

Federal Credit Unions

Considerations for a Credit Union Becoming a Federal Credit Union

Prepared by McDougall Gauley LLP
with assistance from
Centre for the Study of Co-operatives
University of Saskatchewan

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Note: Due to frequent updates to the *Bank Act*, there are no direct links to the individual sections referred to in this paper. There are links to the first several references to the *Bank Act* and readers will find it easy to navigate to particular sections by making use of the *Bank Act's* Table of Contents on the home page. Links to other documents and websites are highlighted in blue in the text.

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Federal Credit Unions

Considerations for a Credit Union Becoming a Federal Credit Union¹

Part 1: Background

CREDIT UNIONS ARE FULL-SERVICE FINANCIAL INSTITUTIONS, established pursuant to provincial laws that authorize them to provide financial services in individual provinces.

Provincial law has expanded significantly over the years, so that credit unions can now offer services that closely parallel those provided by a Schedule 1 bank.² The substantial difference is that provincial law allows credit unions to operate only within the province of legislation, unless another jurisdiction expands that capacity. A Schedule 1 bank, in contrast, operates nationally and, as applicable, internationally. Federal law does apply to credit unions in matters such as settlement and terrorism control.

Over the past few decades, credit unions have grown significantly in size of operation and in the complexity of their services. At the end of 2016, for example, credit unions and

1. This paper examines some of the legal matters relating to the continuance of a credit union as a federal credit union. It is intended to be a general guide and is not exhaustive. In particular, there are extensive business matters not directly addressed in this paper that will also require significant attention.

2. A Schedule 1 bank is a bank listed in Schedule 1 to the *Bank Act*. A Schedule 1 bank may provide services, in accordance with the *Act*, throughout Canada.

caisses populaires combined provided approximately \$307.5 billion in loans and took in around \$292.5 billion in deposits, which represent about 20.5 percent of Canadian banking loans and 18.8 percent of Canadian bank deposits. Members and customers³ being served, and their service demands, have grown immensely both in requirement and complexity. Credit unions are increasingly being asked to provide financial services to persons, businesses, and institutions beyond provincial boundaries. There is a clear demand for credit unions to have full national capacity to service business demands.

From time to time, legislation has authorized credit unions to accept registration in another jurisdiction and to provide the financial services permitted there. This has not functioned effectively for several reasons, including:

- (a) If a Saskatchewan credit union registers and receives deposits in from a resident of Manitoba, is the deposit guaranteed by the Saskatchewan Credit Union Deposit Guarantee Corporation or the Deposit Guarantee Corporation of Manitoba? Would the Saskatchewan corporation even have the legal capacity to extend a guarantee to a non-Saskatchewan-resident depositor?
- (b) Who is the regulator of the extra-provincial credit union services? In the case above, is the Saskatchewan regulator the full-faith official, both for operations and in circumstances of financial distress, including the credit union's Manitoba operations?
- (c) Where do consumer protection rights for appropriate oversight begin and end?

The complexity of the answers to these and many other questions limits the option of extra-provincial registration to expand the legal capacities of a credit union.

In practice, credit unions that provide extra-provincial financial services achieve this by doing one of two things: (1) they incorporate a subsidiary federal financial institution, bank, or trust company to carry on that activity, or (2) they buy the services from an existing federal financial institution such as Concentra Bank. Either case involves significant additional structural and operational cost. Larger credit unions have thus focused their energies on finding a way to expand their in-house capacity to provide full financial services beyond their provinces. This led to a request for an amendment to the *Bank Act* to permit credit unions to become federal institutions while continuing to provide services to members

3. "Customer" here refers to a person or institution that uses the financial services of a credit union, but is not a member.

within a co-operative governance model. The *Bank Act* is now amended and the new regulations and guidelines permit provincial credit unions to become (or “continue as”) Federal Credit Unions.

Purpose

The comments in this paper are intended to provide general information for credit unions considering a decision to continue as a Federal Credit Union under the *Bank Act*. Those giving it serious consideration would also be wise to retain the services of other professionals with expertise in interpreting the *Bank Act*. Unless otherwise specified, references herein to a section number, regulation, guideline, or guide are references to the *Bank Act*.

Becoming a Federal Credit Union (FCU) will give credit unions the ability to legally expand their capacity to conduct inter-provincial and/or international business. The comments made in this paper assume that any credit union considering continuing as an FCU has a history of prudential and successful operations.

It is important in this analysis to remember that the continuation of a credit union to become an FCU does not require the FCU to end its participation in the service relationships had by the credit union with participants in the credit union system. Credit unions are familiar with the International Co-operative Alliance’s principal of co-operation among co-operatives.

Part 2: Establishment Options

A FEDERAL CREDIT UNION may be established under the *Bank Act* in a number of ways, including:

- (a) incorporating as an FCU
- (b) continuing a single credit union as an FCU
- (c) amalgamating a credit union with an existing FCU
- (d) continuing and amalgamating several credit unions (provincially or inter-provincially) to form a single FCU⁴

4. Part III of the *Bank Act*.

While the focus of this paper is on continuance, the details for incorporation and continuance are similar.

Option (d) above, in particular, provides a significant leap in the ability of a credit union to adjust its structure in one step, becoming an FCU and providing services on an expanded provincial or multi-provincial basis. This provision is uniquely designed for credit unions becoming FCUs and significantly enhances the operational capacity of these organizations. Provincial laws do not allow an amalgamation of credit unions in two or more provinces, but this can now be effected by each of the interested credit unions continuing as FCUs and then immediately amalgamating. If credit unions from two provinces wished to become an FCU, the Office of the Superintendent of Financial Institutions will provide a consolidated review of the two credit unions operating as a single FCU.

The *Bank Act* contains provisions to accommodate the processes mentioned in (c) and (d) above. The required member notices for the combined continuance and amalgamation may be consolidated (34 (1.1)) and the minister may provide accommodations respecting member meetings (39.01).

There are detailed structural provisions in the *Bank Act* — both mandatory and elective — to ensure that credit unions becoming “FCU banks” will continue to operate as member-owned and directed financial institutions similar to established Canadian credit union concepts. Importantly, the *Bank Act* provides the flexibility to design the operations and governance structure of each FCU so that it meets the special financial needs of its members, whether operating provincially or inter-provincially (see Part 6: Membership and By-Laws.)⁵

In sum, an FCU will operate as a bank within the prudential operating requirements of the *Bank Act*, but its ownership and governance model will adhere to the co-operative model employed by credit unions.

The International Co-operative Alliance defines the co-operative model in [this document](#), which outlines the co-operative identity, values, and principles. Of particular interest is the concept of mutuality in ownership, capital obligation, governance, and services enjoyed. The capital obligation of a member may be satisfied in a number of ways, including initial investment in member shares and other capital, subsequent investment of patronage allocations, and the creation of reserves rather than distributing annual earnings. The members of the FCU make the by-laws for the FCU to establish this mutuality.⁶

5. By-laws refers to the by-laws of the FCU adopted in accordance with section 192.01.

Section 12.1 of the *Bank Act* lists the co-operative elements required by an FCU, which will be included in the design of the FCU's by-laws. A transparent disclosure of compliance with these requirements is provided as part of the FCU's annual financial statements (section 308 (3) (a.1)).

While corporations other than credit unions can apply to be continued as an FCU (section 33(1) and (2)), this paper is focused on the continuance of credit unions. A corporation wishing to continue as an FCU must meet all of the requirements for continuance (see "Part 11: Continuance," below), and a bank that is not an FCU may convert to one (section 216.01–.07).

Part 3: Why Consider Becoming a Federal Credit Union?

CREDIT UNIONS AND CASISSES POPULAIRES are financial institutions that provide a variety of services to varying classes of members and, in many cases, to other customers who are not members. Providing Canadian financial services is becoming increasingly complex, and credit union operations, as other financial institutions, are subject to significant oversight. In addition, more and more financial transactions are interrelated provincially, nationally, and internationally; customers will demand absolute confidence in the legal capacity of institutions to operate in these arenas.

The international market has a high regard for Canadian banking regulations, and financial institutions known internationally as Canadian banks garner significant "threshold" value. This is not to suggest that credit unions are not recognized as sound financial institutions, but simply that the international market is much more aware of Canadian banks — their capacities, structures, and regulatory regimes — and their availability for financial transactions. Credit unions can operate both nationally and internationally, but they first have to demonstrate that they have the legal capacity to do so, and second, that they have the ability to respond to potential or actual failures of particular transactions.

6. Co-operative governance in a credit union model is discussed in the following two papers: *Governance Challenges in Credit Unions: Insights and Recommendations*, by Dionne Pohler, and *Credit Unions in Canada: Design Principles for Greater Co-operation*, by Murray Fulton, Brett Fairbairn, and Dionne Pohler. Fulton, Fairbairn, and Pohler are all fellows at the [Centre for the Study of Co-operatives](#) at the University of Saskatchewan.

Concern is frequently expressed, both domestically and internationally, regarding the shared federal/provincial regulation of Canadian banking services and the resulting management of interrelated financial risk.⁷ Credit unions and *caisses populaires* represent about 20 percent of Canadian banking risk. Will the Government of Canada be required to regulate this substantial structural risk? Should credit unions, as provincial entities, anticipate a greater influx of federal rules directed to their operations, or in changing rules to participate in existing or new settlement systems?

