FRAMEWORK FOR A

DIFFERENTIAL PREMIUM SYSTEM

FOR ONTARIO CREDIT UNIONS, CAISSES POPULAIRES

AND LEAGUES

DEPOSIT INSURANCE CORPORATION OF ONTARIO
(DICO)

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Executive Summary

This Framework documents the key elements of the Deposit Insurance Corporation of Ontario's (DICO) differential premium system.

A differential premium system (DPS) is an insurance pricing structure whereby an institution's premium rate varies 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.

The DPS benefits the Ontario credit union and caisse populaire system (the System) by rewarding member institutions with lower premiums for adopting lower risk behaviour. Since its purpose is to encourage lower risk behaviour, a DPS represents a lower-cost form of early intervention and supervision for DICO.

DICO's risk assessment program is used to gather all the information necessary to measure the level of risk at an institution and assign a rating. The risk assessment program collects the information required for the DPS through the Annual Member Institution Return, the Member Institution Self-Assessment Report, and On-Site Verifications.

Risk is measured using a rating system that measures five components of a member institution's performance and condition, and provides DICO with an overall composite risk rating for each insured institution. The five components measured are capital, asset quality, corporate governance (management), earnings, and asset/liability.

The DPS employs a 5 tier premium structure, with diminishing premium spreads for lower risk levels. The use of diminishing premium spreads provides greater incentives for institutions classified as high risk to modify their risk behaviour.

Under the DPS, an institution's premium will be based on its fiscal year. Member institutions will receive an invoice for their premium within 90 days following their fiscal year end, payable within 30 days. The premium is calculated using the premium rate that corresponds to the institution's risk rating.

A special one-time transition premium is necessary to facilitate the change from the year 2000 deposit insurance premium calculation method, which was based on the calendar year.

The key elements of the DPS are prescribed in section 9 of Ontario Regulation 78/95, and in the **DICO Risk Classification System** document, both of which are included as appendices.

Objectives

The DPS is an insurance pricing structure whereby an institution's premium rate varies with the level of its risk.

The objectives of the differential premium system are as follows:

- to motivate member institutions to adopt lower risk taking behaviour by providing financial incentives;
- to protect the interests of members; and
- to reduce risk to the Deposit Insurance Reserve Fund (DIRF) and reduce the exposure to the Government of Ontario.

Benefits of a DPS

The benefits of a differential premium system are fairness, and lower risk for member institutions and the System, which will result in lower premiums.

DICO has identified the following benefits of a DPS:

Lower Premiums
Differential premiums deter excessive risk-taking by member institutions by providing a financial incentive to modify risk-taking behaviour. Member institutions with lower risk profiles are rewarded through a lower premium.

Fairness
Differential premiums are fairer to member institutions because they require higher-risk institutions and their members to pay their fair share of the costs of oversight, intervention and problem resolution. Because size is not a factor in the risk rating methodology, there is no differentiation between larger or smaller institutions.

Limits Moral Hazard
A flat-rate system, which does not vary with the level of risk at a member institution, induces institutions to increase risk because they do not incur higher deposit insurance premiums when they do so. Until the introduction of the DPS, intervention programs such as supervision and administration were the primary tools available to modify behaviour. The combination of differential premiums and intervention programs increases the effectiveness of DICO's risk reduction efforts, and minimizes the likelihood of claims against the DIRF and exposure to the government.

Provides a Lower-Cost Form of Early Intervention
The DPS is an ongoing form of lower-cost early intervention, where a mature intervention program is already in place. Both the DPS and intervention programs aim to modify behaviour

toward lower risk taking. Over time, a lower level of risk will reduce the potential frequency and severity of insurance losses. It may also impact the required size of the deposit insurance reserve fund, and prevent its deterioration.

Regulatory Framework

The key elements of the DPS are prescribed in sections 9, 10 and 11 of Ontario Regulation 78/95 (see Appendix I), and in the **DICO Risk Classification System** document (see Appendix II).

Risk Rating Methodology

Risk is the likelihood of failure as measured by a member institution's performance and condition.

An effective DPS requires an accurate risk measurement system. Experience and testing have shown that DICO's risk rating methodology is a reasonably accurate system to measure and differentiate risk, and is an effective basis or tool for establishing different classes of premiums based on relative risk.

