



Ontario

Deposit Insurance
Corporation of Ontario

Société ontarienne
d'assurance-dépôts

Differential Premium System Review

Consultation Paper

November 2007

Ce document est également disponible en français

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Foreword

Deposit insurance provides protection to the people who deposit their money in Ontario's credit unions and caisses populaires. The Deposit Insurance Corporation of Ontario (DICO) is the Ontario government agency that oversees and operates the deposit insurance system for these insured institutions, in accordance with Ontario's *Credit Unions and Caisses Populaires Act, 1994* (the "Act")

Part of our role is to recommend to the Government how the premiums underlying deposit insurance should be set out in the Regulations under the Act. This paper proposes an updated approach to premiums to reflect the evolving structure of the industry and its needs, as well as regulatory changes. It sets out the rationale for a new approach and explains the benefits of the proposed changes, which include lower rates for most institutions and greater fairness and transparency in setting premiums and allocating costs.

We invite participants in the sector to provide feedback on the proposed new approach. Credit unions and caisses populaires, their associations, leagues and federations, and other interested parties may send written comments by January 30, 2008 by mail to the following address:

Deposit Insurance Corporation of Ontario
4711 Yonge Street, Suite 700
Toronto, ON M2N 6K8
Attention: Richard White, Manager, Policy & Research

Alternatively, comments may be provided by e-mail to rwhite@dico.com.

DICO will publish a summary of the comments received and responses to any suggestions or issues raised early in the new year. Following the stakeholder consultation period, staff will evaluate feedback and make final recommendations to DICO's board prior to submission to the Government for approval.

The proposals outlined in this paper reflect input from an advisory panel of senior industry representatives. We wish to thank Jack Vanderkooy (DUCA Credit Union), Rob Wellstood (Kawartha Credit Union), Luc Racette (L'Alliance des caisses populaires) and Jean-Guy Laflèche (La Fédération des caisses populaires) for their valuable assistance.

Copies of this document and other related materials may be obtained by calling DICO at 1-800-268-6653 or by downloading them from DICO's Internet website at www.dico.com.

Executive Summary

DICO has now completed its review of the existing differential premium system (DPS), taking into account several significant changes since the current system was introduced in 2001. These include:

- regulatory changes, including a revised, risk-weighted capital adequacy test for more complex (Class 2) institutions
- the growth of the Deposit Insurance Reserve Fund to a level where assessments will soon be needed only to maintain it within an appropriate target range (and to cover DICO's operating costs)
- increasing consolidation, size and sophistication of the industry and insured institutions, with resulting impacts on individual and industry risk
- DICO's updated approach to risk assessment and risk management, which replaces the CAMEL model and is more tailored to the individual business activities and resulting risks at more complex institutions

The review also considered a variety of comments from member institutions on the current system. As a result of the review, which included discussions with an industry advisory committee, DICO is proposing a new differential premium system with the following features:

Separate premium components to cover DICO's operating costs and for risk premiums

The premium component to cover DICO's operating costs would be based on asset size, in line with the approach used by the Office of the Superintendent of Financial Institutions (OSFI) and other bodies. There would be a minimum base premium of \$1,000 for institutions with total assets of less than \$10 million.

Risk premiums based on a single capital measure.

For Class 1 institutions, this would be the existing leverage test. For Class 2 institutions, it would be the recently introduced BIS ratio. Premiums would be based on the level of additional capital relative to the minimum regulatory requirement. Institutions with additional capital of 100% or more of the minimum requirement would pay the lowest rate, \$0.20, on each \$1,000 of insured deposits. Institutions at the minimum regulatory capital level with no additional capital would pay \$0.70 and those below the minimum regulatory capital level, \$1.40.

A continuous rate structure for risk-based premiums.

In addition to eliminating inequities (as outlined on page 7) associated with the current tier structure by providing a change in premium for any change in risk, a continuous premium rate scale would ensure that the higher risk institutions paid proportionately higher premiums.

The benefits of the new approach include:

- Increased transparency and fairness by distinguishing DICO's cost component premium from the risk-based premium;
- A projected reduction in risk-related premiums for most institutions;
- Lower total premiums (risk premium plus DICO cost component premium) for most institutions;
- A simpler approach to assessing relative risk, based on a single measure of capital; and
- Eliminating the inequities created by the current tier structure for premium rates by moving to a continuous structure for risk based premiums, and ensuring through its design that premiums are proportionate to risk.

DICO proposes to seek Government approval for a revised process incorporating these changes effective January 1, 2009. It will recommend adjustments to the approach for determining premiums described above as necessary to ensure that the reserve fund remains within an appropriate target range. It will also consider transitional measures for the small number of institutions that might be adversely affected in terms of their total assessment under the new system.

