensure that payments from the insurance fund could be made to depositors promptly, should a credit union fail.

We did not look at FICOM's supervision of other financial institutions in BC (such as insurance and trust companies), or at FICOM's other responsibilities, which include real estate, mortgage brokers and pension plans.

Our work was carried out in the fall of 2013. We conducted the audit in accordance with section 11(8) of the *Auditor General Act* and the standards for assurance engagements established by the Chartered Professional Accountants of Canada.

## AUDIT CONCLUSION

We concluded that FICOM uses an appropriate supervisory framework for monitoring BC credit unions; however, FICOM is not currently performing timely reviews of them due to a shortage of staff. FICOM may not be able to detect a worsening situation at a credit union in time to address and reduce the risk of failure.

Overall, we found that FICOM is working towards meeting international industry standards (set out by the Basel Committee on Banking Supervision and the International Association of Deposit Insurers). Improved documentation around FICOM's judgements in determining composite risk ratings since the new supervisory framework was adopted in mid-2012 is a positive change. Some of the standards have not yet been adopted, but FICOM has gone as far as it can go within the existing legislation. Given that the required 10-year review of that legislation (the *Financial Institutions Act* and the *Credit Union Incorporation Act*) is due in 2014, government has an opportunity to consider amending the legislation so FICOM can fully adopt these standards.

Supervision of credit unions is currently significantly constrained due to a shortage of staff. At the time of our audit, 35% of positions identified in its Financial Institutions Division were vacant. As a result, even though FICOM has developed an appropriate supervisory plan, the lack of staff is impeding its ability to carry out the full scope of the plan in a timely manner.

Although FICOM is establishing appropriate risk ratings for credit unions (risk ratings represent the risk profile of a credit union and determine the degree of monitoring required by FICOM), again the lack of staff is stalling the effectiveness of this work. Just over half of the ratings are based on onsite reviews that were over two years old at the time of our audit.

FICOM is using an appropriate method for determining the target size of the deposit insurance fund, although there are upcoming changes in international guidance that should be reviewed. FICOM is also properly maintaining and investing the funds.

While there has never been a failure of a BC credit union that required the deposit insurance fund to make payments to depositors, a detailed operational plan is not yet in place for doing so should a credit union fail. However, a plan is currently being developed. Such a plan is important to ensure that all parties involved would be clear on their roles and responsibilities, and that payments would occur in an orderly and timely fashion to maintain depositor confidence across the credit union system.

# KEY FINDINGS AND RECOMMENDATIONS

## Working to meet industry standards

FICOM adopted a supervisory framework in June 2012 based on the *Basel Core Principles for Effective Banking Supervision*. Those principles have evolved to deal with the increasing complexity of financial services including both banks and credit unions. Credit unions are becoming more complex, and FICOM, as BC's regulator, identified the need to modernize its supervisory practices to maintain robust oversight of the credit union system in this province.

FICOM is still making the transition to this new principled, risk-based approach, and is working on completing, documenting, disseminating and communicating the new approach. We found, however, that FICOM will not be able to adopt some standards without the legislation being amended.

The standards require, for example, that the responsibilities, objectives and powers of the monitoring authority and the operational independence and accountability of the supervisor (FICOM in this province) be prescribed in legislation.

However, the legislation that guides FICOM's regulation of credit unions still reflects a primarily compliance-based approach, as opposed to the principle and risk-based monitoring approach. FICOM's previous approach to regulation was limited largely to the supervision of investment and lending activities.

As well, although the Commission has overall regulatory oversight, FICOM is part of the Ministry of Finance's operations. For example, FICOM's budget is approved through the Ministry. It is also required to follow government's *Core Policies and Procedures Manual* (i.e. financial policies and financial administration procedures), as well as the Public Service Agency's human resource management policies and framework.

While the standards were developed for use by bank regulators, the majority of them are applicable to the regulation of credit unions in BC, and fully adopting all of the applicable standards will give FICOM greater flexibility in dealing with the issues it may encounter with credit unions.