The rating methodology has been used to measure risk by DICO since 1997 and has proven to be effective for risk assessment purposes. Following input from the System, minor modifications were made to the methodology. The current rating methodology may be subject to small revisions over time based on DICO's experience and emerging risk issues.

The risk rating methodology provides DICO with a single composite risk rating, which ranges from 0 to 100. Higher or "better" scores indicate a lower likelihood of deterioration in a member institution's performance and condition and, therefore, a lower likelihood of failure. Lower or "worse" scores indicate a higher likelihood of failure.

The methodology measures five components of a member institution's performance and condition, which are abbreviated **CAMEL**:

- **C**apital – as measured by the level of regulatory capital
- **A**sset Quality – as measured by loan loss experience
- Corporate Governance (**M**anagement) – as measured by the effectiveness of risk management practices, as determined with reference to the *Ontario Credit Unions and Caisses Populaires Act, 1994* (the Act) and DICO By-law No. 5 ("Standards of Sound Business and Financial Practices")
- **E**arnings – as measured by average return on assets
- Asset/**L**iability – as measured by the level of interest rate risk

Each of these five components is scored on a separate scale, and when combined, produce the DPS risk rating from 0 to 100. The component score provides important information about the sources of risk at an institution. Each component rating provides an assessment tool for member institutions, DICO, and FSCO to evaluate performance in key areas, and identifies strengths and weaknesses behind the conclusions provided by the overall rating. Further details about the calculation of each component can be found in the **Member Institution Risk Rating Methodology** paper, which can be downloaded from DICO's website at www.dico.com.

DPS Rating Reports

Member institutions are provided with their risk rating, and with all of the supporting information employed to determine that rating, on a quarterly basis. This provides each member institution with the opportunity to review conclusions about its current risk level, make decisions about which criteria it could affect to improve its score, and implement appropriate strategies.

As risk ratings are confidential, DICO does not publish individual member institution ratings. Member institutions are prohibited from sharing their rating outside of their board and management. Consequently, they cannot share the risk rating with members, nor can they publish their own scores. This includes, but is not limited to the use of risk ratings in advertisements, annual reports or offering statements. Outside of DICO's risk assessment program and differential premium system, risk ratings may be misunderstood or misused by external parties, and could disadvantage member institutions.

Premium Structure

The DPS employs a 5 tier premium structure, with diminishing premium spreads for lower risk levels. A 5 tier premium structure was selected for its ability to modify behaviour given its ability to sufficiently differentiate between member institutions at different risk levels. This has the benefit of allowing DICO to tailor premium incentives that motivate behaviour for distinct groups of institutions, based on their risk level.

DPS Premium Structure

Premium Class	Risk Rating (DPS points)	Premium Rate (per $1000 of insured deposits)
1	Greater or equal to 85 points	$0.90
2	Greater or equal to 70, but less than 85 points	$1.00
3	Greater or equal to 55, but less than 70 points	$1.15
4	Greater or equal to 40, but less than 55 points	$1.40
5	Less than 40 points	$2.10

With diminishing premium spreads, movements to lower risk categories bring premium relief, but at a decreasing rate. Note in the chart above, how the differences between premium rates for each category changes with the level of risk. Moving from category 4 to 3 gives $0.25 relief, from category 3 to 2 $0.15, and from 2 to 1 only $0.10. The use of diminishing premium spreads provides greater incentive to high-risk institutions to modify their risk behaviour.

Premium Year

Under the previous premium system, the premium year for all member institutions coincided with the calendar year. Under the DPS, the premium year for each member institution coincides with each institution's fiscal year. Member institutions will receive an invoice for their premium within 90 days following their fiscal year end. Member institutions are required to pay the premium within 30 days of the invoice date.

Transition Period

For all institutions, there will be a gap between the 2000 premium year (which ends December 31, 2000) and the new premium year, which begins on the first day of each institution's subsequent fiscal year in 2001. Premiums for this transition period, which vary in length depending on the date of the institution's fiscal year end, have been assessed through a one-time transition premium.