Background

When the current system of differential premiums was introduced in 2001, DICO committed to undertake a review after a reasonable period of time to see if changes would be appropriate.

The main focus at the time was to introduce member institutions to the concept of a differential premium system, in which an institution's premium rate varied with the level of its insurance risk. (Risk is defined as the likelihood of failure as measured by a member institution's performance and condition.) Institutions were placed into one of five tiers, based on measures of capital, asset quality, corporate governance (management), earnings, and asset/liability, which together comprised the "CAMEL" model. Premium rates declined through the tiers, with differential rates intended to encourage institutions to adopt behaviors that would lessen the risks associated with the CAMEL measures.

Over the past few years, changes in the structure and activities of the industry and other factors have affected how we assess risk. As well, changes have been made to the Act. Our review of the current system, which is the subject of this paper, therefore took into account:

- recent regulatory changes, including the adoption of a risk-weighted capital test for more complex institutions
- the growth of the Deposit Insurance Reserve Fund
- trends in the size, structure and risk profile of member institutions
- DICO's current approach to risk assessment and risk management

Our analysis also considered comments and suggestions from institutions about the current system.

Regulatory changes

In line with recent changes to Ontario Regulation 76/95 to the Act, a new measure of capital adequacy for more complex institutions was introduced. The regulation defines these "Class 2" institutions as having more than \$50 million in assets, or holding commercial loans, or both.

Under the new BASEL (BIS) II approach, the amount of capital required for each Class 2 institution is based on its risk profile and total risk-weighted assets. For example, an institution with mostly high-risk assets such as commercial loans and market investments would need a higher amount of capital than a similar-sized institution with mostly low-risk assets (cash, deposits and mortgages, for example). Capital requirements under this approach "self-adjust" as risk changes. The new risk-weighted test also includes additional capital requirements for operational risk and interest rate risk.

The amendments also require Class 2 institutions to take a “prudent person” approach to lending, and further expected changes would expand this approach to investments and liquidity management.

Features of the previous system have been retained for less complex institutions which offer limited products and have similar risk profiles. Instead of the BIS II requirements, they continue to be subject to the basic capital adequacy (leverage) test. They are also subject to restricted lending and investment rules.

Finally, under the revised Act, DICO would assume responsibility for all solvency related regulation.

Growth in the Deposit Insurance Reserve Fund

The reserve fund is now near a level where premium assessments will no longer be necessary to build the fund but rather to maintain the fund within an appropriate target range and still enable DICO to meet its obligations under the Act. It is expected that in the next year or so, aggregate premiums can likely be reduced.

When the current model was introduced, DICO committed to adjust premium rates as necessary to meet a long-term target for the reserve fund. In line with that commitment, we recently had a major consulting firm carry out a review of the model and its assumptions.

The review indicated that the reserve fund should range between 56 and 68 basis points of insured deposits. It also recommended some minor changes in model assumptions and an update to reflect improvement in loss experience since 2001. Our actuarial consultants have made these changes.

Our intention is to allow the fund to operate within the upper and lower limits recommended by the consultants, as opposed to maintaining a fund at a fixed target of 60 basis points. Analysis by our actuarial consulting firm using the updated model shows that the upper limit of the range (68 basis points) provides a high level of confidence that the fund will not be in a deficit position over the next 20 years. We believe that this is an appropriate upper limit for the fund’s size.

Allowing the fund to operate within a range will help to achieve premium stability over normal economic cycles. Analysis shows that if the fund fell below 56 basis points, some form of premium surcharge would likely be needed. Conversely, an increase in the fund beyond the 68 basis point level would probably enable DICO to recommend to the government some form of premium relief.

Trends in Size, Structure and Risk Profile of Institutions

Table 1 below illustrates the significant structural changes to the sector since 2001. These include continued consolidation, with the number of institutions falling from 321 at the end of 2000 to 212 as at 2Q2007. Total sector assets have grown by 65%, and average assets

per institution have tripled to \$120 million. As well, off-balance sheet exposure and commercial lending have increased substantially.

Commercial loans more than doubled during the period and now account for 24% of total loans, compared to 15% for personal loans. Off-balance sheet assets such as mutual funds have increased more than six-fold, pointing to the increasing sophistication of the product offerings at many institutions.