In the case of deposit insurance coverage, the *Core Principles for Effective Deposit Insurance Systems* (published jointly by the Basel Committee and the International Association of Deposit Insurers) discourage unlimited deposit insurance because of the potential incentive for increased risk-taking by the institutions.

As well, a new view of deposit insurance coverage is emerging in the industry[3] in which the predominant function of coverage is to promote confidence, financial stability and prevent chaotic depositor withdrawals. Accomplishing that can be done by:

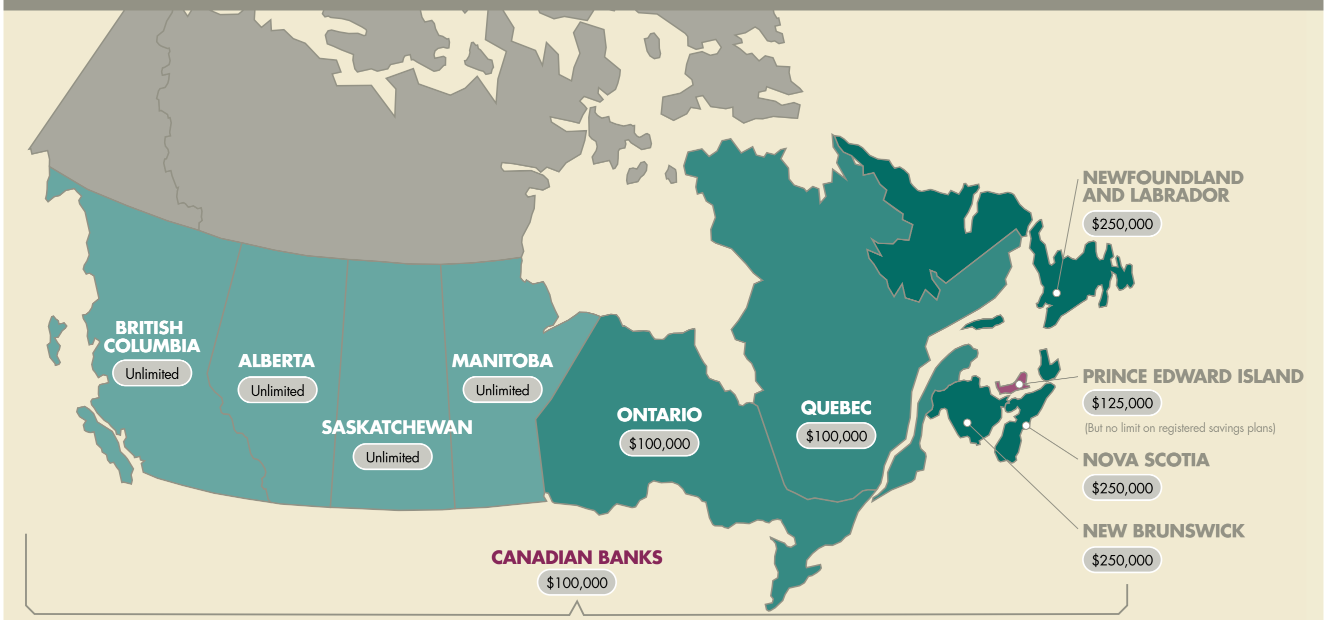
- covering fully most, but not all, depositors and ensuring that depositors are informed on the limit of coverage (where it exists); and
- ensuring that a significant portion of the value of the deposits are not fully covered.

3 "*Enhanced Guidance for Effective Deposit Insurance Systems: Deposit Insurance Coverage*," guidance paper, (International Association of Deposit Insurers, March 2013).

The Financial Stability Board recognizes Canada as having appropriate deposit insurance coverage.[4] It gives Canada's "bank" deposit insurance system as an example of a jurisdiction where an appropriate balance has been sought: the insurance covers an estimated 97% of eligible deposit accounts, but only 35% of the total value of deposit liabilities.