With the Bank of Canada requiring increased provincial support for credit union settlement in the Canadian clearing and settlement systems,⁸ authorities have become more aware of the risks inherent in the operation of provincial credit unions. As a result, provincial credit union regulations have changed to more closely emulate the capital, liquidity, and business protocols required by banks. This move towards federal rules will simplify the transition for credit unions wishing to become FCUs.

Credit unions examining their long-term provision of financial services to members should consider the prudence of becoming an FCU from a number of perspectives.

1. What is the value to the credit union and its members of being a financial entity with a recognized, non-disputed capacity to operate in the competitive financial market, both nationally and internationally? A credit union with a province-only capacity may be limited in its ability to provide the services its members/customers require.
 - (a) Can a credit union have a member who (or that) is not ordinarily a resident of its province of incorporation and provide all financial services to that member? How does this apply to an incorporated entity that is either a member or a customer of a credit union that is ordinarily resident in another province? How do the limitations of a credit union's extra-territorial capacity impinge upon its operations?
 - (b) Can a credit union make a loan or participate in a lending structure that is designed to provide a financial facility beyond its provincial border?
 - (c) Can a credit union solicit and receive a deposit, or other funds described as

7. See Nicholas Le Pan, *Opportunities for Better Systemic Risk Management in Canada* (Toronto: C.D. Howe Institute, 2017) for an excellent review of the issues.

8. "Settlement" refers to the process by which financial claims on one institution from another are paid through the clearing systems operated by [Payments Canada](#) — for example, a cheque drawn by a member of a credit union deposited for settlement with a bank by the payee of the cheque. The Bank of Canada may provide emergency lending assistance (ELA support) to a financial institution to help it settle payment items drawn on it. "Payment items" are defined in the by-laws of Payments Canada's settlement systems.

a deposit, from the general public, including non-provincial persons? Can a provincial deposit agency guarantee a deposit from a person, member or not, if the credit union does not have the capacity to receive it?

- (d) Are there specialty financial services that the credit union would develop and supply if it had the capacity to supply this service on a cross-border basis?
2. What is the importance to the credit union of having its governing laws updated on a regular basis in a manner that would be consistent with meeting the increasingly complex rules for supplying national and international financial services? Increasingly, the rules for providing financial services require prompt international attention.
 3. How do credit unions (in each province) fit into the changing concepts of monetary structures and values? Federal regulations protect the supply and value of Canada's monetary assets, which increases federal control of credit union operations. The national rules and controls for new value transfer systems will apply to a credit union and detail how, as provincial entities, they will operate within these new rules. Provincial financial legislation generally follows federal laws, but often with a notable time lag. While timing can be critical in a competitive market, it is also important to recognize that credit unions and *caisses populaires* have financial services authorities not permitted to banks, particularly in the field of insurance. But what is the ability of provincial authorities to deal promptly with changing financial structures such as those resulting from new market risks? The reputational risk of credit unions in one province is affected by the actions of those in another. Credit unions should consider this systemic effect as they examine the advisability of adopting an FCU structure and in designing it should they choose to do so.
 4. The regulatory impact of provincial operational and prudential rules is limited to the credit unions in each particular province, with differing legislation among the provinces. Will this create competitive and operational risks and uncertainty among credit unions in different provinces?
 5. Does the credit union have the capacity to meet future needs? As Canadian businesses mature, more and more of them will require full access from their financial institution to both national and international markets. This must be taken into account to ensure that the credit union model is not limited by a provincial structure that may not meet the future needs of its members. A manufacturing business, for example, may require national market services, including capital, to be successful.

6. What is the risk tolerance of customers of a credit union in circumstances of final claims? All financial institutions that provide for deposit taking, lending, and investment activities must be as risk free as possible. Of significant importance here is the ability of the institution to operate within well-defined rules at times of difficulty.

Here are some considerations:

- (a) If an FCU experiences financial difficulties, the rules established by the [Office of the Superintendent of Financial Institutions](#) (OSFI)⁹ and the [Canada Deposit Insurance Corporation](#) (CDIC)¹⁰ are in place to react. Importantly, under section 648 of the *Bank Act*, OSFI may place an FCU under oversight management and, with the assistance of the *Winding-up and Restructuring Act*, may restructure it for future operations. If the FCU's financial difficulties require a reorganization, the rules set out in [section 39](#) of the *CDIC Act*, including the rules under section 39.371 to establish a "bridge FCU," will help protect members and depositors. These rules and regulations can assist the FCU to continue providing financial services to its members and customers.
- (b) Provincial deposit protection agencies provide deposit insurance and have the right to supervise credit unions in financial difficulty and to take control of and manage their assets and liabilities. There are limits to what a provincial deposit protection agent may do, however, as legislation relating to insolvency is a federal matter. If a credit union becomes an insolvent person, as described in the *Bankruptcy and Insolvency Act*, the Provincial Deposit Protection Agency loses legal capacity to manage the financial resources and obligations of the credit union. An insolvent person is an entity that does not have sufficient financial resources to pay all its immediate financial obligations. As this determination would be made after the fact, the ability of the Provincial Deposit Protection Agency may be restrained in circumstances of uncertainty. The federal regime clearly applies if the credit union has become an insolvent person. Because the *Bankruptcy and Insolvency Act* does not apply to a credit union that is a member of a central that is a member of Payments Canada, there is limited federal insolvency legislation available for a credit union in this position. The options available to an FCU mentioned in paragraph (a) above are not available for a credit union. The concept of certainty in final financial accountability may be of significant concern for a credit union or its

9. OSFI is a reference to the superintendent appointed under the *Office of the Superintendent of Financial Institutions Act*. The superintendent is responsible for the oversight of federal financial institutions, both for their compliance with the *Bank Act* and with prudential practices.

10. CDIC is incorporated by the *Canada Deposit Insurance Corporation Act* and provides insurance for federal and selected provincial deposit-taking institutions.

customers, and this may well limit the acceptability of a credit union for a specific funding or service relationship. Despite these caveats, it is important to remember that the credit union system has developed many successful processes, including settlement systems, that protect members from the effects of financial distress. However, it is well to know that there is a potential limit to the extent of provincial deposit protection in circumstances of financial difficulties.

7. Is an expanded access to settlement services important to the credit union? As a bank, an FCU becomes a member of Payments Canada (section 3 of the *Canadian Payments Act*). Payments Canada rules permit the FCU to be both a member of Payments Canada and a participant in the Credit Union Clearing Group¹¹ (section 28 of the *Canadian Payments Act*, By-law 3). This is important in planning settlement services for the FCU, including the selection of Participants and one or more Direct Clearers, described in the *Canadian Payments Act*, By-laws 3 and 7.
8. What is the value to the credit union and its members/customers to know with certainty that the business is operating within Canada's constitutional structure? Provincial governments can legislate only within provincial authority. How important is it for a credit union to know that providing its present and future financial services to members and customers can be authorized by provincial legislation? [Section 91\(15\)](#) of Canada's *Constitution Act* gives exclusive federal jurisdiction to "Banking, Incorporation of Banks, and the Issue of Paper Money," while [section 91\(14\)](#) addresses "Currency and Coinage."

A credit union expanding its financial services to customers who are not members drives it more clearly into the provision of "banking services." Are there limits on the legal capacity of a credit union to provide financial services to customers such as corporations, which may be engaged in national and/or international operations? Are there differences between making loans and receiving deposits when supplying services to members and customers?

It is important to note that the federal authority is not limited to making laws for

11. The Credit Union Clearing Group consists of the Credit Union Centrals of Manitoba, Saskatchewan, Alberta, and British Columbia, established as a Clearing and Settlement Group in accordance with [section 28](#) of the Payments Canada By-law 3. [Central 1](#) is currently the group clearer for the Credit Union Clearing Group. The operation of the Credit Union Clearing Group is more completely described in a 2016 document issued by Central 1 entitled *If not now, when?*

“banks” but rather, “banking.” This expression is very broad. Section 983 of the *Bank Act* limits the use of the expression “bank” or “banking” to an actual bank. Credit unions do engage in banking activity, but there are risks in describing their services as banking. If the extent of a credit union’s banking activity is exclusively provincial and with persons who are members and who ordinarily reside in the specified province, it is expected that the courts would maintain the constitutional validity of provincial credit union activity. This concept has been tested in the Canadian courts.¹² The federal budget of 27 February 2018 suggests that, in appropriate circumstances, section 983 may be amended to permit the use of generic banking words. That change would not expand the provincial legal authority of a credit union to provide financial services.

Credit unions have long been aware of the potential issues around the extent of the services they may engage in under a provincial charter. Each credit union should carefully review the extent of the authorities that it will require, now or in the future, to provide services to its members and customers. Can these services be supplied with certainty within a provincial authority? Might certain functions be brought into question? If so, are they likely to cause an erosion of confidence and/or a market interruption?

Continuing as an FCU is not a panacea for all the issues a credit union may expect to encounter in its planning forecast. Becoming an FCU should be seen as one possible option to review in parallel with others. In most cases, the detailed analysis required in preparing the five-year business plan will provide the answer.¹³

Credit unions are well managed and are subject to highly competitive regulatory and prudential and practice rules. The analysis of continuing a credit union as an FCU must commence from that point.