**Table 1: Ontario Credit Unions and Caisses Populaires
System Summary Statistics: 2000-2007**

	2000	2002	2004	2006	2007 ¹
Number of Institutions	321	276	240	219	212
Total Assets (\$ billions)	\$15.4	\$17.9	22.3	24.7	25.4
Average Assets per MI (\$millions)	\$42	\$57	\$93	\$113	\$120
Aggregate Capital (% of assets)	6.73%	6.89%	7.02%	7.10%	7.27%
Profitability (% of asserts)	0.52%	0.38%	0.29%	0.40%	0.50%
Total Off-balance Sheet Assets (\$billions)	\$0.8	\$1.7	\$2.6	\$4.5	\$4.9
Total Commercial Loans (\$billions)	\$2.0	\$2.6	\$3.6	\$4.7	\$5.1
% Commercial Loans (as % of Total Loans)	17%	19%	21%	24%	24%
Insurance Fund (\$millions)	\$15	\$43	\$74	\$100	\$110
Insurance Fund (bps of insured deposits)	10	33	45	56	60

Today, there are significant variances in the types and sizes of institutions. There are now four institutions with assets in excess of \$1 billion each, together accounting for 33% of total system assets. These institutions, plus another 50 with assets of more than \$100 million, together account for 82% of total system assets and more than 90% of total commercial loans. At the other end of the scale, there are 61 institutions with less than \$10 million in assets each, accounting for less than 1% of total system assets. Typically, these institutions have a single service location and offer limited deposit and personal lending products.

These changes have an impact on the risk profile of individual institutions, because commercial lending is generally considered higher-risk than, for example, residential mortgages. The concentration of assets in fewer, larger organizations also has an impact on risk for the industry as a whole.

DICO's New "Net Risk" Approach

DICO recently implemented a new approach to risk assessment and management. This "net risk" approach replaces the CAMEL system, which was used for both risk assessment and premium purposes. The new approach recognizes the widening diversity of member institutions and the different risks to which they are exposed. It also responds to the

¹ As at 2Q2007

industry's recommendations to move towards an approach more tailored to the individual business activities and resulting risks at more complex institutions.

The objective of the new model is to assess the soundness of each institution through an in-depth understanding of:

- the significant activities in which it is engaged
- the environment in which it operates
- the material risks to which it is exposed
- the quality and effectiveness of its governance and risk management practices

This new approach focuses on risks arising from the significant business activities of each institution, which are often unique to the institution, and mitigation of these risks. Because this new approach provides a more prospective view of risk than do the current ratings, which are based mainly on historical results, it also provides earlier identification of risk and the opportunity for institutions to resolve any material issues that may be identified, and minimize intervention by DICO.

Under the net risk model, the assessment process is mainly qualitative and relies heavily on the analysis and judgment of the DICO regional managers assigned to specific institutions. Discussions between the regional manager and an institution's board and management, supported by on-site reviews of higher risk areas where appropriate, are key to the process.

Current DPS Issues

One of the most significant issues with the current DPS structure is that its design places institutions with a fairly wide range of risk scores into the same tier, paying the same premium. For example, an institution with 70 points pays the same premium as an institution with 84 points because their scores both fall into tier 2. However, the difference of 14 points represents significantly different levels of risk, primarily in the level of capital and earnings. Conversely, an institution in tier 3 with 69 points pays a much higher premium than an institution in tier 2 with 71 points, even though the change in scores of two points represents a minimal increment in risk. A number of industry representatives have suggested a more continuous or graduated scale that would eliminate these inequities.

We also received comments regarding the various measures used in the current system. Some institutions suggested incorporating the quality of capital into the capital measure by applying a higher weight to retained earnings than other forms of capital. Other suggestions included making changes to the earnings measure to recognize non-cash dividends, such as patronage shares, which can result in a more favourable tax treatment than other types of dividends and are retained as part of capital. Having looked these concerns, we have concluded that current legislation and supporting guidelines appropriately address the treatment of different types (tiers) of capital for regulatory purposes.

Another issue that developed over the past few years is the significant improvement in the governance/management ratings after the current system was introduced. Virtually all member institutions now substantially comply with DICO By-law No. 5 standards. As at July 31, 2007, for example, 90% of institutions are rated effective in all standards and 93% in the credit and market risk standards. As a result, this factor is no longer a differentiating risk criterion. In the future, we believe that adherence to the standards will be more effectively managed outside the premium system through DICO's new "net risk" approach.

Designing a new approach

In view of the trends, changes and issues outlined in the previous section, we developed and considered a number of possible options for premiums in consultation with our industry advisory panel.

Of paramount importance in the re-design of the system was an agreement on the design principles. During the initial design process in 2000, we spent considerable time with an industry advisory panel discussing these principles. We believe that the principles developed at that time are still valid today:

- Fairness
- Transparency
- Timeliness
- Accuracy
- Effectiveness
- Efficiency
- Flexibility

On the recommendation of the advisory panel for the current review, we have added a further principle:

- Affordability

These principles guided us in the consideration of design options.