In Canada, only BC, Alberta, Saskatchewan and Manitoba have unlimited deposit insurance coverage applicable to credit unions (see Exhibit 2). In all other provinces and territories, credit unions and federally incorporated financial institutions have limits varying from $100,000 to $250,000 (although some provinces place no limit on the amount of registered savings plans that are insured). BC's deposit insurance limit is set in legislation and, therefore, not controlled by FICOM or CUDIC.

**Exhibit 2:** Deposit insurance limits for credit unions in Canada




Note: Where limits exist, they are usually account-specific. Investors therefore often have the option of arranging their affairs to have more than one insured account. This is a summary only. For complete details, check with the appropriate deposit insurer.

Source: Compiled by the Office of the Auditor General of British Columbia

## *Legislation review is due in 2014*

The *Financial Institutions Act* requires that government initiate a review of the legislation every 10 years to determine what changes, if any, should be made. The last review was completed in 2004, so another one is due in 2014. We see this review as an opportunity for government to consider whether, or to what extent, it wants to make changes to enable FICOM to implement the Basel standards.

**RECOMMENDATION 1:** ***We recommend that the Ministry of Finance ensure that in its review of the Financial Institutions Act and the Credit Union Incorporation Act, it also review the standards set out in the Core Principles for Effective Banking Supervision and the Core Principles for Effective Deposit Insurance Systems.***

4 "*Thematic Review on Deposit Insurance Systems,*" Peer Review Report, Financial Stability Board (February 8, 2012).

## FICOM does not have adequate staff to carry out its supervisory plan

An effective supervisory plan for monitoring credit unions should:

- provide for the development and maintenance of a forward-looking risk profile for individual credit unions;
- account for risks relating to the credit union system as a whole; and
- focus efforts proportionate to the relative importance of each credit union within the whole system.

Such a plan allows action to be taken when needed.

We found that FICOM's supervisory plan generally follows the industry standards. Each credit union's *composite risk rating* (see sidebar) includes an assessment of how the risk might change in the near future. The importance of each credit union to the system as a whole is taken into account when onsite reviews are planned, and there are periodic reviews of the potential impact of key economic factors, such as trends in the local and broader real estate market. As well, the process of *staging* each credit union (see below) enables an early response to issues that may arise.

Even though FICOM has an appropriate supervisory plan, we found that it cannot implement the plan due to a lack of staff.

### Composite risk rating for credit unions in British Columbia

The composite risk rating, which represents risk profiles of credit unions, is central to the risk-based approach to monitoring credit unions. Each rating reflects a credit union's significant business activities (e.g., commercial lending), earnings, liquidity and capital. It can be low, moderate, above average or high; and it can be rated as decreasing, stable or increasing.

How a credit union is rated then determines the degree of monitoring required by FICOM.

For example, a credit union's composite risk rating might be "low, increasing, six months." This means that while low now, that institution's level of risk could potentially increase in the next six months if a specific issue is not dealt with.

### Staging

Each credit union's composite risk rating determines what FICOM's level or stage of intervention will be. At each stage, the following supervisory actions typically occur:

**Stage 0 – normal:** Periodic onsite reviews; monitoring of monthly, quarterly and annual financial and other information; and other supervisory actions, as needed, are carried out.

**Stage 1 – early warning:** A credit union at this stage is not expected to fail or pose any immediate risk of loss to depositors. However, specific concerns do need to be addressed. Typical supervisory actions may include: more frequent onsite reviews and detailed collection and analysis of data; communication of concerns to directors, management and auditors; requests for specific analysis of risk scenarios; special examinations; and expectations for specific action.

**Stage 2 – risk to financial viability or solvency:** The credit union's business operations or circumstances potentially put depositors at risk, and specific problems need to be addressed quickly. The credit union may be given directives to increase the capital or restrict certain activities. Whatever the directives, the credit union must implement improvements to resolve the identified issues immediately.