12. See [Canadian Pioneer Management Ltd. et al. v. Labour Relations Board of Saskatchewan et al.](#), [1980] 1 S.C.R. 433.

13. See the Office of the Superintendent of Financial Institutions [Pre-Continuance Business Plan](#). See also “Part 12: The Business Plan,” in this document.

Part 4: Legal Status of Federal Credit Unions

AN FCU IS A SCHEDULE 1 BANK, under the *Bank Act*, with the full capacity of any Schedule 1 bank to provide banking and extended financial services throughout Canada and internationally. The prudential banking rules for FCUs are substantially similar to those that apply to other Schedule 1 banks, with the fundamental distinction that an FCU will provide its financial services and effect its governance in accordance with the co-operative basis rules stated in section 12.1 of the *Bank Act* (see discussion immediately below).

Name

Assuming the selected name otherwise meets the requirements of the *Bank Act*, an FCU can be incorporated with a name that includes the words “credit union” or “co-operative,” as long as the name also includes the word “federal” or “bank.” (section 40.1).

Thus, the name “Victoria Co-operative Bank” or “Regina Federal Credit Union” would be available choices. It is recommended that the name selected for an FCU be designated as (location/purpose/or?) Co-operative Bank. The word “bank” is well understood both nationally and internationally and will greatly enhance the acceptability of the FCU in many foreign jurisdictions, whereas the nomenclature “federal credit union” (used in the US) may create confusion and require significant explanation regarding structure, which may delay a transaction or cause people to avoid it entirely.

Further, using the name “co-operative bank” draws a clear distinction between an FCU and a provincial credit union, which will not only lessen confusion, but will also distinguish more directly between the services of the two entities. This may be important in circumstances of financial difficulty for either entity and reduces the potential for systemic risk.

In addition, provincial governments and regulators may, from a policy perspective, prefer the name “co-operative bank” for the reasons mentioned above. And the term “co-operative bank” will create more clarity in the marketplace if the FCU issues a public offering of securities.

Before an FCU is established, the Minister of Finance must first determine that it is in the best interests of the Canadian co-operative financial system (section 27.i). The use of the name “co-operative bank” and the distinction brought to the Canadian co-operative financial system would be important.

Co-operative Nature

An FCU must maintain the governance model of a co-operative financial institution. As mentioned, the co-operative basis rules are found in section 12.1, which has taken the International Co-operative Alliance’s [co-operative principles](#) into consideration.

- (a) The majority (at least 51 percent) of the members must be “natural persons” (i.e., individuals). Section 47.11 of the *Bank Act* prohibits a corporation or partnership from becoming a member, if that would result in less than a majority of the members being natural persons. This concept is important to the application of the ownership rules and the governance structure for FCUs provided for in the *Bank Act*.
- (b) The FCU must provide services “primarily” to members (section 47.12). Although the word “primarily” is not defined in the *Bank Act*, it is generally applied in the *Income Tax Act* to be in the order of 90 percent. That concept is expected to be followed in the *Bank Act*.
- (c) An FCU’s annual financial statement (section 308(3)(a.1)) must confirm:
 - (i) the percent of the members who are natural persons
 - (ii) the percentage of the FCU’s business done with members
 - (iii) whether the FCU is organized and operating on a co-operative basis as defined in section 12.1

This declaration in the audited financial statements will be extremely important in the FCU’s banking and financial transactions and in its supervision by OSFI. It also provides an annual report to members on the extent to which their FCU is operating as a co-operative financial institution.

- (d) There must be open, nondiscriminatory membership available to persons who can use the FCU’s banking services (section 12.1(1)(c)), and the person requesting this must accept the responsibilities for that class of membership, as described in the by-laws. The FCU by-laws may establish classes of members. Members in different classes would normally participate in different levels of business with the FCU, such as personal banking or commercial banking. The FCU’s by-laws may establish separate obligations and relationships for each of the classes. This may include, for example, different capital contribution requirements or designated service rules.

The FCU may be structured with a closed-bond relationship, limiting membership — for example, to employees of a national business — or with an open-bond relationship — with membership generally available to persons who use the FCU’s services.

- (e) Each member or delegate is entitled to one vote. Members of an FCU may, by by-law, establish a delegate structure for member voting (or governance), designed for that particular FCU (see discussion under “Part 6: Membership and By-laws,” below). Importantly, a delegate is not a proxy; a delegate has only one vote, regardless of the number of members he or she represents (section 192.01(1)(d)).

Credit unions with a large membership have found that members may more effectively participate in the governance of their credit union if the by-laws establish a delegate structure to participate in the governance of the FCU on behalf of members. Delegates may be elected by members on a regional basis, for example, or on the basis of membership groups — e.g., one delegate for each geographic area of business operations. There may be a thousand members in area 1 and fifteen hundred in area 2, and each delegate has one vote at FCU meetings (see “Part 8: Delegate Considerations,” below).

Fairness among members is important. Note that section 153(1.1) gives “at least two members,” who represent at least 1 percent of the FCU’s members, the right to call a special meeting of the FCU. And section 144.1(1) gives each member the right to submit a proposal of matters to be discussed at a meeting, including amendments to the by-laws. Section 144.1 also contains rules to prohibit abuse. For example, to submit a proposal, a member must be a member of the FCU for twenty-one days ([Regulation 2006–314](#)), and the proposal may not relate to a personal complaint. If the proposal relates to the nomination of a person for election as a director of the FCU, it must be supported by the lesser of 250 members and 1 percent of the members (section 144.1(7)).

- (f) Dividends on membership shares are limited to the rate specified in the incorporation documents or by-laws of the FCU (section 12.1(1)(f)).
- (g) Surplus earnings may be used for capital needs and to pay patronage allowances and dividends on membership shares to members (section 12.1(1)(g)).

These rules will maintain co-operative relations among members and between members and the FCU. Co-operative governance is essential for the direction and management of the FCU, providing assurance to members that their FCU is their credit union.

The application of paragraphs (a) and/or (b) (above) to any FCU may be exempted by

the minister on appropriate terms (section 47.19). Unless an exception is permitted by the minister, an FCU must always operate in full compliance with the definition of co-operative basis, as outlined in section 12.1. This will be required for OSFI's order permitting the FCU to carry on business (section 53(1)). Section 192.1 confirms that the by-law is binding on the members of the FCU.

Taxation¹⁴

An FCU is not a bank for the purposes of the *Income Tax Act* (ITA); the ITA rules for a credit union apply to an FCU.

Part 5: Capital

Membership Shares

MEMBERSHIP SHARES are the ownership shares of an FCU. They are held by members, for their individual accounts, but are also capital for the FCU for the mutual benefit of all members. If a member withdraws, the FCU may repurchase the membership shares at the value provided in the by-laws, but may not do so if the FCU requires that capital (see "Capital Adequacy," below).

There is a significant change in the nature of membership shares when a credit union becomes an FCU. Provincial laws establish the membership shares of a credit union as par value shares, which means that a share with an issue price of \$5 is worth \$5, regardless of the balance sheet value for that share. On continuance, FCU membership shares are converted to non par value, which gives them (in the aggregate) the net value of the FCU at the time of determination. The result of this legal "demutalization" requires section 79.4 to stipulate that an FCU by-law *must* specify the value at which the FCU membership shares will be issued and the value rights of members when membership shares are repurchased by the FCU.

The FCU's by-laws must specify the main attributes for the membership shares, including the effect of sections 79.4 (issuing value formula) and 192.01 (repurchasing value formula). This is absolutely necessary to permit the FCU to operate in a mutualized manner.

14. See [section 248\(1\)](#) of the *Income Tax Act*, Definitions, Bank.

The FCU uses membership capital in common, issuing and repurchasing membership shares, to:

- (a) set the cost for a person to become a member at a value that is not an impediment
- (b) provide a pricing formula for the purchase of membership shares when a member withdraws or is expelled that is fair to the credit union and its members, considered on an ongoing basis; this will be important in the FCU receiving regulatory exemptions for the issue and purchase of membership shares
- (c) maintain the capital value of the FCU for the benefit of the membership group
- (d) establish the capital rules for the FCU so that it meets its capital requirements (see “Capital Adequacy,” below), and as may be specified by OSFI
- (e) authorize the FCU’s directors to manage the issue and repurchase of membership shares on the basis of the rules in the by-laws. As a result of section 79.4 and the by-laws, directors do not need to be concerned about the true fair value of a membership share on issue or repurchase.

The cost for a person to become a member of an FCU must be reasonable and not discriminatory, normally in the order of \$10 for one membership share. For another class of membership, the investment required may be more, such as an obligation to purchase one hundred shares. The repurchase of membership shares must not result in an extraction of capital from the FCU that, as a consequence, gives an unfair benefit to a member or a particular class of members. For example, repurchase may be at the original issue price, a formula that recognizes long-term member contribution, or another formula. All membership shares are entitled to the same value per share, as determined by the by-law at that time.