Design Considerations

In considering a new premium system, we looked at the following questions:

- Should there be a separate premium component to cover DICO's operating costs?
- Is it possible to keep the current system for risk premiums and simply adjust some of its measures to address deficiencies?
- Should the current five (CAMEL) risk measures be replaced by a single regulatory capital measure?
- Should a continuous premium structure replace the current five premium tiers?

Separate Premium Component for DICO's Operating Costs

At present, each institution makes a single payment to DICO for its insurance premium. The focus has been on building the reserve fund as quickly as possible, and during this period there is little advantage in separating out the fund's operating expenses. As the fund matures, however, we believe that it will be more appropriate to separate the risk premium component needed to cover the fund's actual/projected losses from the premium component to cover DICO's operating costs.

Such an approach would also be more in line with DICO's transition to both insuring deposits and acting as a solvency regulator. As DICO takes on its new regulatory responsibilities it will no longer be appropriate to cover our operating costs with premiums based solely on each institution's risk factors. Using an institution's size (as measured by assets) would be fairer. This is similar to the way the leagues, the Financial Services Commission of Ontario (FSCO) and OSFI calculate their assessments.

Also, should DICO's operating costs change as a result of transferred responsibilities from FSCO under the revised Act, the proposed approach will provide greater transparency for any change in costs. FSCO currently assesses the credit union sector approximately \$1.2 million in costs based on assets.

We have concluded that the proposed approach offers greater transparency and fairness. Each institution would pay its fair share of DICO's annual operating costs, plus a risk premium component to maintain the reserve fund within an appropriate target range.

Refine the Current Differential Premium System

There might be merit in keeping the current system for risk premiums, since institutions know it well, as long as it could be adjusted to address the issues raised. We looked at a number of possible changes, including using revised capital and earnings measures and eliminating the management component. The latter would require adjusting the weights of the remaining measures.

Our analysis indicates that most of the possible changes we considered would not result in any significant overall change in ratings. Some of the changes, however, would result in lower ratings and higher premiums for many institutions. Also, some changes would add complexity and others might reduce the accuracy and fairness of the measures.

For those reasons, we have concluded that updating the premium system entirely is the best way to ensure fairness and accuracy and minimize complexity.

Replace the five CAMEL measures with a single regulatory capital measure

A single measure – regulatory capital requirement – provides a more timely and simpler basis for determining premium rates than the current five measures. Capital is measured on an “as at” basis. Some of the current measures are more historic in nature. Earnings and

Asset Quality are measured over the latest three-year, for example, and Management findings may be from an OSV conducted up the 36 months earlier. These may not accurately represent current risks.

A change to the single measure of capital also makes sense in light of recent changes to capital requirements for more complex institutions. The new “risk-weighted” (BIS II) capital measure for Class 2 institutions provides a clearer differentiation of risk, especially as these more complex institutions move into higher risk activities. It is also more equitable for institutions with minimal balance sheet risk. As well, this approach provides institutions with greater flexibility to structure their balance sheets to optimize capital. It will be more effective in differentiating risk in the future, as the amount of capital required by institutions is based on the unique and changing risk profile of each member institution, rather than total assets under the current leverage test. The five CAMEL risk measures currently used for premium purposes will be redundant under the new risk weighted measure.

For less complex (Class 1) institutions, representing less than 4% of total sector assets, the basic regulatory leverage test has been retained from the CAMEL model as an appropriate capital-related measure of risk. These institutions tend to have more operational risk rather than balance sheet risk, as they offer a limited range of products and services.

Adopt a Continuous Risk Premium Structure

We have already discussed how the current tier structure creates inequities, either by placing institutions with very different risk levels in the same tier or by placing institutions with similar risk scores into different tiers. Increasing the number of tiers would reduce such inequities, but would not eliminate them. The only effective alternative is a fully continuous premium structure. Two approaches to a continuous system were examined: a straight-line option or a curve.

Under the straight line option, each change in risk would result in a similar pro-rated change in risk premium. For example, if the risk level rose by 10%, the premium rate would also increase by 10%. The mid-points of the risk range and premium range would coincide.

Under the proposed continuous “curve” option, premium rates would change by slightly different amounts according to the level of risk. Higher-risk institutions would see smaller changes in premiums as risk improved while lower-risk institutions would see slightly larger changes in premiums as risk improved. In other words, if a relatively low-risk institution were to increase its additional capital, it would benefit more than a high-risk institution making the same proportionate change.