**Stage 3 – future financial viability and solvency in serious doubt:** The credit union has severe safety and stability concerns and is experiencing problems. The credit union may be placed under FICOM's administration, wound down or merged with another credit union.

**Stage 4 – non-viability/insolvency imminent:** At this stage, there is insufficient capital to protect depositors from loss. The credit union may be placed into liquidation and the insurance fund may have to make payments to the depositors.

Source: Adapted from the Financial Institutions Commission

## FICOM is short staffed

At the time of our audit, FICOM had 25 staff vacancies representing 35% of positions in its Financial Institutions Division. As FICOM operates under the government-wide hiring restrictions, it sought permission to be exempted from this. In the summer of 2013, it was given permission to hire 17 staff; despite posting those positions, by the end of our audit it had been unable to fill any of them.

The staff shortage means that supervisory work, such as onsite reviews, has been scaled back significantly over the last two years. For instance, FICOM completed only 7 of 17 planned onsite reviews of credit unions in 2012/13. Four more were rolled over to and completed in 2013/14. For 2013/14, the 16 planned onsite reviews have been reduced to three to focus on the larger institutions.

At this rate, it will take more than three years to complete an onsite review for each of the 10 largest credit unions, and over 14 years to review all of BC's credit unions. At the time of our audit, two of the 10 largest credit unions had not had an onsite examination since 2010.

This situation concerns us. An up-to-date onsite review is an important part of determining a reliable composite risk rating. A worsening situation at a credit union may not be detected in time to address and reduce the risk of failure.

Given that FICOM is funded entirely by credit unions and the other entities it regulates, and in recent years it has not spent all of the revenue it receives, it should be able to hire additional staff without an increase in its funding.

**RECOMMENDATION 2:** ***We recommend that the Ministry of Finance work with FICOM to find ways to enable it to hire and retain the staff it requires to fulfill its mandate.***

## FICOM lacks important staff expertise and competencies

Vacant positions in the Financial Institutions Division are concentrated in senior level roles and specialized positions. As a result, in addition to being short staffed, the team responsible for monitoring credit unions does not have all the expertise and competencies it needs to carry out forward-looking analysis or system-wide analysis. While some staff are required to focus on the forward-looking analysis, they have been unable to devote their time to this function because of competing priorities and limited resources.

Use of external experts on a temporary basis to fill capacity gaps is common in many professions, and FICOM is increasingly using contract resources. While FICOM should have such expertise in-house to ensure continuity and consistency of its supervisory oversight, this may work temporarily for specialized positions. However, trying to carry out a mandate with too many contractors can be a risk especially with gaps in senior positions. FICOM needs experienced and knowledgeable staff to oversee the work performed by its own staff and any contractors, when used. As well, having specific technical expertise on staff would improve the quality and rigour of credit union reviews, and help FICOM better meet the demands of assessing some of the larger credit unions as they become more complex in their operations.

**RECOMMENDATION 3:** ***We recommend that FICOM improve key supervisory areas of its Financial Institutions Division by recruiting staff with the required expertise and competencies.***

## Documentation of composite risk ratings is inadequate in some cases

We found that FICOM gathers sufficient and appropriate evidence to determine a composite risk rating for the credit unions it reviews, and that the risk ratings it arrives at are appropriate. It reviews a multitude of documents, such as audited financial statements, internal audit reports, credit union policies and loan records, and interviews credit union directors and officers. We also found that the quality of documentation around FICOM's judgements in determining composite risk ratings has improved considerably since the new supervisory framework was adopted in mid-2012.

An area that did concern us, however, was that in some cases not all of the decisions supporting the risk rating were adequately documented. For example, the commercial lending activity of one credit union was not considered when determining the composite risk rating. Commercial lending is often a significant line of business for a credit union. However, after reviewing the financial data we determined that the commercial lending activity for this credit union was not significant, and so it properly did not need to be considered. However, this rationale should have been documented.