The number of membership shares held does not dictate voting rights. The concept of one member (or delegate) having one vote is one of the basic concepts of co-operative governance (section 47.13). See additional discussion under “Part 6: Membership and By-laws,” below.

An FCU may continue as an “ordinary” bank under the *Bank Act* (section 216.08). In that case, the membership shares become common shares and reflect the fair value of the bank, shared among the members at the time in accordance with established rules ([Regulation 2012-268](#)).

Preferred Shares

An FCU may issue preferred shares¹⁵ if the by-laws permit it (section 60.1). The purpose of section 60.1 is to allow an FCU to obtain the consent of the members to employ nonmember capital in financing the organization. It may be useful to have this enshrined in the FCU's initial by-laws. The particular attributes of any offering of preferred shares will be separately authorized.

Those holding preferred shares may elect up to 20 percent of the FCU's directors in either of two circumstances:

- (a) if there is a breach of a covenant in the preferred share rights
- (b) if a fixed number or percentage of directors is permitted in the by-laws

Directors appointed by the holders of preferred shares need not be members, *but*, in all circumstances, at least two-thirds of the actual directors of an FCU must be members (section 159.1).

Note the following conditions:

- (a) If preferred shares are to be issued to a member, and if this issue is exempt from provincial prospectus disclosure requirements, the FCU must provide a written disclosure to said member, as set out in [Regulation 2012–265](#).
- (b) Holders of preferred shares may not make a proposal to the FCU (section 144.1) nor participate in the making or amending of the FCU's by-laws (section 192.03).
- (c) Dividends must not be paid on preferred shares if, after that payment, the FCU does not have adequate capital or liquidity (see “Capital Adequacy,” below).

Capital Adequacy

Credit unions are well aware of the need to identify operational risks and to maintain adequate capital to address them. Continuing as an FCU attracts further stringent rules for maintaining adequate capital and liquidity for operations (section 485(1)).

Each FCU must maintain the “at risk” capital determined by the Office of the Superintendent of Financial Institution's (OSFI) [Capital Adequacy Requirements policy](#)

15. A preferred share is any share issued by the FCU that is not a membership share.

(CAR). OSFI will review the FCU's proposed operations and determine how the guideline is to be applied to it.

CAR represents Canada's policy implementation of the capital rules established by the [Bank of International Settlements](#) as expressed in the [Basel III framework](#), which sets out the international regulatory framework for banks.

Essentially, CAR outlines the capital necessary to manage the various financial and operational risks in operating an FCU, both for identifiable and contingent risks. Compliance with CAR requires determining the operational risks, the amount of capital needed to manage them, and the type of capital to support them. Capital may consist of acceptable forms of membership shares, preferred shares, debt instruments, and financial reserves that, collectively, provide the components of the capital the FCU will need for compliance with CAR on an ongoing basis. However, note that section 485(3) of the *Bank Act* permits OSFI to direct the FCU to increase its available capital, even if it is in compliance with CAR.

CAR has an impact on structuring the capital of an FCU as well as on the structure of its by-laws that establish the attributes for its capital. Of particular importance are the transitional rules for taking membership shares into account when establishing capital, and phasing out the credit unions' pre-continuance qualifying capital. The five-year pre-continuance Business Plan (see below) required by the OSFI [pre-continuance guide](#) must show consistent evidence that the FCU has adequate capital to meet CAR's conditions for continuance. CAR will influence the FCU's regulatory right to repurchase membership shares, the acceptable features of preferred shares and debt instruments that are to form part of capital, and amounts of return paid on capital and the payment of patronage allocations. In addition, CAR may affect the timing and amounts of the return paid on preferred shares or debt instruments, as well as the payment of patronage allocations.

Liquidity

Section 485 also requires that an FCU maintain adequate and appropriate forms of liquidity. The capital adequacy requirements ([OSFI Guideline A-3](#)) address the FCU operations for which liquidity must be provided, the ratio and types of financial resources necessary for potential claims, and the required ongoing liquidity. The guideline covers the various matters to be taken into account in assessing an FCU's liquidity adequacy — Liquidity Coverage Ratio, Net Stable Funding Ratio, Net Cumulative Cash Flow, Liquidity Monitoring Tools,

and Intraday Liquidity Monitoring Tools. The overall purpose of the guideline is to ensure that the FCU has adequate liquidity available to meet all payment obligations for both expected and extraordinary claims.

[Guideline B-6: Liquidity Principles](#) outlines the governance practices necessary to managing liquidity risk; it also establishes risk-measurement policies.

Part 6: Membership and By-Laws

FCU BY-LAWS represent the mutual understanding among members as to how they will provide governance, oversight and directions for their business to provide themselves with banking and related financial services. Subject to the provisions of the *Bank Act* and the OSFI’s prudential oversight, the by-laws will govern member relations (section 47.03). FCU by-laws are similar to partnership relations and may be made only by the members, except in the limited circumstances of section 192.03(2), whereby directors may make “operational by-laws,” which nevertheless must be approved by the members at their next meeting. However, if the FCU has issued preferred shares, their attributes may restrict members from making certain changes to the by-laws, such as altering the agreements related to the net earnings required before a distribution of patronage allocations or dividends on membership shares.

The by-laws set out the relationship among the members and between the members and the FCU. Sections 12.1, 47.03–47.19, 79.1–79.4, 146(2), 159.1, 176(2), and 192.01 of the *Bank Act* are critical and should be carefully considered.

The by-laws must address the basic member rules for the FCU:

- (a) each person must pay for and own share(s) in the FCU (these may differ among classes) in order to be a member; there may be other conditions, such as an additional capital contribution to receive special services
- (b) there must be a process to determine the value of membership shares when issuing or repurchasing them, and the maximum percentage dividend on membership shares
- (c) a member has the right to withdraw from membership and the FCU has the right to expel a member; this includes the member’s right to receive the value of the membership share(s) and, if expelled, the right to appeal and, in appropriate circumstances, to be reinstated

- (d) each member, or delegate, has one vote at FCU meetings
- (e) membership is not transferable and membership shares may only be transferred by a resolution of the directors
- (f) the FCU will operate in accordance with the requirements of section 12.1

Section 192.01(1) lists mandatory provisions for the by-laws of any FCU, while subsection 192.01(2) refers to others that should be considered in order to comply with the *Bank Act* and to design the FCU's member relations so that they meet member expectations.

Mandatory Rules

Section 192.01(1) sets out the mandatory provisions for FCU by-laws:

- (a) The qualification for membership. The by-laws must state:
 - (i) the minimum number of shares that must be owned by a member
 - (ii) the applicant's financial contribution as a condition for membership, which may include investments other than membership shares
 - (iii) any obligations for the use of any FCU services that are part of the relationship between the FCU and a member
 - (iv) if class relationships exist, the membership obligations with respect to each class that are part of the relationship between the FCU and the member
- (b) The manner by which applications for membership, including membership for a special class, will be accepted; this could include the ability of the FCU to delegate this function.
- (c) The joint member rights in the FCU.¹⁶ Can a single member apply to terminate the joint membership and withdraw from membership? Is the joint membership a single membership for voting? Can more than one person in a joint membership qualify to be a director of the FCU? Is each participant in a business association (such as a partnership), which is a member of the FCU, required to be a member of the FCU?
- (d) The number, appointment, and qualification of directors and director committees. Section 160 lists persons who may not be directors of an FCU. The by-laws may add to these conditions such as:
 - (i) setting qualification goals among the directors
 - (ii) requiring people to be members for a term before qualifying to be a director

16. Joint membership is one in which two or more persons share the member relationship. The simplest example is a household membership.

- (iii) limiting the term of a director (see “Part 9: Director Considerations,” below)
- (e) The rules to be followed by a member who wishes to withdraw from the FCU — notice; the repurchase value of membership shares at the time of the withdrawal; terms for payment; offset for amount owing.
- (f) The rules the FCU must follow if it wishes to expel a member, including the right of the member to receive advance notice of the resolution; to make representation on the matter; to appeal the decision; and, in appropriate circumstances, to be reinstated (section 47.06).
- (g) The principles for the distribution of the FCU’s surplus earnings by patronage allocation or otherwise. Section 12.1(1) limits the maximum dividends on membership shares and specifies the purposes for which surplus earnings may be distributed (members may wish to have the by-laws provide specific direction). The *Income Tax Act* applies to distributions by a FCU in the same manner that it applies to credit union distributions. All distributions are subject to the capital and liquidity requirements of the FCU.
- (h) The rules for holding member or delegate meetings by means of a telephonic, electronic, or other communication facility.
- (i) Sections 79.1–79.4 requires the by-laws to define the attributes of membership shares, and section 60.1 requires them to define the attributes of preferred shares. These attributes may be affected by an applicable CAR provision (see “Capital Adequacy,” above), an exemption (see “Part 14: Exemptions,” below), or the Order to Commence Business (see “Part 17: Order to Commence Business,” below).
- (j) Section 176(2) requires the by-laws to state if the persons who elected a director have the exclusive right to fill a vacancy.
- (k) Section 146(2) specifies the basic rules around quorums at meetings; if the FCU wishes the rule to be changed, this must be included in the by-laws.