This is different from the current approach, which was designed to provide higher financial incentives to higher risk institutions to adopt more prudent risk management practices as measured by the CAMEL model. Under the new risk-weighted capital measure for most institutions, these incentives are built in to the BIS measure and are no longer needed in the premium structure. More risk requires more capital and there is no longer any

requirement to motivate change. However, we believe that institutions with minimal levels of additional capital still present significant potential risk to the DIRF and should be assessed at a higher rate than those with much higher levels of additional capital and thus represent lower risk to the DIRF.

From our analysis, a continuous curve premium structure provides several benefits over the current tier structure, including:

- a more equitable overall distribution of risk premiums
- distinct premium rates for all levels of risk (additional capital)
- relatively lower premium rates for institutions that present lower risk

Preferred Structure

Based on our review and analysis, we propose to implement a revised premium/assessment structure with the following elements:

Separate premium components for DICO's operating costs and risk premiums.

1. Premium Component to Recover DICO's Operating Costs

This would include a base premium using total on- and off-balance sheet assets, with a minimum of \$1,000 for institutions with total assets of less than \$10 million, plus a pro-rated premium using average assets for the latest 12 months. Section I of the Technical Supplement attached to this Consultation Paper provides a sample calculation.

2. Risk Premium Component

Risk premiums based on a single capital measure. Instead of the current five measures, premiums would be calculated using a single measure of capital. For Class 1 institutions, this would be the existing leverage test. For Class 2 institutions, it would be the recently introduced BIS risk weighted ratio.

Premium levels related to regulatory capital requirements. Premiums would be based on the level of additional capital relative to the minimum regulatory requirement. Institutions with additional capital of 100% or more above the minimum requirement would pay the lowest rate, \$0.20, on each \$1,000 of insured deposits. For Class 1 institutions, 100% additional capital equates to a leverage ratio of 10%; for Class 2 institutions, 100% additional capital equates to a BIS ratio of 16%. Conversely, institutions with the minimum required capital – that is, 5% leverage for Class 1 or a BIS ratio of 8% for Class 2 – would pay the highest rate on the scale, \$0.70. Institutions that fall below the minimum regulatory capital requirement for their class would pay a “non-compliance” rate of \$1.40.

A progressively increasing structure for risk-based premiums. In addition to eliminating inequities associated with the current tier structure, a continuous premium rate scale based on a curve would ensure that the higher-risk institutions paid proportionately higher premiums.

Section 2 of the attached Technical Supplement provides more details on how risk premiums would be calculated. A “Risk Premium Calculator” and formulas are available on DICO’s web site to help institutions determine risk premium rates and premium expense for any level of additional capital.

Impact on institutions

1. Premium component to Recover DICO’s Operating Costs

Premiums to recover DICO’s operating expenses are about \$0.0025 of average assets or the equivalent of \$0.35 on each \$1,000 of insured deposits, based on current system levels.

A few institutions may be affected by the change in the basis of assessing DICO’s operating costs. Institutions with very low levels of insured deposits currently pay a much lower pro-rated share of DICO’s costs because these expenses are covered solely by the premium on deposits. DICO however needs to be concerned about all of an institution’s activities.

2. Risk Premium Component

The effective risk premium rate would be roughly \$0.40 on average, based on current capital levels. This compares to the current equivalent effective risk premium rate of \$0.65, excluding assessments for DICO’s operating expenses. This translates into an effective reduction in risk premiums of almost 40%.

Institutions with higher levels of additional capital, and therefore lower risk, would likely see even more significant reductions in risk premiums. For these institutions, risk premiums would likely be at or close to \$0.20 on each \$1,000 of insured deposits.

Based on our analysis, no institution would pay a higher risk premium than under the current system.

Aggregate Premiums

With the changes, the overall aggregate premium rate is projected to be equivalent to about \$0.75 on each \$1,000 of insured deposits. This translates into a reduction of approximately 25% from the current level of premiums, which cover both the risk premium and DICO’s operating costs.

Based on 2Q2007 information, our analysis indicates that the majority of institutions would see a reduction in aggregate premiums if these proposals were introduced today. Some smaller institutions would see a small increase in overall premiums as a result of the

introduction of a minimum base premium of \$1,000 for DICO operating costs. This structure is similar to the minimum rates currently in use by FSCO and OSFI.

While the amounts involved are not projected to be material, we will be looking at ways to minimize the impact on institutions when these proposals are implemented. This may be by way of special transition rules to limit or defer any potential increase compared to existing equivalent rates for a period of time.

Conclusion and next steps

The DPS has achieved its original dual objectives in encouraging institutions to adopt improved risk management practices and the establishment of an appropriate base for managing insurance risks. We now believe that a single regulatory capital measure will be more effective in differentiating risk in the future and that moving to a continuous premium structure is more equitable for all institutions. We also believe that premiums to cover DICO's operating costs should be separately determined from risk premiums as they relate primarily to required regulatory activities regardless of risk.

