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To: Chairs and CEOs of All Member Institutions

Subject: **Revised DICO By-law No.5
Standards of Sound Business and Financial Practices**

We are pleased to advise you that the revised By-law No.5 – *Standards of Sound Business and Financial Practices* has now been proclaimed by the government of Ontario and will come into effect for all member institutions at their first fiscal year ending after July 1, 2005.

The purpose of this communication is to provide you with:

- An overview of significant changes from the current by-law requirements;
- A description of the revised assessment and reporting requirements;
- A summary of the tools developed to assist member institutions in implementing the new standards; and
- The implications of the new standards for DICO's risk assessment program.

Overview of Significant Changes

The revised standards have been developed in recognition of the increasing complexity of the financial services environment and the need to provide member institutions with greater flexibility in implementing a risk management process that meets their specific needs. The standards also help to clarify the different roles and responsibilities of the board of directors and management in identifying and managing the significant risks to which the institution is exposed. Significant risks are those risks that, if not appropriately managed, could have an adverse affect on the institution's reputation, safety and ultimate viability.

Many of the elements from the current standards are incorporated in the revised standards with additional elements relating to emerging risk areas such as operational risks (e.g., technology development and maintenance and outsourcing services) and structural risks (derivatives and hedging strategies). Some standards have been renamed to better reflect the nature of the risks involved.

A summary of specific changes to By-law No. 5 is provided in Appendix I.

Revised Assessment and Reporting Requirements

The revised standards also include new assessment and reporting requirements as part of the deposit insurance renewal process. These replace the current Assessment Standard which requires the completion and filing of the Member Institution Self Assessment Return – “MISAR”. As a result, it will no longer be necessary to complete or file the MISAR for a fiscal year ending after July 31, 2005. **Please note that institutions with a fiscal year end before July 1, 2005 may either conduct the annual MISAR assessment for 2005 or adopt the changes outlined in the revised standards.** If you require any further clarification concerning these options please contact your Regional Manager.

Annually, the board and management of each member institution will be required to review and assess the operations of the institution and submit a Board Resolution in a form prescribed by DICO. A copy of the required Board Resolution is included with By-law No.5. Since adherence to the standards is an ongoing process, the annual review may be conducted at any time during the year and need not be completed at the fiscal year end. For example, the review could be completed before year end when the business planning process is undertaken.

The resolution confirms that the board is familiar with its responsibilities under the standards and, to the best of its knowledge and abilities, is fulfilling its responsibilities under the standards. A copy of the Board Resolution is to be forwarded to DICO within 75 days of the institution’s fiscal year end commencing the first fiscal year end after July 1, 2005.

Please refer to Appendix II for details of the first year filing deadlines.

The board resolution also confirms that the board has received a representation letter from management concerning its adherence to the standards. The board is not required to have direct personal knowledge of all compliance related activities of its institution. The board is entitled to rely upon the Management Representation Letter concerning management’s adherence to its responsibilities under the standards together with whatever external collaborative information the board deems appropriate under the circumstances. A sample Management Representation Letter is included with the self-assessment workbooks outlined below. The sample letter may be modified as appropriate to meet the specific needs of individual member institutions.

DICO’s Policy of Deposit Insurance has been modified to incorporate these changes. A revised Policy of Deposit Insurance and Certificate of Insurance will be provided to all institutions at the next insurance renewal date.

Implementation Tools

As indicated above, to streamline the reporting process the requirement to MISAR has been eliminated as part of the revised by-law. Member institutions now have the flexibility to implement appropriate and prudent risk management practices rather than those prescribed in the MISAR.

Sample Workbooks

With the assistance of the Sound Business and Financial Practices Advisory Committee sample workbooks have been developed to help member institutions implement appropriate risk management practices and assist with the annual review and assessment of adherence to the standards.

Separate workbooks have been developed for the board and management. The workbooks outline a number of criteria for consideration in determining adherence to the standards. The workbooks have also been designed to provide comments, exceptions or reference sources of other documents which may be helpful in completing the assessment process.

The assessment criteria outlined in the workbooks have been developed from best business practices in the system but it should be stressed that they are **not** mandatory requirements. Member institutions may modify the workbooks to meet their specific needs or develop their own self-assessment tools as appropriate. The criteria outlined incorporate many of the current MISAR considerations with some additional criteria to reflect minor modifications to the standards.

Additional workbooks have been developed for less complex and smaller institutions with limited product offerings. These workbooks have been designed for institutions with specific characteristics by recognizing their limited resources. Criteria that would not apply to these institutions have been removed or modified. Additional criteria surrounding operational risk have also been included for consideration by these institutions in view of potential risk due to their limited resources. The workbooks will be made available to institutions that generally have the characteristics outlined and will also be available in electronic form on DICO's web site.