Optional Inclusions for By-Laws

The optional provisions for the by-laws (section 192.01(2)) contribute to designing a unique service relationship that meets the member expectations and governance concepts for a specific FCU. Optional provisions address:

- (a) Membership entitlements by classes of persons. The FCU may design its membership shares in a manner that best meets its banking and governance needs and that best accommodates its membership rules, as long as they comply with human rights laws. As an FCU begins to provide services across Canada and internationally, a requirement may arise for different classes of membership. As noted above, an FCU may be structured with an open bond,

which permits any person to be member, or a closed bond, which restricts membership to a defined category of persons.

- (b) Delegate rules for members or some members, including rules for the qualification and appointment of delegates and the rules for a meeting of the FCU involving delegates. Again, as the FCU begins to provide services more broadly, a carefully designed delegate structure will be exceedingly important, in order to fairly represent both members and specific interests (see “Part 8: Delegate Considerations,” below).
- (c) Basic rules for patronage allocations. This may be regarding allocation in respect to banking services or other permitted services (refer to sections 135 and 137(2) of the *Income Tax Act*. The by-law requirements for these choices differ; e.g., will patronage allocation apply to earnings on services, earnings on financial services, or a combination of the two?
- (d) A formula to determine the value of issued or repurchased membership shares (sections 192.01(2)(e) and (f)). This requires careful planning. While having the same value on (for) issued and repurchased membership shares provides for operational simplicity, this may not accommodate the interests of members on withdrawal or, specifically, on withdrawal from a particular class of membership. If a person has been a member for thirty years, for example, should there be a payment in addition to the original \$10 per share purchase price? Note also that the by-laws cannot override section 47.08 of the *Bank Act*, which does not allow any redemption of shares if the FCU requires the money to meet its capital or liquidity obligations.
- (e) Authority to issue preferred shares (section 60.1). Even if there is no immediate plan to do so, an FCU may wish to have the authority to permit future financing flexibility (see “Preferred Shares,” above).
- (f) Rules for distributing the value of the FCU on voluntary wind-up. Section 79.4 confirms that FCU membership shares must be issued with no par value. Unlike provincial credit union practice, the *Bank Act* provides no mandatory rules for FCU’s distributing surplus on a wind-up. The by-laws must establish the rules, which could, for example, call for a demutualization in which each share received its fair value, or the surplus could be transferred to another entity, such as the Co-operative Development Foundation. Or there could be a combination of several principles. Importantly, in the absence of other rules, the final value of the FCU accrues to the membership shares on a share-by-share basis. The demutualization formula provided in [Regulation 2012–268](#) of the *Bank Act* may provide guidance.
- (g) Such other rules as may be desirable for the FCU.

Essentially, the by-laws must address the overall governance structure for the FCU, including, as applicable, the rules for governance with a delegate or district structure.

A few important things:

- (a) Members may present proposals to the FCU (even if represented by a delegate):
 - (i) A member may propose a matter to be discussed at a meeting of members (section 144.1) with the right to speak to that matter at the meeting, even if the meeting is a meeting of delegates.
 - (ii) Not less than 250 members (or one percent of the members) may make a proposal to nominate a person to be a director (section 144.1(7)). If FCU directors are elected on a district basis, and a proposal is provided for the nomination of a director, that nomination relates to the applicable district.
 - (iii) A member may make a proposal to make, amend, or repeal a by-law (section 192.04).
- (b) One percent of FCU members, represented by not less than two members, may request a special meeting of members (section 153(1.1)).
- (c) The by-laws may be required to reflect any OSFI conditions in the Order to Commence Business (section 53), or any prudential agreement entered into with OSFI (section 644.1).
- (d) The by-laws must reflect the effect of any exemption provided by the minister (see “Part 14: Exemptions,” below)
- (e) Section 146(2) specifies the basic meeting quorum rule; if the FCU wishes the rule to be changed, this must be included in the by-laws.
- (f) OSFI must review and approve the by-laws as part of the projected business plan discussed under pre-continuance matters, below.

Members control the by-laws and make or amend them. Section 192.1 confirms that every FCU by-law is a binding contract between the FCU and its members and among members. Directors may make or amend a by-law if it is consistent with an existing member by-law (192.03(2)). A director by-law must be approved by the members at the next general meeting; if not approved, it fails.

The FCU must provide a copy of each by-law amendment to the OSFI (section 633). In practice, the OSFI should review amendments prior to their enactment.

The management of the FCU by-laws should be seen as a living assignment, overseen by a senior person within the organization responsible for corporate governance. The delegate structure should be reviewed every five years, perhaps more often depending on the growth of membership and the specialization of financial services.

Part 7: Who Can Own Membership Shares in a Federal Credit Union?

THE BANK ACT (SECTION 12.1(C)) includes a concept of open membership in an FCU to persons who can use the services of the organization and will accept the responsibilities of membership.

Section 47.03 expands this further, providing that, subject to the *Bank Act*, FCU membership is governed by the by-laws. Section 192.01 requires the by-laws to outline the qualifications and obligations of membership, while section 192.01(2) permits the by-laws to provide for membership class restrictions, as long as they comply with the laws of human rights.

The by-laws may provide for an “open membership” or a membership that offers services to specific classes of persons, whether a nationality or purpose function (a closed-bond FCU). Within that context, any person, individual, or entity may be a member, subject to the rule that requires a majority of the members to be individuals, unless expressly exempted by the minister, as noted above.

No person may own a significant interest¹⁷ in an FCU, or control it, without the approval of the minister. There are two concepts here:

1. Legal control (section 3(1)(a.1)); a person controls an FCU if he or she has control of more than 50 percent of the votes at the FCU’s annual meeting, or the ability to direct the appointment of the majority of the directors. A person who has control may not extinguish it without approval (section 377.2).
2. *De facto* control (section 3(1)(d)); [Regulation SOR 2012-278](#) describes the factors to consider in establishing if defacto control may result from an existing circumstance or one that is purposed. Here is the test: if a person has influence over the FCU’s decisions, is the FCU free to make its decisions with that influence?

In determining the percentage of membership or preferred shares a person owns, you

17. A significant interest, in either membership shares or preferred shares, exists if a person, together with the entities they control, owns 10 percent of the membership shares or preferred shares (section 8).

must consider the rules that aggregate these shares if two or more people are exercising ownership rights together. In that circumstance, the people are deemed to act in concert and to hold the shares owned separately as an ownership held in common (sections 9.1 and 9.2). E.g., if a person owns 5 percent of the membership or preferred shares, and another person holds an equal amount, and they have agreed to exercise the rights in common, each is deemed to have a significant interest in the FCU for the purpose of establishing whether control exists or may exist. The acting-in-concert rules for an FCU may be expanded by the effect of the Associates rules in section 371.

Part 8: Delegate Considerations

LARGE CREDIT UNIONS have found that members can participate more effectively in the governance of their organization if the by-laws establish a delegate structure to represent members at meetings and in other governance activities. Delegates may be elected on a regional basis or on the basis of membership groups — one delegate for each geographic area of business operations. There may be a thousand members in area 1 and fifteen hundred in area 2, but each delegate has one vote at meetings.

The design of an effective delegate structure requires care and sophistication. Delegates represent FCU members, but perhaps more importantly, they should also be seen as the representatives of the FCU's board and management. Their role is both to keep members informed and also to carry forward member input.

Delegates may be seen as an extension of the FCU's board of directors, assisting the board in its service and governance relationships. Since they are also the people with the interest and capacity to eventually become directors, FCUs should carefully consider how they define delegate qualifications and the manner in which they are elected.

Because delegates have a close relationship with members, describing the base from which they will be appointed needs careful thought. Will they be appointed solely on a geographic basis? This may include several provinces or, indeed, international interests. Or should they be chosen based on diverse member interests, suggesting, perhaps, separate classes of delegates?

The *Bank Act* does not place limitations on the classification of delegates; members will structure this in the by-laws.

Part 9: Director Considerations

GOVERNANCE IS FUNDAMENTAL to the success of any entity, but in an FCU, with its co-operative roots, there are additional components to consider.

The by-laws must support the selection of qualified persons who, as a board:

- (a) have the skills to oversee and direct the financial activities of a sophisticated financial institution
- (b) are adequately skilled to populate the committees of the board, especially the audit committee (section 194) and the conduct review committee (section 195)
- (c) can maintain sufficient contact with member interests to achieve the co-operative services nature of the FCU

Delegates must be provided with regular skills training to maintain current knowledge of financial and governance matters.

The OSFI [Guideline 2013: Corporate Governance](#) describes the expectations for directors, which are, in summary, as follows: “OSFI expects Boards and Senior Management of FRFIs¹⁸ to be proactive, and to be aware of best practices related to corporate governance that are applicable to their institution. Where appropriate, FRFIs should adopt these best practices.”

The *Bank Act* also addresses many matters relating to FCU directors, including:

- (a) An FCU must have at least seven directors (section 159.1).
- (b) Not less than two-thirds of the directors must be members or represent members of the FCU (section 159.1).
- (c) Holders of preferred shares may elect up to 20 percent of the directors (section 60.1(4)). Subject to (b) above, these directors are not required to be members.
- (d) Cumulative voting is not permitted in an FCU (section 168.1).
- (e) Not more than two-thirds of the directors may be affiliated with the FCU

18. FRFIs are federally regulated financial institutions.

(section 163; [Regulation 92–325](#)). An affiliated person is defined as an officer or employee of the FCU, a major borrower from or investor in the FCU, or someone who has a loan that is not in good standing.