DICO plans to put in place a revised process incorporating the proposed changes effective January 1, 2009 subject to Government review and approval of necessary regulatory changes. The implementation process will take into account comments received through this consultation period.

TECHNICAL SUPPLEMENT

Section 1: Premiums to Recover DICO's Operating Costs

Premiums to recover DICO operating costs will include:

- (a) A base amount; and
- (b) A pro-rated amount

(a) Base Amount

This is determined using the total on- and off-Balance Sheet assets. Off-balance sheet assets are limited to those assets that are included for the calculation of risk-weighted capital under Section 15 for the Regulation for Class 2 institutions. The minimum base amount is \$1,000 for institutions with total assets of less than \$10 million.

Table 2: Base Assessments

Total Assets (On/Off Balance Sheet)	Base Amount	Total Assets (On/Off Balance Sheet)	Base Amount
>\$3 billion	\$400,000	<\$500 million	\$50,000
<\$3 billion	\$300,000	<\$250 million	\$25,000
<\$ 2billion	\$200,000	<\$100 million	\$10,000
<\$1.75 billion	\$175,000	<\$50 million	\$5,000
<\$1.5 billion	\$150,000	<\$40 million	\$4,000
<\$1.25 billion	\$125,000	<\$30 million	\$3,000
<\$1 billion	\$100,000	<\$20 million	\$2,000
<\$750 million	\$75,000	<\$10 million	\$1,000

(b) Pro-Rated Amount

Premium for the balance of DICO's operating costs are pro-rated according to average assets for the latest 12 months. An example is provided in Table 3 below.

Table 3: Pro-Rated Assessments

	System	Institution 9999
Total Assets	\$26,000,000,000	\$29,000,000
Average Assets	\$25,000,000,000 (A)	\$28,000,000 (AA)
DICO Expenses	\$6,250,000 (B)	
Base Amount	\$3,000,000 (C)	
Balance	(B)– (C) = \$3,250,000 (D)	
Pro-rated Amount	\$3,250,000 (D) ÷ \$25,000,000,000 (A) = 0.00013 (E)	\$28,000,000 (AA)×0.00013 (E) = \$3,640

EXAMPLE: Total Premiums to Recover DICO Operating Costs (Institution 9999): \$3,000 (Table 2) + \$3,640 (Table 3) = \$6,640

Section 2: Overview of the Proposed Risk Premium Component

Table 4: Proposed Structure

Description	Details	Comments and Rationale
Premium Structure	Continuous premium structure (CURVE)	<ul style="list-style-type: none"> Institutions with lower risk will have proportionately lower risk premium rates
Risk Measure	Class 2 institutions - Risk weighted capital test (BIS II) Class 1 institutions - Leverage test	<ul style="list-style-type: none"> Premiums are allocated according to the reported (audited) regulatory capital of each institution at its fiscal year end Risk weighted capital is a better measure of the impact of failure on the DIRF as capital will be more clearly aligned with the business operating model and risk profile of each (Class 2) institution Uses revised BASEL II risk weights and incorporates earnings (operational risk) and interest rate risk components for complex institutions Basic leverage test used for less complex institutions
Criteria – Minimum	Additional Capital 0.0%	<ul style="list-style-type: none"> This will be equivalent to the minimum statutory capital adequacy requirements. For Class 2 institution this equates to 8% BIS ratio. For Class 1 institutions this equates to 5% leverage ratio. Institutions below this minimum statutory level will pay the non-compliance premium rate
Criteria – Maximum	Additional Capital 100% of minimum regulatory capital	<ul style="list-style-type: none"> Institutions with capital at or above this level are deemed to represent little additional risk to DICO. At this level, capital is considered sufficient to cover most potential loss requirements that may arise. This is the equivalent of 16% BIS ratio or 10% leverage ratio.
Premium range for institutions that meet regulatory capital requirements	\$0.20 - \$0.70	<ul style="list-style-type: none"> Premiums will be based on the level of additional capital for each institution. Institutions with 100% or more additional capital (equivalent to a 16% BIS ratio or 10% leverage ratio as applicable) will pay \$0.20. Institutions with 0% additional capital (equivalent to a 8% BIS ratio or 5% leverage ratio) will pay \$0.70
Non-compliance rate for institutions that do not meet regulatory capital requirements	\$1.40	<ul style="list-style-type: none"> This rate is set to penalize institutions for being undercapitalized

Section 3: Current Capital Levels

A review of capital levels as at the second quarter of 2007 helped to confirm an appropriate range of additional capital for the purposes of risk premiums. As indicated in Figure 1 and Figure 2 below, the majority of institutions have additional capital in the range of 50% to 150% above the minimum regulatory requirements.

