Capital Management

Executive Summary

Capital represents the difference in value between a credit union's assets (such as its loans and fixed assets), and its liabilities (such as deposits by its members and debts owed to its creditors). Capital fills this gap, providing a buffer against losses, and provides room for growth.

The board of directors is responsible for determining the level of adequate capital for their credit union. The amount of capital needed by a credit union will vary with the degree of risk inherent in its assets and upon its environment; the riskier the underlying assets of a credit union, or the less stable an economic environment, then the greater need for capital. At a minimum, capital should meet the regulatory minimum set out in the Act and in Regulation 76/95.

In order to maintain or increase capital to adequate levels, a credit union can either build retained earnings, raise capital investment, or reduce the asset base. Capital investment can be raised by increasing the Membership share investment, restricting the redemption of existing shares, or issuing non-membership share capital.

Failure to maintain adequate capital can lead to intervention by FSCO or by DICO, or by both, and loss over control of the credit union by the board.

A credit union can meet standards of sound business and financial practices by ensuring it has developed and implemented capital policies, risk and performance measurement techniques, and risk management procedures comparable to those contained in this chapter. Policies, techniques and procedures should be appropriate for the size and complexity of the credit union's operation.

Legislative Summary

Capital related regulatory requirements are prescribed in Part VI of the Act, Part V of Regulation 76/95 and the FSCO's Capital Adequacy Guideline.

These regulatory requirements prescribe the minimum levels of capital required to be held, and the types of capital that can be held, by a credit union. They also describe the consequences of failing to meet the minimum regulatory capital requirements.

Provided below is a summary of the important regulatory restrictions pertaining to capital management. As only a summary is provided, readers should refer to the Act, Regulation 76/95 and FSCO Guidelines and Interpretative Bulletins for a complete description of a credit unions regulatory rights and obligations.

Schedule 4.1
RELEVANT CAPITAL RELATED LEGISLATION

	The Act	Regulation 76/95
Capital adequacy	84	12-15 *
Directors orders - additional capital requirements	85 - 88	
Report to director on capital	89	
Capital structure	Part V	5-11

*Also refer to FSCO's *Capital Adequacy Guideline*.

Prescribed Types and Quality of Capital

Section 14 of Regulation 76/95, along with FSCO's Capital Adequacy Guideline, lists the different forms of capital and equity that qualify as regulatory capital for purposes of the Act. The Capital Adequacy Guideline categorizes these forms of capital into two distinct quality groupings, identified as Tier I capital ("core capital") and Tier II capital ("supplementary capital"). Examples of Tier I and Tier II are illustrated in Schedule 4.2.

Schedule 4.2
PRESCRIBED FORMS OF REGULATORY CAPITAL

Form of Capital	Quality
• membership shares	Tier I
• retained earnings	Tier I
• contributed surplus	Tier I
• non-membership shares (non-redeemable portion)	Tier I
• non-membership shares (redeemable portion)	Tier II
• subordinated debt	Tier II
• investments by a stabilization authority	Tier I & II

Refer to section 14 of the Act and the *Capital Adequacy Guideline* for a complete description of regulatory capital.

Tier I capital comprises a higher quality of capital than Tier II capital because it has greater permanence and has a higher level of freedom from mandatory fixed charges (i.e. tier 1 capital is not subject to withdrawal by the member, and interest payments on them is at the discretion of the board).

Prescribed Levels of Regulatory Capital

Regulation 76/95 prescribes two different tests for capital adequacy; leverage ratio, and risk weighted assets ratio. Both ratios measure capital adequacy differently, and both must be met for a credit union to be in compliance. The two ratios for capital adequacy are prescribed in section 12 of Regulation 76/95, and are defined in sections 13 to 15.

Failure to Meet a Standard

Any credit union that is below the minimum capital to assets target, and therefore is not adequately capitalized, will require a variance order from the Superintendent in order to continue operations. A variation order will usually be subject to restrictive terms, such as prohibiting the payment of cash dividends to members, or requiring the credit union to raise additional capital.

DICO Depositor Protection Program

DICO also prescribes capital adequacy requirements with respect to its depositor protection programs. These requirements are described in DICO system releases. When a credit union fails to meet these requirements, DICO, in its role as a stabilization authority, may request FSCO to order a credit union into DICO's Supervision Program. (DICO is granted this authority under section 285 of the Act). Under Supervision, DICO works closely with the board of a credit union to correct specific operational problems which necessitate intervention.

If capital reaches low levels, such that it represents extreme risk to depositors, DICO also has the authority under section 294 of the Act to place a credit union under its Administration Program. Under Administration, DICO is required to undertake the direct management of a credit union with the objective of protecting depositors and minimizing the risk of any future loss to DICO's deposit insurance reserve fund.