- (f) A person disqualified by the *Bank Act* (section 160) may not be a director. Of special interest is the disqualification of anyone who fails to meet any of the requirements set out in the FCU's by-laws, which establish reasonable rules that director's must meet — e.g., to have been a member for five years and to be a member while also being a director.
- (g) A director may be removed by the persons entitled to elect the director (section 173).

The by-laws address the process by which directors are elected, the qualifications required for election, and the circumstances in which a director will be retired. While the *Bank Act* addresses these concepts generally, FCUs must design their requirements to meet their individual governance expectations.

The first question is, who qualifies to be a director? There are two driving concepts — the need for members to be adequately represented and the necessity for board members to have the skills to manage the FCU.

Examples of rules for the election of directors include:

- (a) Directors may be elected globally by members or by delegates for the members.
- (b) Directors may be elected on a “district basis,” which relates to a group of members using the FCU's services in a defined locality.
- (c) Classes of members may nominate one or more persons to be elected as directors.
- (d) In appropriate circumstances, holders of preferred shares may elect directors (see section on preferred shares, above).

Co-operative governance models stress the development of a matrix that identifies the skills that would be useful for the board. This information is then provided to persons entitled to elect the board. The by-laws may mandate the development of the matrix, its review, and communication. No matter how they are elected, all directors have the same rights and obligations, and although they may have particular personal interests, they must always act in the best interests of the FCU.

Each financial institution should define a set of skills required for effective board governance. This should identify the importance of each criteria and must address at least:

- (a) the preferred educational experience, in general, and specifically, experience relating to the operation and governance of the FCU
- (b) the general business, management, and advisory skills expected for a federal, deposit-taking, financial institution
- (c) co-operative governance and member relations experience
- (d) the expected service relationship

The governance structure for an FCU must operate so as to identify and avoid conflicts of interest, both potentially and actually. Except in special cases, directors of an FCU should not be a director of another entity that is engaged in a business relationship with the FCU.

Committees of the Board

While the management of the FCU will require a number of committees, there are two that are mandatory: the audit committee (section 194) and the conduct review committee (section 195). Each committee must have at least three directors, the majority of whom cannot be affiliated persons or an employee or officer of the FCU.

The audit committee supervises the FCU’s internal financial controls, oversees the preparation of appropriate financial reporting, and manages relations with the external auditor.

The conduct review committee ensures that the FCU has policies to identify and control self-dealing and conflicts of interest between the FCU and its interests with directors, senior officers, and individuals with a significant ownership in the organization.

Self-Dealing

Except as permitted by the *Bank Act*, people with a significant interest in the FCU’s preferred or membership shares, as well as directors and senior management, cannot participate directly or indirectly in business transactions with the FCU (section 489). Part XI of the *Bank Act* outlines the exceptions to this rule. Transparency and financial and business fairness are the general rules.

The conduct review committee ensures that the conflicts policy is appropriate and also that it is enforced. Transactions with directors and senior officers require the approval of two-thirds of the directors (section 497), and no director or officer with an interest may be present at a meeting either to discuss a self-dealing transaction or to vote on the resolution.

Conflict of Interest

Directors and officers must declare any personal interest they have or may have in a business transaction with the FCU or with an entity in which they have an interest (section 202). The declaration must be made either when the matter is first being reviewed by the board or, if the conflict occurs later, at the first meeting of the board after the conflict occurs (section 202(2) and (3)). Whether or not a personal benefit accrues from a transaction, a director or officer will be deemed to have an “interest” if the person has a relationship with another participant in the transaction and is in a position to potentially influence the decision. Unless permitted (section 203), no interested director may be present at a board meeting that is reviewing or voting on a matter in which that person has a conflict.

Part 10: Member Communication

CREDIT UNIONS MUST DEVELOP a comprehensive communications strategy to build an understanding among members and customers of the considerations involved in leaving the provincial arrangements behind and adopting a national structure for their credit union. The comments in this section are limited to communication with members pertaining to legal requirements, and there are some critical matters here.

First, members must make a special resolution that authorizes the credit union’s directors to apply to OSFI for continuance as an FCU and, as applicable, to apply for the restructuring of the FCU’s corporate charter.

Second, members need to make the by-laws for the FCU, which must be in compliance with the *Bank Act* and reflect the relationship among members and the FCU. They must include the establishment of a co-operative governance structure and be consistent with the operational concepts in the FCU’s business plan provided to OSFI (see “Part 12: The Business Plan,” below). Members will need to be adequately informed if they are to become engaged in understanding the draft by-laws they will be asked to approve.

Third, the resolutions outlined in section 47.02 — making the by-laws, electing directors, and appointing an auditor — are necessary to obtain the Order to Commence Business required by section 48 of the *Bank Act*.

As they must be made before continuance, it is important that the by-laws and the mem-

ber resolutions meet all material requirements as there is limited ability to expand or alter them if a correction is needed for continuance. To address this concern, the credit union may choose to deal with the mandatory resolutions at a different time; e.g., members might first make the special resolution to approve continuance, and then at a second meeting, deal with the resolutions required by section 47.02.

In appropriate circumstances, section 39.01 may assist the FCU in meeting the legal requirements for member voting.

Fourth, the credit union must comply with the [Disclosure on Continuance Regulations 2012–267](#) (the [Canada Deposit Insurance Corporation](#) (CDIC) rule), which require that at least four months before the members vote on the continuance resolution, the credit union will provide them with a notice stating that CDIC will provide deposit insurance after continuance, but with a transition for existing provincial insurance.

The *CDIC Act* (section 12.1) provides that:

- (a) for ordinary deposits, provincial deposit insurance will continue for up to 180 days after continuance
- (b) for term deposits, provincial deposit insurance will continue for the fixed term of the deposit (but not a renewal of the term)

After the end of the transition period, CDIC will provide all deposit insurance for the FCU.

Fifth, while the CDIC rule does not require a notice to customers who are not members, the credit union must carefully review its legal obligations to these individuals for any deposits they may have with the organization prior to continuance.

If the continuance involves credit unions from more than one province, additional member communication is required. Member communication must be provided in a fair and adequate manner to enable members to make prudent judgements for the future of the credit union.

Part 11: Continuance

SECTION 27 OF THE BANK ACT lists the matters that the minister of finance must take into account before issuing letters patent to continue a credit union to the status of an FCU. The multitude of steps that need to be taken prior to

the minister's section 27 review are detailed in the [Guide for Continuing a Local Cooperative Credit Society as a Federal Credit Union](#) (the pre-continuance guide).

An applicant for continuance must demonstrate to the minister of finance that:

- (a) the FCU will be operated and managed in accordance with the *Bank Act* and that, based on a five-year business plan, it is expected to be a financial and operational success during the term of the plan
- (b) based on a review of other types of financial institutions, operating as an FCU is the best option available
- (c) the FCU will be managed on a co-operative basis
- (d) FCU members have approved the FCU model for the delivery of their financial services
- (e) the province of incorporation has approved the application
- (f) the application is consistent with the interests of both the Canadian financial system and the Canadian co-operative financial system

The *Bank Act* outlines three rules for a credit union continuing as an FCU:

- (a) the continuation of a credit union that itself qualifies to become an FCU (section 33(2))
- (b) the continuation of a credit union that, immediately after continuance, amalgamates with another federal credit union to qualify as an FCU (section 33(3))
- (c) two or more credit unions, from one or more provinces, continuing as FCUs and then merging to qualify as a single FCU (section 33(4))

The OSFI pre-continuance guide will assist credit unions to prepare this information and also outline the assurances they must provide to satisfy the OSFI requirements (see "Part 12: The Business Plan," below)

The rules for clauses (b) and (c), above, address at least two additional matters. In the case of (b), a single credit union on its own may not meet the requirements to become a federal financial institution, or the benefits of continuance may not justify the expected cost. In the case of (c), the parties proposing to amalgamate may be from two or more provinces, and current provincial regulations do not allow cross-border mergers. Clause (c) allows for the creation of a single FCU through multi-province amalgamations.

The flexibility provided to credit unions in (b) and (c), above, is enhanced by sections 34(1.1) and 39.01. The former permits the applicants to jointly provide the notices required by the *Bank Act* for continuance and amalgamation, while the latter allows the minister to

accept member resolutions that may be technically deficient, if the intent is clear and substantially complies with the requirements. Also note that the *Bank Act* provides rules for transitional and other exemptions to assist in the design and operations of FCUs (see “Part 14: Exemptions,” below).

Credit unions applying to become an FCU must receive the consent of their provincial authorities to continue outside the province in question. Depending on provincial law, this may include several approvals, including the provincial regulator and the relevant deposit guarantee corporation. The minister is expected to seek input from the Canada Deposit Insurance Corporation (CDIC), the Bank of Canada, and representatives of the Canadian co-operative financial system. And CDIC will require input from the credit union on its eventual operations as an FCU, including its participation in clearing systems.