In supervising credit unions that range in size and complexity, FICOM tries to adapt its supervisory framework and processes to accommodate the smaller credit unions. We therefore understand that the documentation inconsistencies we identified could be due to FICOM staff making these adaptation decisions but not documenting them in the files.

When judgements and conclusions are not documented, two problems can result:

- It is possible that the overall risk rating of a credit union could be incorrect, since an invalid assumption may have been made and therefore an incorrect level of supervision applied.
- FICOM may be unable to show that it has exercised due diligence in its supervision of credit unions.

As well, good documentation can be used for training and quality assurance purposes.

**RECOMMENDATION 4:** ***We recommend that FICOM implement policies and processes to ensure consistent documentation by staff when determining composite risk ratings.***

**RECOMMENDATION 5:** ***We recommend that FICOM document the work processes to be used in supervising smaller credit unions.***

## The method for determining the deposit insurance fund balance is appropriate

**Actuary:**
An expert in statistics, especially one who calculates insurance risks and premiums.

There is no worldwide standard as to the optimal balance for a deposit insurance fund, although the International Association of Deposit Insurers is working to address this. As a result, a variety of techniques are being used to establish target fund sizes for deposit insurers. Some jurisdictions aim to have their fund equal the amount of insured deposits in a few small or medium-sized institutions. Others determine the fund size based on their experience with failed financial institutions, sometimes using sophisticated modeling techniques. Still others opt to cover losses by borrowing the funds to pay out insured depositors and then repay the borrowing later.

The funding models for deposit insurance used by all Canadian jurisdictions involve accumulating a reserve of funds before those funds are needed. In all cases in Canada, the funding comes from the institutions where the deposits are insured. Federally, and in all provinces except Quebec, a target fund balance has been established. (In Quebec, the institutions pay an annual premium to the deposit insurer, but there is no target fund size.)

In BC, an actuary's recommendation is used to determine the target size for the insurance fund. Each credit union in the province pays into the deposit insurance fund.

While there are some limitations to using only an actuarial valuation (e.g., the calculation mainly uses historical data, which is not necessarily a good indicator of the future), it does consider both quantitative and qualitative factors. Overall, then, we think this is an acceptable approach.

Common practice is to have an actuarial valuation done every three to five years. In BC, the target for the deposit insurance fund size was last reviewed in 2008. It has not been adjusted since. An actuary was engaged in late 2013 to review the target fund size and to recommend ways to enhance the model used to determine that size. In our view the target fund size should be reviewed annually and adjusted, if needed, to respond to regular economic fluctuations such as the expected rate of interest being earned on the fund and changes to the credit union system such as deposits growing faster than anticipated. Doing this would not require a new actuarial review each year.

**RECOMMENDATION 6:** ***We recommend that the Commission establish policies and guidance for determining an appropriate target size for the deposit insurance fund.***

**RECOMMENDATION 7:** ***We recommend that the Commission implement the guidance on target fund size being prepared by the International Association of Deposit Insurers, once it is available.***

**RECOMMENDATION 8:** ***We recommend that the Commission annually review and, if needed, adjust the deposit insurance target fund size to ensure it remains sufficient for its purpose.***

## The deposit insurance fund size is being properly maintained

**Basis point:**
A basis point is 1/100th of 1%.
Example: 88 basis points is 0.88%.

In 2008, the limit on deposit insurance coverage was removed by the Province. As a result, FICOM, guided by a report from an actuary, increased the target size of the deposit insurance fund to 88 basis points (see sidebar) of insured credit union deposits. The fund size at the time was 73 basis points. The decision was to move to the higher target size over a period of years so the credit unions would not be assessed a large, unexpected expense all at once. At March 31, 2013, the fund size was 85.1 basis points. The goal is to reach the new target in fiscal 2016.