Sources of Data

The DPS risk rating is formulated based on information obtained from the following reports received from member institutions:

- Annual Member Institution Return (AMIR) (including the Certificate of Insured Deposits);
- On-Site Verification Report (OSV);
- Member Institution Self-Assessment Return (MISAR); and
- Member Institution Return (MIR) (transition period only).

The DPS risk rating used to determine the annual premium will be based on audited data, as reported in the AMIR. This will provide member institutions and DICO with greater confidence regarding the accuracy of financial information and the member institution's rating, and as a result, greater confidence in the relative fairness of the premium and the level of insured deposits.

Conclusions formed in the OSV Report and the filing of the MISAR are used to assess a score for the Corporate Governance (Management) component, and verify other information, such as the level of insured deposits.

Member Institution Filings

In order for DICO to calculate the appropriate premium level, the member institution must file the following documents within the specified time periods:

Report	Filing deadline
Annual Member Institution Return, Part I, (including the Certificate of Insured Deposits) together with two copies of the Audited Financial Statements and the auditor's Management Letter	• within 75 days of the member institution's fiscal year end

Report	Filing deadline
Member Institution Self-Assessment Return	• within 6 months of the member institution's fiscal year-end

Failure to file any of these reports could lead to a member institution becoming ineligible for a differential premium rate, and DICO may at its discretion assign the highest premium category.

Review of the Corporate Governance Score

DICO conducts an On-Site Verification process that ensures each credit union is inspected at least every 36 months. Since it is possible that a credit union may correct identified deficiencies prior to its next scheduled OSV, a Corporate Governance Score Review Process has been implemented that allows credit unions to have their Corporate Governance scores reviewed earlier. This review is at the credit union's expense. A review can be requested once evidence is available to confirm that deficiencies identified in the latest On-Site Verification (OSV) Report have been corrected.

Member institutions wishing to have their Corporate Governance score reviewed are required to give written notice to DICO. The notice should specify which deficiencies have been corrected and require a review. The cost of the review or on-site visit is to be paid by the credit union. Payment is required in advance.

Review of the Risk Rating

Member institutions may seek clarification of their DPS risk rating from DICO. The request must be made in writing. DICO will review the rating, and will either confirm or restate it. If the member institution does not agree with the result of the review, they may request a further review of their rating by the Risk Management Committee (RMC), a subcommittee of DICO's Board of Directors. The request for a further review by the RMC must also be made in writing.

The risk rating review carries a nominal administrative fee of $500, to cover associated costs. The fee is fully refundable if the member institution's review is successful. There is a time limit of 45 days from receipt of the rating for the filing of a request for review.

Conclusion

The introduction of a DPS benefits all stakeholders. Deposit insurance premiums are set on a more equitable basis for member institutions, one that rewards lower risk taking behaviour and that will result in lower System risk and further premium relief. Lower institution and System risk affords greater protection to credit union members and their deposits, reduces the risk to the Deposit Insurance Reserve Fund and reduces exposure to the Government of Ontario.

Should you require any further information, or have any additional questions, please feel free to contact the Risk Assessment Department at (416) 325-9444, or toll-free at 1(800) 268-6653 or by e-mail at rad@dico.com.

Appendix I: Sections 9, 10 and 11 of Ontario Regulation 78/95, regarding the Annual Premium

9. (1) For the purposes of subsection 276 (2) of the Act, the prescribed conditions under which the Corporation may establish, assess and collect an annual premium are set out in this section.

(2) The Corporation shall determine the risk rating of each credit union and league in accordance with this section and with the rules set out in *DICO Risk Classification System*, dated November 10, 2000, as amended from time to time, and published by the Corporation in *The Ontario Gazette* on November 25, 2000.

(3) The risk rating of a credit union or league at a particular time is determined with reference to the following components:

1. Capital: the level of regulatory capital of the credit union or league.

2. Asset quality: the loan loss experience of the credit union or league.

3. Management: the effectiveness of the risk management practices of the credit union or league, as determined with reference to the Act and By-law No. 5 of the Corporation ("Standards of Sound Business and Financial Practices").

4. Earnings: the average return on assets of the credit union or league.

5. Asset and liability management: the level of interest rate risk of the credit union or league.

(4) The annual premium payable by a credit union or league is calculated at the rate set out in Column 3 of the Table to this section opposite the category of risk rating set out in Column 2 within which the credit union's or league's risk rating falls.