Section 27(i) requires that the minister consider the best interests of both Canadian financial institutions and the Canadian co-operative financial system. The latter may include not only credit unions and centrals but also provincial deposit guarantee corporations, the Credit Union Clearing Group, or other co-operative financial service providers.

Credit unions intending to amalgamate on continuance (sections 33(3) and (4)) must each comply with both the requirements to continue (section 27) and to amalgamate (section 224). In practice, the requirements are consolidated by OSFI (see the [pre-continuance guide](#)).

It is not unusual for there to be outstanding matters at the point of continuance that are expected to be complied with in due course. In that case, the minister may provide exemptions (see “Part 14: Exemptions,” below), or conditions may be set in the Order to Commence Business. The business plan must note the exemptions or conditions and indicate the intention to achieve compliance within an agreed-upon time.

Part 12: The Business Plan

SINCE ANY CREDIT UNION APPLYING FOR CONTINUANCE will obviously be one that complies with its provincial regulatory and prudential requirements, the concepts for the development of the business plan will be generally understood and will be amplified during discussions with OSFI.

The [pre-continuance guide](#) will assist the credit union in its application and will also identify the information OSFI requires to determine its acceptability. Before going ahead with an application, credit unions should review the guide to see if they have access to the technical and professional skills required to prepare the necessary materials. Financial projections require special qualifications.

The pre-continuance guide is structured in increments, with Phase 1 focused on OSFI and the credit union becoming familiar with each other as well as on extensive details of the OSFI and the *Bank Act* requirements. While the first meeting(s) with OSFI will tend to be in the form of information gathering, the credit union must quickly position itself to provide the Phase 1 materials. The sections identified in the pre-continuance guide offer a useful checklist, and credit unions are advised to follow them closely for an effective presentation of their materials.

Essentially, Phase 1 requires a detailed ownership, governance, and operational review, based on a five-year forecast that demonstrates that the FCU is anticipated to be successful and will comply with “the expected prudential, regulatory, and legislative criteria.” This forecast is supported by accounting and legal opinions. OSFI may require supplemental materials beyond the pre-continuance guide requirements in order to make its recommendation to the minister that the continuance be permitted. The business plan must document, in particular, that the FCU will operate on a co-operative basis during its existence and, further, must satisfy the minister that the continuance and operations of the credit union will be “in the best interests of the financial system in Canada, including in the best interests of the co-operative financial system in Canada.” Unfortunately, the guide provides no leadership to assist the credit union in complying with that requirement. A careful discussion will be required on how the FCU, if established, will relate to Canadian co-operative financial institution operations.

Below are a few comments on drafting the business plan.

Issues around Settlement Services

On continuance, the FCU is a member of Payments Canada ([section 4\(b\) *Payments Canada Act*](#)), the Canadian body that regulates the settlement of payment items (ACSS Services) and payment messages (LVTS Services) drawn on the FCU.¹⁹ Prior to continuance, the credit union may not be a member of Payments Canada if it is a member of a central. But it is ex-

pected to be a member of the Credit Union Clearing Group (CUCG) (see footnote 11), supported by its provincial central both in operations and liquidity. The Desjardins *caisses populaires* system through *le Fédération des caisses Desjardins du Québec* has a similar system structure and provides services for its members.

On continuance, the FCU will have several choices to obtain settlement services for itself and for those of another entity for which it is to provide these services:

- (a) [Section 28\(1\)](#) of Payments Canada By-law 3 permits an FCU, subject to the policies of the CUCG, to be or to continue as a member of the group.
- (b) As a member of Payments Canada, the FCU may be an indirect clearer of the Group Clearer or any other direct clearer for the CUCG (see footnote 11)
- (c) As a member of Payments Canada, the FCU may be an indirect clearer of any other direct clearer.

A further advantage of being a member of Payments Canada is the FCU's ability to establish a similar relationship with a participant (LVTS Services).

The choices are not exclusive for all payment items or messages. The FCU may negotiate the settlement of certain payment items with one direct clearer and use a different clearer for others. The choices have significant costs, as well as operational and prudential issues.

The decisions made may require the FCU to employ alternate approaches to participate in the ACSS, LVTS, and CDS systems²⁰ and other domestic or foreign settlement systems.

Participation in the present Credit Union Clearing Group, either directly or as an indirect clearer, permits FCUs to share in several internal credit union system services that allow access to clearing and settlement outside the Payments Canada structures. There may be significant economies for an FCU that continues the Acculink relationship to settle payment items drawn on a CUCG member that is payable to another member of that group.

19. The Automated Clearing Settlement System (ACSS; Canada Payments By-law 3) clears and settles Canadian dollar cheques and electronic payment items such as direct deposits, ATM withdrawals, point-of-sale transactions, online payments, and pre-authorized debit and bill payments. The Large Value Transfer System (LVTS; Canada Payments By-law 7) is a system in Canada for electronic wire transfers of large sums of money that permits the participating institutions and their clients to send large sums securely in real time with complete certainty that the payment will settle.

20. The Clearing and Depository Services System (CDS) clears and settles eligible exchange-traded and over-the-counter equity, debt, and money-market transactions. The expressions "Group Clearer," "Direct Clearer," and "Indirect Clearer" have the meanings provided in Canada Payments By-law 3, and the expression "payment messages" and "participant" have the meanings provided in Canada Payments By-law 7.

Within the CUCG, centrals also provide sub-settlement services (referred to as Central Settlement Services) before sending payment items to the group clearer. The central performs these services via a direct debit or credit to the account of the individual credit union. An example is the services provided by CUPS (Credit Union Payment Services), which offers payment processing solutions to credit unions across Alberta, Saskatchewan, and Manitoba. Central 1 provides a similar service for BC and Ontario credit unions. As a member of the CUCG, it is also possible to continue participating in system services such as existing Interac and other direct payment arrangements.

In making its settlement decisions for the FCU, the credit union should consider the possibility of being eligible for a Bank of Canada [Emergency Lending Assistance](#) loan as well as the assistance of a loan noted in section 39.02 of the *Bank Act*, both of which could aid the FCU in the transition of its settlement services.

Appropriate decisions for clearing and settlement are critical conditions for the OSFI's approval of the application for continuance and must be anticipated in the FCU's business plan. Payments Canada is continually updating its settlement rules, and any credit union considering continuance as an FCU must become fully familiar with the most recent settlement guidelines, directly or through a group, and make its choices based on that information.

Further Business Plan Requirements

The business plan must demonstrate, among other things, that the credit union's decision to become an FCU is appropriate and that the FCU will operate in accordance with the capital and liquidity rules. Below are some critical, but not exclusive, conditions:

- (a) each substantial investment of the FCU (more than a 10 percent interest) is permitted by the *Bank Act* (Part IX) or, if there is a non-compliance, then an appropriate application for an exemption is provided in the application
- (b) each significant interest in the FCU is permitted by the *Bank Act* (Part VIII) or, if there is a non-compliance, then an appropriate application for an exemption is provided in the application
- (c) each business activity of the FCU is in compliance with the *Bank Act* (Part VIII) and if not, then an appropriate application is made for exemption; in practice, a credit union's activities in the provision of insurance or trust services could be an issue

- (d) as a member of Payments Canada, the FCU will have adequate and risk-averse clearing and payment services
- (e) on continuance, the FCU will become a member of CDIC and have system reporting capacity and otherwise meet CDIC's requirements for a federal credit union
- (f) on continuance, the FCU will be in compliance with the requirements of the *Financial Consumer Agency of Canada Act*

Phase 2 of the pre-continuance guide rests on the assumption that the Phase 1 requirements have been met and that OSFI has provided conditional approval of the application for continuance. Phase 2 identifies the areas of the business plan that need to be addressed in order for OSFI to give its final approval. This phase can move fairly quickly if all the Phase 1 requirements are in place.

The first item under Phase 2 requires the credit union to advertise its intention to be continued as an FCU. If an amalgamation is part of the plan, the notice must include this information as well. It is important to note that OSFI must approve the wording of the notice (sections 25(2) and 34(1.1)).

Since the minister's approval will rest at least partly on the quality of the business plan, applicants should pay careful attention to the *Bank Act's* section 27 requirements to ensure that the plan complies.

Each application will have its special operational and governance issues that may require additional attention under the *Bank Act*. The above discussion is for guidance only.

Part 13: Financial Support

SECTION 39.02 AUTHORIZES THE MINISTER OF FINANCE to provide a loan guarantee to a new FCU for a period of three years from continuance. While the purpose of the loan is not restricted, its availability to assist the FCU in its transition to the Payments Canada settlement system is a logical fit.

Payments Canada requires an indirect clearer to establish a settlement account with its direct clearer. If the FCU clears through the CUCG, its settlement account may be with the central that maintains its operating account. This will give the FCU a significant financial advantage, permitting it to obtain the benefits of Central Settlement and Acculink services before items are passed to Payments Canada.

The agreement between the FCU and its direct clearer will establish the amount and make-up of the cash and securities in the FCU's settlement account. A section 39.02 loan to assist with the management of this account could help the FCU gain experience in the adequacy, availability, and economies resulting from the operation of its new account.

A section 39.02 loan may only be made by a federal financial institution. This restricts the availability of these loans for FCUs participating in the group clearing structure, since the centrals are not federal institutions. A section 39.02 loan could be established with a bank such as Concentra Bank.