Policy Guidance

Changes to policies may be necessary as a result of the revised standards and criteria. When the existing standards were introduced in 1997, DICO provided a set of sample policies as policy guidance for member institutions. Since then, all institutions have implemented their own customized sets of policies reflecting their own circumstances. DICO does not propose to re-issue those sample policies.

However, we are pleased to advise that Credit Union Central of Ontario (Central) has undertaken to amend its model policies within their Operations Manuals program to incorporate the changes to the standards for both complex and less complex institutions. Central has kindly authorized DICO to make these available on DICO's web site. We also understand that other leagues are in the process of updating their policies in a similar manner.

A summary of policy updates is provided in Appendix III.

Other Reference Materials

The DICO Director's Handbook and Reference Manual are being revised to reflect the changes to By-law No. 5. Those sections in the Reference Manual affected by the changes to the standards will be updated. Similarly, the Director's Handbook is being updated with the revised standards of sound business and financial practices, including the new assessment and reporting requirements. The revised Handbook also includes the Audit Committee Checklist and additional references to Privacy and Money Laundering legislation.

Electronic versions of the revised Reference Manual and Director's Handbook will also be available on DICO's web site. Printed copies will also be available upon request for those institutions that do not have access to the electronic version.

Revisions to the Virtual Encyclopedia are not being made at this time as further changes may be required following the review of the Credit Unions and Caisses Populaires Act which is now taking place.

Implications for DICO's Risk Assessment Program

As part of its risk assessment and On-Site Verification (OSV) process DICO has been testing the risk management practices of each institution against a prescribed set of assessment criteria covered in the MISAR which formed part of the existing by-law. The majority of member institutions have demonstrated full compliance with the requirements of the existing by-law, with appropriate policies, procedures and controls.

The revised by-law provides increased flexibility to member institutions for managing their significant risks by moving from the previous prescriptive approach to a more customized approach. This approach recognizes and accommodates the increasing diversity and complexity of member institutions and acknowledges that a single prescriptive approach to risk managing is no longer appropriate.

DICO's risk assessment and OSV programs have already been modified to focus on material risks. The revised standards are not expected to materially impact these now revised programs. Modifications are being made to the On-Site Verification (OSV) process to reflect the changes to the by-law and DICO is developing a revised risk assessment model that recognizes the increasing diversity and complexity of member institutions. With the introduction of the revised by-law, DICO will rely on the results of a member institution's self-assessment of its adherence to the standards and its ability to identify and manage the significant risks to which it is exposed.

An electronic version of the revised OSV Manual will be made available on DICO's web site and further information outlining DICO's new risk assessment model will be distributed shortly.

Implications for the Differential Premium System (DPS)

In anticipation of a number of potential changes to capital rules and other regulatory requirements and in line with changes to the By-law, DICO is undertaking a full review of the Differential Premium System (DPS) during 2005. This review will include exploring different options for DPS measurement criteria and premium structure.

Based on feedback received from member institutions in the past, potential changes under consideration include:

- eliminating the management component of the current test since virtually all institutions now meet the standards;
- employing quantitative measures, such as excess capital based on a risk weighted capital test and profitability as the sole basis for premium ratings; and
- adopting a more continuous premium scale rather than a tiered approach.

A discussion paper on possible changes to the DPS and the long term implications on the OSV and risk assessment processes is expected to be distributed later this year for review and feedback by member institutions and other stakeholders.

Sound Business and Financial Practices Advisory Committee

On behalf of all member institutions, FSCO and DICO we would like to express our thanks and appreciation to the members of the advisory committee for their time, dedication and contributions in developing the revised By-law over the past twenty months.

A list of the participants is provided in Appendix IV.

Questions and Help Line

Should you, your staff or other board members have any questions about the new standards, please do not hesitate to contact your Regional Manager directly or any one of our staff at 1-800-268-6653, or visit our website at www.dico.com.

Yours truly,

Andy Poprawa

Enclosure: DICO By-law No. 5 Standards of Sound Business and Financial Practices

APPENDIX I

Summary of Specific Changes to DICO's By-law No.5

Credit Union Central of Ontario (Central) has undertaken to amend its model policies within their Operations Manuals program to incorporate the changes to the standards. Please refer to Appendix III for further information on the changes made.