TABLE

COLUMN 1	COLUMN 2	COLUMN 3
Premium Class	Risk Rating	Premium Rate
1	85 points or more	$0.90 per $1000 of the funds described in subsection (5) for a credit union and in subsection (6) for a league
2	At least 70 points and less than 85 points	$1.00 per $1000 of those funds
3	At least 55 points and less than 70 points	$1.15 per $1000 of those funds
4	At least 40 points and less than 55 points	$1.40 per $1000 of those funds
5	Less than 40 points	$2.10 per $1000 of those funds

(5) The calculation of the annual premium for a credit union is based only on Canadian funds on deposit with the credit union, and no premium is payable with respect to that portion of a deposit that is uninsured by virtue of section 270 of the Act.

(6) The calculation of the annual premium for a league is based only on Canadian funds on deposit with the league for a person that is not a credit union, and no premium is payable with respect to that portion of a deposit that is uninsured by virtue of section 270 of the Act.

(7) The Corporation may estimate the amount of funds on deposit with the credit union or league using the quarterly financial return of the credit union or league and may adjust the premium upon receiving the audited financial statements.

(8) The annual premium payable by a credit union or league that carries on business for less than one year shall be reduced by an amount proportionate to the period during which it did not carry on business.

(8.1) Despite subsections (4) and (8), the minimum annual premium payable by a credit union or league is $250.

(9) The Corporation may use approximate figures in determining or calculating an amount under this section.

10. A credit union or league shall pay its annual premium within 30 days after the date of the invoice for the premium.

11. A credit union or league shall file an audited statement of its deposits with the Corporation at such time as the Corporation directs and respecting such period as the Corporation directs.

Appendix II: DICO Risk Classification System Document
Published, *Ontario Gazette*, November 25, 2000

November 10, 2000

1. Overview

This publication, which has been authorized by the Deposit Insurance Corporation of Ontario ("DICO"), details the rules for establishing a member institution's[1] premium class under section 276 (4) of the *Credit Unions and Caisses Populaires Act, 1994* (the "Act") and Regulations.

2. Premium Classes

For purposes of calculating the annual premium, each member institution is placed in one of the following premium classes, based on its risk rating.

Premium Class	Risk Rating
1	Greater or equal to 85 points
2	Greater or equal to 70, but less than 85 points
3	Greater or equal to 55, but less than 70 points
4	Greater or equal to 40, but less than 55 points
5	Less than 40 points

3. Differential Premium System ("DPS") Risk Rating

The DPS risk rating is based on five performance and condition measures outlined in section 4, and calculated for each member institution in accordance with the following table. The risk rating is calculated as at the member institution's fiscal year-end based on information from the sources of data outlined in section 5.

(Note: Points are determined by matching a member institution's results in each performance and condition measure against the range in column 2, and the corresponding points in column 3.)

[1] Throughout this document, "member institution" is defined to mean a credit union, caisse populaire, or a league.

Condition and Performance Measures	Criteria	Points
CAPITAL ADEQUACY	Equal to or greater than 7.5% From 6.25% to 7.49% From 5% to 6.24% From 3.75% to 4.99% Less than 3.75%	35 26.3 17.5 8.8 0
ASSET QUALITY	Less than 0.10% From 0.10% to 0.24% From 0.25% to 0.49% From 0.50% to 0.74% Equal to or greater than 0.75%	10 7.5 5 2.5 0
MANAGEMENT (CORPORATE GOVERNANCE)	No weaknesses 1 weakness 2 weaknesses; or 1 critical weakness 3 weaknesses; or 1 critical weakness + 1 weakness 4 or more weaknesses; or 1 critical weakness + 2 weaknesses; or 2 critical weaknesses; or non-filing of the MISAR	20 15 10 5 0
EARNINGS	Equal to or greater than 0.66% From 0.33% to 0.65% From 0% to 0.32% From -0.10% to -0.01% Less than -0.10%	25 18.8 12.5 6.3 0
ASSET / LIABILITY	Less than or equal to 5 bp[2] From 6 bp to 10 bp From 11 bp to 15 bp From 16 bp to 25 bp Greater than 25 bp or failure to Report or measure properly	10 7.5 5 2.5 0
	Total points	Maximum 100

4. Performance and Condition Measures

Calculations for the five performance and condition measures are detailed below.