Figure 1: Additional Capital Class 1 Institutions

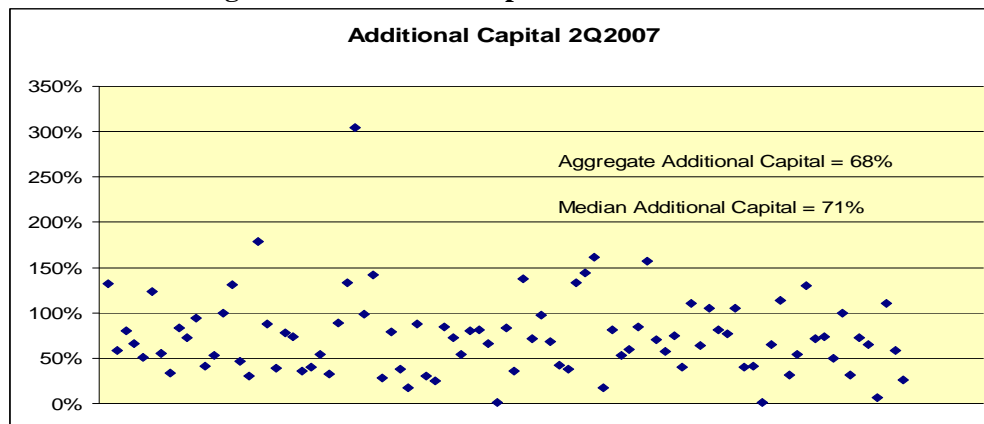
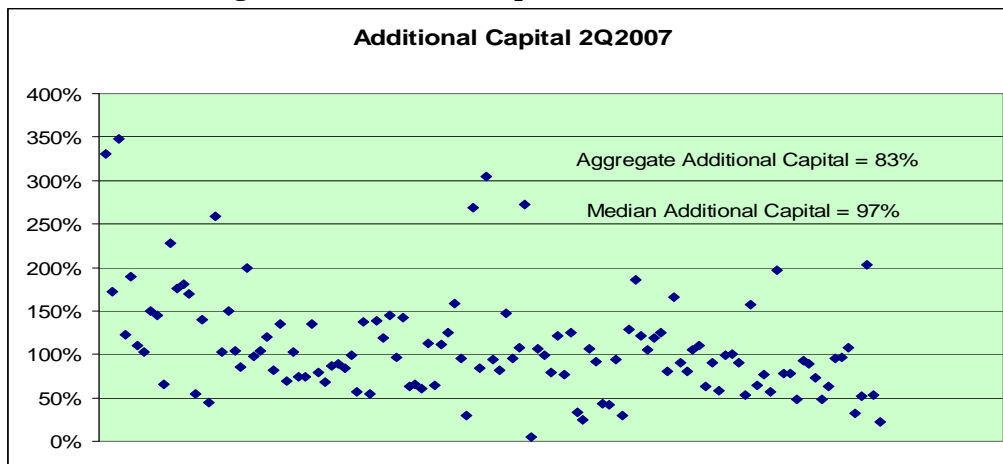


Figure 2: Additional Capital Class 2 Institutions



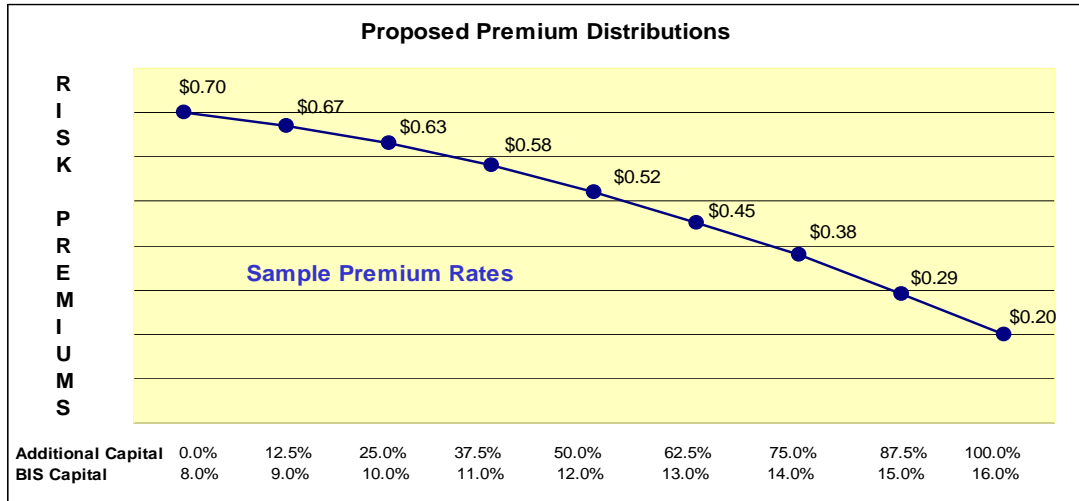
As at 2Q07:

- A total of 77 institutions have additional capital of more than 100% and would qualify for the minimum risk premium of \$0.20
- A total of 126 institutions have additional capital of more than 75% and would pay a risk premium of less than \$0.40
- Only 6 institutions have additional capital of less than 25% and would pay a risk premium between \$0.65 and \$0.70
- One institution would pay the non-compliance rate of \$1.40 under the proposed changes.