Standard	Material change to existing standards	Comment
All	References to the assessment criteria outlined in the MISAR have been removed	Assessment criteria have been developed for consideration where applicable. These may be modified as necessary to meet the specific needs of individual member institutions.
Governance	Includes current standards for the Annual Business Plan, Code of Conduct and Human Resources and Performance Appraisals	New Governance standard distinguishes the different responsibilities of the board and management
Governance: Board of Directors	Establishing appropriate and prudent risk management policies for standards 2-7 and obtaining reasonable assurance that the institution is adhering to its risk management policies for significant risks	This requirement was previously outlined in the by-law under the board of directors' roles included under each of the risk management standards and embedded in the MISAR. The material change helps focus on "significant risks".
	Establishing the responsibilities, accountability and authority of board committees	Not previously specifically addressed. New standard helps increase the awareness of this important aspect to ensure board committees are effective in discharging their responsibilities.
	Establishing the business objectives of the institution consistent with cooperative principles and approving the institutions business strategy and business plans	The revised standard includes reference to cooperative principles. Details of this requirement are outlined in the Act (Section 24)
Governance: Management	Implementing appropriate and prudent risk management policies, procedures and controls for standards 2-7	This requirement was previously outlined in each of the risk management standards and embedded in the MISAR
	Providing the board of directors with timely, relevant accurate reports on the implementation of the institution's business strategy and business plans and any material risk that may affect business objectives	Most of this requirement was previously embedded in the MISAR. The new standard incorporates the need for timely relevant and accurate reporting including material risk
Capital Management	Distribution of dividends and redemptions of capital instruments to members	This requirement was not previously addressed. With the increase in the level of investment share capital and the use of different dividend distributions, it is important that institutions adequately address this issue.
Credit Risk Management	Includes both on-and off-balance sheet exposures	Emerging risk area not previously required
	An effective credit assessment system	This requirement was previously embedded in the MISAR
	Defined and prudent levels of decision making authority for approving credit exposures	This requirement was previously embedded in the MISAR

Standard	Material change to existing standards	Comment
Operational Risk Management	Replaces previous Internal Controls standard. New standard increases scope to incorporate other elements of operational risk.	Renamed to reflect wider nature of risks
	Technology development and maintenance	New standard developed to address emerging risk area
	Safeguarding of the institution's premises, assets and records of financial and other key information	Standard updated to incorporate requirements under privacy legislation
	Disaster recovery and business continuity plans	This requirement was previously embedded in the MISAR.
	Outsourcing of services	New standard developed to address emerging risk area
Market Risk Management	Replaces previous Investment Management standard	Renamed to reflect wider nature of risks
	Includes both on-and off-balance sheet exposures	This requirement was previously embedded in the MISAR
	Identifying, measuring, providing for and recording market impairments	Expands previous standard to include recording market impairments
Structural Risk Management	Replaces previous Assets/Liability Management standard	Renamed to reflect wider nature of risks
	Includes both on-and off-balance sheet exposures	Not previously addressed
	Use of appropriate techniques for measuring the institution's structural risk and evaluating the potential impact under current and reasonably foreseeable scenarios	Part of this requirement was previously embedded in the MISAR. The new standard incorporates the need for the use of appropriate techniques for measuring and evaluating structural risk (e.g. in some cases, more than one technique may be appropriate)
Assessment	Assessment standard removed from the By-law	Revised By-law includes a similar requirement which is now linked to the Policy of Deposit Insurance. No assessment criteria are prescribed under the revised By-law although sample assessment criteria have been developed for consideration. Member institutions will need to establish appropriate criteria to determine adherence to the standards and pass annual board resolution.
	Board Resolution	Board Resolution confirming adherence to the standards is to be passed. Copy of Board Resolution to be forwarded to DICO within 75 days of FYE

APPENDIX II

Sound Business and Financial Practices: DICO By-law No.5 Filing Schedule for Board Resolution

A copy of the Board Resolution confirming that the board is fulfilling its responsibilities under the standards of By-Law No.5 is to be forwarded to DICO within 75 days of the member institution's fiscal year end.

The following table provides details of the first year filing requirements.

Member Institution Fiscal Year End	Copy of Board Resolution to be submitted to DICO by:
July 31, 2005	October 15, 2005
August 31, 2005	November 15, 2005
September 30, 2005	December 15, 2005
October 31, 2005	January 15, 2006
November 30, 2005	February 15, 2006
December 31, 2005	March 15, 2006
January 31, 2006	April 15, 2006
February 28, 2006	May 15, 2006
March 31, 2006	June 15, 2006
April 30, 2006	July 15, 2006
May 31, 2006	August 15, 2006
June 30, 2006	September 15, 2006

POLICY GUIDANCE

The following is a summary of amendments to Central’s model policies for more complex institutions¹ within their Operations Manuals Program to incorporate the changes to By-Law No. 5. Distribution of these policies is scheduled for the spring of 2005.