Although the target is static at 88 basis points, the target fund size in dollars continues to grow because the amount on deposit at credit unions continues to grow. At March 31, 2009, the target fund size (88 basis points) was $343 million. Four years later, at March 31, 2013, the target fund size (still 88 basis points) had grown to $443 million – $100 million more. During the same period, the actual fund has grown by $142 million (from $286 million to $428 million).

Based on the history of the fund growth from investments and the additional assessments, the fund is expected to reach its target of 88 basis points in fiscal 2016.

## The fund balance is being properly invested

Legislation requires CUDIC to put the deposit insurance fund balance in any investment that a pension plan under the BC *Pension Benefits Standards Act* is allowed to make. The only limit is that it may not invest more than 3% of the fund's balance in shares of a central credit union.

We found that the money in the deposit insurance fund is with the British Columbia Investment Management Corporation and held in investments that comply with the legislation and CUDIC's policies. (Over 90% of the fund is invested in federal and provincial government bonds.)

## A plan for insurance fund payments is required

Maintaining consumer confidence in BC's credit union system should one of the institutions fail depends on depositors feeling assured they could be paid quickly. The logistics in doing so, however, could be considerable, since the largest credit unions have up to 1 million accounts, and FICOM would need to ascertain who the account holders were, verify the amounts they had on deposit, and make payments to them.

Although there has never been a failure of a BC credit union that required the deposit insurance fund to make payments to depositors, sorting out what needs to be done, how and by whom is not something that should be worked out as a failure unfolds. As for any other emergency preparedness scenario, government needs a plan so that if a failure occurs, the relevant parties know what needs to happen.

Also critical is that a plan for making insurance payments to depositors ensures that temporary liquidity funding is available so the deposit insurance fund can issue the necessary payments before liquidating the credit union's assets. The deposit insurance fund target size is the estimated amount needed to cover the net loss after the orderly liquidation of a credit union. It is not intended to be enough to provide liquidity funds for a quick pay out. Indeed, at March 31, 2013, each of the 15 largest credit unions had amounts on deposit that exceeded the fund balance. Since an orderly liquidation would take some time, additional temporary funding may be needed to cover the insurance payments to depositors.

Unclear or informal standby funding arrangements that would likely require additional approval before the funding is made available could jeopardize the speed of handling insurance payments and shake financial stability. This could create a general lack of confidence in the credit union system.

We know that a joint FICOM and Ministry of Finance group is working on such a plan. Until that plan is complete, however, the province is not in a position to give the public assurance that payments from the insurance fund could be made to depositors promptly were a credit union to fail.

**RECOMMENDATION 9:** ***We recommend that the Commission ensure that the joint FICOM and Ministry of Finance group finishes the operational plan for payments to insured depositors by an agreed-to date, and ensure that the plan includes:***

- ***operating protocols;***
- ***a target timeframe for reimbursing depositors; and***
- ***formal funding mechanisms including back-up funding options.***

**RECOMMENDATION 10:** ***We recommend that the Commission establish a policy for reviewing the operational plan for payments to insured depositors on a regular basis once it has been prepared, and for updating the plan as needed.***

We also note that guidance from the International Association of Deposit Insurers states that, for a deposit insurance system to be effective, the public must be regularly informed about the benefits and limitation of the deposit system. We found that although some information is made available to British Columbians on FICOM's website, nothing about the reimbursement process to depositors is explained.

**RECOMMENDATION 11:** ***We recommend that the Commission inform the public of the reimbursement process, explaining how, when and where depositors may file claims and receive reimbursements in the event of a credit union failure.***

# LOOKING AHEAD



**We will follow up** with FICOM, the Commission and the Ministry of Finance to assess their progress in implementing the recommendations in this report. Our Office looks forward to the operational plan for payments to insured depositors in development by FICOM and the Ministry of Finance, and encourages the publication of relevant information to the public as soon as possible in 2014.

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