Section 4: Proposed Continuous Risk Premium Structure

Risk premiums will vary between \$0.20 and \$0.70 for the percentage of additional capital institutions hold between 0% and 100%. Undercapitalized institutions will pay the maximum premium of \$1.40. Figure 3 provides an overview of the premiums payable at selected levels of additional capital. For example, with additional capital of 50% (BIS ratio of 12% or Leverage ratio of 7.5%), the risk premium rate is (approximately) \$0.52 per \$1,000 of insured deposits. Actual risk premium rates will be calculated to four decimal places. Capital and additional capital levels will be calculated to two decimal places. Institutions with capital below the statutory minimum will pay \$1.40

Figure 3: Approximate Risk Premium Rates - Class 2 Institutions



A “Risk Premium Calculator” and formulas are available on DICO’s web site to help institutions determine risk premium rates and premium expense for any level of additional capital. Selected risk premium rates are provided in Table 5 below.

Table 5: Selected Comparative Risk Premium Rates

Class 1 Institutions			Class 2 Institutions		
Capital (Leverage ratio)	Additional Capital %	Risk Premium Rate	Capital (BIS ratio)	Additional Capital	Risk Premium Rate
<5.00%	<0%	\$1.4000	<8%	<0%	\$1.4000
5.00%	0%	\$0.7000	8%	0%	\$0.7000
6.00%	20%	\$0.6448	9%	12.5%	\$0.6681
7.00%	40%	\$0.5672	10%	25.0%	\$0.6275
			11%	37.5%	\$0.5781
7.50%	50%	\$0.5200	12%	50.0%	\$0.5200
8.00%	60%	\$0.4672	13%	62.5%	\$0.4531
9.00%	80%	\$0.3448	14%	75.0%	\$0.3775
10.00%	100%	\$0.2000	15%	87.5%	\$0.2931
>10.00%	>100%	\$0.2000	16%	100.0%	\$0.2000
7.50%	50%	\$0.5200	>16%	>100.0%	\$0.2000

Section 5: Comparison of Design Principles

The following table provides a comparison of the current DPS and proposed Risk Premium Component Structure to the design principles established for a differential premium system.

Table 6: Design Principles

Design Principles	CURRENT DPS		PROPOSED DPS	
	Met	Comments	Met	Comments
Fairness	Not Fully	By incorporating tiers, institutions with higher risk can pay the same premiums as institutions with lower risk in the same premium tier	Yes	Institutions with similar risk pay a similar premium. Continuous structure ensures that premiums are distinct for each different level of risk.
Transparency	Yes	Structure and measurement criteria documented and published. However, institutions must understand five separate risk measures.	Yes	Uses a single statutory capital measure reported on the institution's audited financial statements
Timeliness	Not Fully	Some risk measures are based on results over three years. This can result in a delay in premium adjustment for some institutions as a result of a change in risk. Also, Management component is based on latest OSV results which may be have been conducted up the 36 months earlier.	Yes	Uses capital as reported at fiscal year end when premiums are calculated
Accuracy	Not Fully	Includes qualitative measure (Management) which is subjective in nature. Weights assigned to each measure may not always result in an accurate "composite" rating.	Yes	Based on a single quantitative risk measure using audited results.
Efficiency	Not Fully	Premium calculations can be complex for amalgamations, purchase and sale transactions and changes to fiscal year ends etc. due to 3 year measures for earnings and asset quality	Yes	Uses one single "year end" capital position for premium calculations
Flexibility	Yes	Can be modified although modifications can be more complex due to number of risk measures, weightings and tiers	Yes	Premium rates can be adjusted as necessary to reflect higher or lower premium requirements without change to the risk measure.
Affordability	Not Fully	Use of tiers limits premium relief as all institutions within tier pay the same premium.	Not Fully	Revised premium structure provides improved differentiation of premiums based on risk. Institutions can minimize premiums by maintaining higher levels of additional capital. Lowest premium rate of \$0.20 compares to \$0.14 for CDIC.