Part 14: Exemptions

THREE CATEGORIES OF EXEMPTIONS in the *Bank Act* may assist a credit union to accomplish continuance as an FCU.

1. Section 35.1(4) permits the minister to exempt the applicant from any requirement under Part III of the *Bank Act* — the provisions for incorporation and continuance. The business plan must identify each exemption, its potential market effect, and any prudential rules that might apply.
2. Section 39 permits the minister to grant transitional exemptions related to the FCU's business activities at the time of and following continuance (see also the [pre-continuance guide](#)). These exemptions have time limits, but an FCU (section 39(2)(ii)) may continue a non-conforming business in accordance with the conditions set out in an agreement approved by the minister (section 973.02).
3. Section 47.19 relates to structural matters, exempting the FCU from compliance with certain of the co-operative basis requirements in sections 47.11, 47.12, and 47.18.

Each exemption must be applied for specifically, and there may be multiple exemption requests in an individual application. FCU officials must make themselves familiar with and comply with all conditions and undertakings, but note that the pre-continuance guide deals only with the section 35 and 39 exemptions.

The minister may, as noted in section 47.19, exempt the FCU from the applications of sections 47.11 (majority individual members), 47.12 (services primarily to members), and 47.18 (at least five members) on the terms and conditions he or she considers appropriate.

The section 47.19 exemptions may be required either on a transitional or continuing basis, depending on the anticipated purpose and governance of the FCU.

Section 47.19 permits the minister to waive one or more of the co-operative basis requirements, but note that the Order to Commence Business as an FCU requires that the FCU operate on a co-operative basis (section 53(2)).

The minister’s discretion under section 47.19 would normally function similarly to the transition rule in section 39(2), i.e., within a timeframe, but section 47.19 does not contain that requirement.

Part 15: Investments

SUBJECT TO CERTAIN RESTRICTIONS, an FCU will be permitted to “acquire control of, or acquire or increase a substantial investment in” a financial or financial services entity, which may include a joint venture, a partnership, or a corporate entity, among other possibilities (see section 468). These investments are subject to:

- (a) approval from either the OSFI or the minister if the investment results in acquiring a substantial investment (section 468)
- (b) the establishment of a “reasonable and prudent person” policy on investments and loans to avoid risk and ensure a reasonable return (section 465)
- (c) the rules applicable to the acquisition and control of each investment (sections 468, 469, and 470)

The FCU may be required to gain both legal and *de facto* control of the entity in which the investment will be made in order to limit the external risk resulting from third-party ownership interests, or if the entity proposes to engage in financial intermediation services that carry a deposit liability, or any other financial risks for the FCU.

The *Bank Act* (sections 477 and 478; [Regulation 2001–393](#)) limits the aggregate amount that may be invested in entities, expressed as a percent of the FCU’s regulatory capital.²¹ The *Bank Act* ([Regulation 2001–402](#)) also limits the aggregate amount that the FCU can invest in

21. Regulatory capital is the capital of the FCU that is counted for the purposes of capital adequacy (see “Capital Adequacy” and “Liquidity,” above).

entities that it does not control (i.e., minority investments), again, to a percentage of regulatory capital.

Below are the basic rules pertaining to substantial investments:

- (a) A substantial investment is 10 percent of the voting rights in the entity or 25 percent of its shares or ownership interests.
- (b) The OSFI may require the FCU to acquire legal and de facto control of the entity to limit or manage risk.
- (c) The minority investment rules ([Regulation 2001–402](#)) limit the investments that can be made without control of the entity.
- (d) Rules outlined in section 382.1 permit up to a 5 percent increase in investment without separate approval.

Credit unions should conduct a careful review of section 468 if they intend their new FCU to retain an investment on continuance or plan to acquire a substantial investment in operations. Investments of this type will require approval at the point of continuance.

Part 16: Organizational Meeting

IMMEDIATELY UPON THE DATE OF CONTINUANCE, the FCU and its first directors must make the resolutions and take the actions required by sections 47.01 and 47.02.

The first directors' meeting referred to in section 47.01 must be held in advance of the first members' meeting noted in section 47.02. The first directors' meeting formally admits individuals into membership in the FCU for the meeting required by section 47.02.

The first members' meeting must:

- (a) make the by-laws for the FCU
- (b) elect directors for the FCU
- (c) appoint an auditor for the FCU

It is important to note that the meeting required of members to approve their credit union's continuance as an FCU (section 34(2)) is held in compliance with provincial law, whereas the meeting required by section 47.02(2) is a meeting of FCU members held in compliance with the *Bank Act*.

The meetings detailed in sections 47.01 and 47.02 are required to put the new FCU in a legal position to operate, and each is a condition for the issue of an Order to Commence Business (section 52(1)). These meetings must be effective at the point when the Letters of Continuance are issued; i.e., the members of the credit union must make resolutions anticipating their membership in the FCU and make the section 47.02(2) resolutions as FCU members. The same legal concept applies to the first directors for the purposes of the meeting required by section 47.01(1).

Part 17: Order to Commence Business

AN FCU CANNOT BEGIN OPERATIONS until it has received an Order to Commence Business (section 48). Section 52 details the conditions that must be met for this to happen. A number of items are of special interest to FCUs:

- (a) An Order to Commence Business must have a condition that the FCU be operated on a co-operative business (section 53(2)).
- (b) The organizational meetings required by sections 47.01 and 47.02 have been held.
- (c) The Order to Commence Business must come into place concurrent with the continuance to ensure that the credit union/FCU can carry on business without interruption.
- (d) The credit union must develop a list of approvals and/or exemptions that it may require for the issue of the Order to Commence Business. This may include:
 - (i) the minister's approval of each exemption, concurrent with the issue of Letters Patent of Continuance (see "Part 14: Exemptions," above), and conditions for the issue of each exemption, including the FCUs commitment to fulfil any agreed-upon undertaking, compliance, or prudential agreement
 - (ii) the superintendent's issue of approvals relating to substantial investments, significant interests, and other requirements of the Bank Act, and the compliance with each condition of that approval, including the FCU's commitment to fulfil any agreed-upon undertaking, compliance, or prudential agreement

In summary, the Order to Commence Business is subject to any condition that reflects any exemption or approval, including the prudential conditions and/or limitations that may apply to them.

Part 18: Business Operations

CREDIT UNIONS CONSIDERING BECOMING FCUS must make themselves familiar with the rules of the *Bank Act and Regulations* relating to business operations. The comments below are intended to be helpful, but are not exhaustive.

As any bank, an FCU is vested first of all with the capacity to provide banking and related services, but the *Bank Act* also includes a great deal of other information that clarifies and expands upon this primary role. Having the capacity to carry on banking goes beyond the nominal ability of a credit union “to provide financial services,” particularly if the FCU operates in the international arena. The *Bank Act* adds specific capacities that are intended to provide broad-based operational powers for a Schedule 1 bank.

That said, Part VIII of the *Bank Act* does limit business capacity and business operations in specific areas, e.g., insurance. The federal rules may, in fact, be more limiting than those in several provinces. Section 39 outlines transition rules that may be established with the OSFI following continuance.

The *Bank Act* outlines a number of prudential rules that restrict or prohibit FCU business functions in certain areas, including:

- (a) granting guarantees (section 414)
- (b) participating directly in the distribution of securities, although this can be done through a downstream entity (section 415)
- (c) granting charges on the FCU’s assets; there must be an acceptable policy, with prohibitions against granting a creditor the right to appoint a receiver or to manage the FCU (sections 419 and 420)
- (d) participating in partnerships (section 421)

The FCU’s participation in any banking or other business will always be subject to the prudential rules (e.g., standards for capital and liquidity) provided by the *Bank Act* and regulations, as well as the OSFI’s policies and guidelines. The OSFI has the capacity for extensive oversight and review, including the right to issue directions of compliance (*Bank Act* section 645) or to require the FCU to be party to a prudential agreement “to maintain or improve its

safety and soundness” (section 644.1). Such an agreement may be required for a business reason, a governance reason, or any other matter related to the FCU’s existence and operations.

If an FCU becomes a concern to the Office of the Superintendent of Financial Institutions, the Canada Deposit Insurance Corporation, or the financial market, the OSFI may take over its management (section 648). Among other remedies, the OSFI has recourse to the *Winding-up and Restructuring Act* to assist it in managing the FCU or its assets, and CDIC may establish a bridge FCU for this purpose.

A credit union looking to continue as an FCU should carefully examine the [OSFI Policy Guideline B-10](#) — “Outsourcing of Business Activities, Functions and Processes” — in order to prudently manage and minimize the risks associated with these activities. It must also consider with great care all current OSFI Guidance Notes, Guidelines, and Guides to identify the matters that require specific attention.

On continuance, the FCU will have the benefit of the special security rules provided by the *Bank Act* (section 425), which will be valuable in lending activities.

The management of a credit union wishing to continue as an FCU must be able to demonstrate that they understand the OSFI policies relating to each of the financial services they propose to offer as well as those that apply to federal financial institutions in general. In addition, they will need to show that the directors of the new FCU have received sufficient training to understand the policy issues they will encounter in the FCU’s operations.