All quantitative measures, except for the Asset/Liability measure, are expressed as percentages, and rounded to two decimal places. The Asset/Liability measure is rounded to the nearest basis point.

Capital

Capital is measured using the following formula:

$$A \div B$$

[2] "bp" stands for basis point. One basis point is equal to one one hundredth of one percent.

Where A = regulatory capital as set out in section 14 of Ontario Regulation 76/95.
Where B = total assets as set out in section 13 of Ontario Regulation 76/95.

Asset Quality

Asset quality is measured using the member institution's average loan loss ratio (loan costs divided by average assets) for the past three years, weighted for recency, and is expressed by the following formula:

$$[3 \text{ x } (\text{loan costs}_{y1} \div \text{average assets}_{y1}) + 2 \text{ x } (\text{loan costs}_{y2} \div \text{average assets}_{y2}) + (\text{loan costs}_{y3} \div \text{average assets}_{y3})] \div 6$$

where:

y1 = "Year 1", the 12 month period preceding the most recent fiscal year-end
y2 = "Year 2", the 12 month period preceding Year 1
y3 = "Year 3", the 12 month period preceding Year 2

and "average assets" for each year are calculated as follows:

$$(\text{assets at beginning of year} + \text{assets at end of year}) \div 2$$

Management (Corporate Governance)

Management (Corporate Governance) points are assigned through DICO's On-Site Verification ("OSV") process. Management points are based on the OSV's assessment of the effectiveness of the following risk management practices:

- Corporate Governance
- Capital Management
- Credit Management
- Investment Management
- Asset/Liability Management
- Liquidity Management
- Internal Controls

Effectiveness is measured by assessing compliance with DICO's Standards of Sound Business and Financial Practices (which are specified in the Corporation's By-law No. 5), relevant sections of the Act, the Regulations promulgated under the Act, and the member institution's own by-laws.

A "critical weakness" is defined as either ineffective credit or investment management practices. A "weakness" is defined as any other ineffective risk management practice.

Late or non-filing of the Member Institution Self-Assessment Return ("MISAR") results in 0 points for Management. The MISAR must be filed within 6 months of the member institution's fiscal year end.

Earnings

Earnings are measured using an average of the past three years return on assets ("ROA") (net income divided by average assets), weighted for recency. ROA is calculated after all charges, including dividends, taxes, and extraordinary items, and is expressed by the following formula:

$$[3 \times (\text{net income}_{y1} \div \text{average assets}_{y1}) + 2 \times (\text{net income}_{y2} \div \text{average assets}_{y2}) + (\text{net income}_{y3} \div \text{average assets}_{y3})] \div 6$$

where:

y1 = "Year 1", the 12 month period preceding the most recent fiscal year-end
y2 = "Year 2", the 12 month period preceding Year 1
y3 = "Year 3", the 12 month period preceding Year 2

and "average assets" for each year are calculated as follows:

$$(\text{assets at beginning of year} + \text{assets at end of year}) \div 2$$

Asset/Liability

The Asset/Liability component is based on the member institution's interest rate risk measurement, as reported in the Annual Member Institution Return ("AMIR") and verified by the member institution's external auditor.

Member institutions are expected to employ interest rate risk measurement techniques that are appropriate for their size and complexity, and that meet the requirements of section 78 of Ontario Regulation 76/95.

If it is concluded during the course of an OSV that the member institution does not have effective Asset/Liability Management practices, it will result in 0 points for the Asset/Liability measure.

5. Sources of Data

The DPS risk rating is calculated based on information documented in the following:

- AMIR;
- OSV Report; and
- MISAR.

Where a member institution does not file its AMIR within the prescribed time, the member institution will be assigned to Premium Class 5. The Corporation may adjust the Premium Class upon receipt of the AMIR.

6. Transition Period

A one-time transition premium will be calculated for each member institution for the period beginning January 1, 2001 to each institution's fiscal year-end in 2001.

The DPS risk rating for the transition period will be calculated based on information documented in the following:

- Member Institution Return (“MIR”) or AMIR;
- OSV Report, and
- MISAR.