1997 Standards	2004 Standards	Policy Modifications
Governance: Annual Business Plan Code of Conduct Human Resources	Governance - Board of Directors	A new section has been added, outlining the policy objectives of board governance, which includes the responsibility, accountability and authority of board committees <ul style="list-style-type: none">• the addition of an annual board resolution on adherence to By-law No.5 to be sent to DICO• reviewing and approving the credit union's risk management policies and ensuring that policies address the significant risks• assessing risk management reports presented by management to ensure adherence to policy and any material weaknesses or deficiencies have been reported and are being addressed• additional detail on establishing appropriate succession plans for the general manager and senior management• two new sections outlining compliance and policy approval/review• the inclusion of a nominating committee• the audit and credit committees remain in the main area of the policy, the other committees have been moved to the Appendix
	Governance – Management	This is a new policy, however the requirements were previously included within the MISAR <ul style="list-style-type: none">• includes a management representation letter to be sent to the board on an annual basis - this letter (which may be modified as appropriate) indicates that management is familiar with By-law No.5 and that they are fulfilling their responsibilities, that management has identified any outstanding deficiencies or exceptions, and includes an action plan to address any of these outstanding deficiencies or exceptions• material contained within the policy objectives outlines management's responsibility to implement policies for the risk areas outlined in By-law No.5• the reporting section outlines content requirements for regular board reports including identifying and addressing any material weaknesses or deficiencies in risk management practices, and confirming compliance with legislation and by-laws• management's responsibility for producing comparison reports on actual performance and business risk measurements to the credit union's annual business plan and previous year to date performance

¹ Policy amendments for less complex institutions are under final development

1997 Standards	2004 Standards	Policy Modifications
Capital Management	Capital Management	Fuller clarification on policy objectives: <ul style="list-style-type: none">• Addition of controls for aggregate segregation of responsibilities and duties• Addition of reports to the board on compliance with various legislation• New section outlining the conditions for distribution of dividends and redemption of capital instruments to members
Credit Management	Credit Risk Management	This policy is an update from DICO's original credit risk management policy dated 1997. The existing policies for personal, mortgage and commercial lending will be updated accordingly: <ul style="list-style-type: none">• New section of substandard and/or deteriorating risk for commercial and agricultural borrowing within the policy• New credit risk rating system for commercial, agricultural and business loans within the appendices• Loan to value ratio changes within business and commercial loans, commercial mortgages (including construction loans) and agricultural lending• Limits on loans to connected parties and establishment of limits to large loans by the board• Pricing on loans based on level of assessed risk and realistic net contribution to earnings• Clarification on credit union loan to value ratio versus overall loan to value ratio
Investment Management	Market Risk Management	New standard replaces Investment Management. Expanded to include off-balance sheet exposures, other financial instruments, measuring market impairments. Fuller clarification on policy objectives: <ul style="list-style-type: none">• New section on diversification by counterparty, credit ratings etc.• New section on decision making authority and approval authority on areas including investment exposures and large or complex transactions. Third party brokerage activity is also included.• Within the Authority Levels section, notes are included, providing additional guidance and clarification on the use of derivatives to include provisions within structural risk management• New section on market impairments, including the requirements for credit unions to identify, measure, provide for and record market impairments

1997 Standards	2004 Standards	Policy Modifications
Asset/Liability Management	Structural Risk Management	New standard replaces Asset/Liability Management, includes A/L plus risk inherent in off-balance sheet activities, use of appropriate techniques for structural risk: <ul style="list-style-type: none"> • Fuller clarification on policy objectives
Liquidity Management	Liquidity Risk Management	Minor changes include: <ul style="list-style-type: none"> • Referencing the new names for structural risk management and liquidity risk management • Definition of operational liquidity • Fuller discussion of minimum operating liquidity requirements • Fuller discussion of controls to ensure adequate segregation of responsibilities and duties
Internal Controls	Operational Risk Management	New standard replaces Internal Controls. Changes include: <ul style="list-style-type: none"> • clarity on policy objectives, with particular attention to disaster recovery and business continuity plans, outsourcing of services and safeguarding of premises, assets and records (full objective has been expanded) • within policy guidance, addition of accountability for on-balance and off-balance sheet activities, and the inclusion of safeguarding premises, including protection of members and staff from exposure to crime or injury • detailed information regarding setting up the appropriate framework for technology development • new section on outsourcing of services, including documenting a process for selecting service providers, standards, procedures and schedules for reviews of contracts
Assessment	Included under reporting requirements of By-law	Incorporated under Governance policies

APPENDIX IV

**By-law No. 5 Review
SBFPAC Participants List**

Mr. Daniel Atlin
Ms. Lesley Mansfield
Mr. Marty Von Wuthenau
Credit Union Central of Ontario Limited

M. Raymond Boucher,
Caisse populaire de Kapuskasing Limitée

M. André Cadieux
Caisse populaire Rideau d'Ottawa Inc.

Ms. Lori Gaudette,
Oshawa Community Credit Union Limited

M. Denis Laframboise,
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Mr. Fred Marchildon,
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Mr. Bert Whitmell,
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Mr. Andy Poprawa
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