Special Orders

In addition to compliance with Part V of Regulation 76/95 and FSCO's Capital Adequacy Guideline, a credit union may also be required to comply with a Superintendents orders (such as increasing capital or providing additional liquidity) in unusual circumstances. (Refer to section 85 of the Act). These circumstances may include a situation where the credit union has not been complying with sections of the Act or Regulations. It may also include a situation where the Superintendent feels such measures are necessary to protect the interests of the credit union's members.

Policy

It is recommended that the credit union adopt a policy that addresses:

- authorized types of capital;
- minimum capital levels;
- distribution of dividends and redemption of capital instruments to members
- compliance with regulatory requirements;
- frequency, form and content of board reports.

These recommended objectives of capital policy are discussed in greater depth in Sections 4201 to 4204. Adopting a capital policy will assist the credit union to manage risk and to comply with the Standards in DICO By-law No. 5.

These are minimum policy elements required by sound business and financial practices; the credit union may elect to establish other policy elements as appropriate.

Reference Materials

Examples of capital policy are available in the DICO publication Sample Policies, and are available to the industry for customization as appropriate. As well, the information provided in Sections 4201 to 4204 will also assist in establishing policies of capital management.

Regulatory Compliance

Capital policy must not conflict with regulatory requirements - specifically, the capital requirements prescribed in Part VI of the Act, Part V of Regulation 76/95, and FSCO's Capital Adequacy Guideline.

Capital Management Philosophy

Adopting a capital management philosophy is an important first step in drafting capital policy. The philosophy should set out the broad goals and objectives of the credit union's capital base, as established by the board of directors. This philosophy governs all capital policy constraints and helps address new situations where policy does not yet exist.

While goals and objectives will differ depending upon the circumstances and environment of the credit union, the principles of capital management should always address the importance of:

- maintaining a prudent cushion of equity to protect the credit union's economic viability and finance new growth opportunities;
- maintaining sufficient capital to meet regulatory requirements.

Forms of Capital

In the case of more complex operations, capital policy establishes the types of regulatory capital the credit union may issue. A variety of capital forms are permissible, each with unique advantages and disadvantages. The different forms of capital used by credit unions are listed in Schedule 4.2 (located in Section 4100). A description of the more common of these forms are provided in depth below.

Membership Shares

The minimum share capital investment required for membership, or "membership shares", are equity interests in a credit union held as a condition of membership. Membership shares provide the share holder with the right to receive dividends on those shares when declared by the board and the right to receive the remaining property of the credit union upon dissolution.

Members are required to hold a specified number of membership shares (as detailed in the by-laws of the credit union), and are given voting rights under section 35 of the Act. Credit union members have equal rights to vote (one member, one vote) and participate in decisions affecting the credit union, without regard to the amount of savings or deposits or the volume of business they conduct.

The cost of a membership share can have implications on the attractiveness of membership in the credit union. A high membership share price may be a barrier for new members, while a low membership share price may help to attract new members. When setting the price for membership shares, management should consider share prices for credit unions in the same peer group.

Member to any other individual or organization. However, membership shares are redeemable upon certain circumstances such as death, voluntary membership withdrawal or member expulsion. Redemptions can be indefinitely deferred, however, by the credit union in accordance with the Act whenever such requests jeopardize the viability of the organization. Given the general tendency for total membership to either increase or maintain itself, however, membership shares provide a perpetual form of financing. Membership shares are eligible to receive non-cumulative, variable rate dividends, related to earnings, which is treated as an interest expense.

Non-membership Shares

Under section 53 of the Act, credit unions may issues other shares than those required for membership, and which may be purchased by members on a voluntary basis. These "non-membership shares" are distinguished from membership shares in that a member does not hold them as a condition of membership, but for other purposes, such as a higher investment return. (Non-membership shares usually provide higher dividend income than membership shares.) .. Normally, these shares do not carry a maturity date, but have redemption features frequently anytime after five years. In some cases, redemption can even occur earlier than five years. As a result, they would be considered Tier II Capital due to their characteristics of less permanence. Sections 53 and 57 of the Act set out the possible rights and conditions these non-membership shares may have. These rights and conditions are briefly summarized in Schedule 4.3.

Non-membership shares are only transferable to other members of the credit union or to persons prescribed under the Act, which include DICO, a league or stabilization authority. It is not intended that non-membership shares be traded with speculative investors who do not already have a legitimate interest in the credit union system. Procedures for issuing non-membership shares are discussed in Section 4502 of this Reference Manual.

Schedule 4.3 *CHARACTERISTICS AND FEATURES OF NON-MEMBERSHIP SHARES*	
Classes of shares:	The credit union may issue a number of different classes of non-membership shares, each one having different rights and conditions.
Series of shares:	The credit union may offer multiple series of non-membership shares within each class, each series having different rights and conditions (usually different issuing prices).
Proxy rights:	Proxy rights allow a shareholder to give another person the authority or power to exercise his or her voting rights.
Preemptive rights:	Preemptive rights gives the holders of a class of non-membership shares the right to purchase on a pro rata basis new issues of the same class of non-membership shares.
Rights:	A right or option attaches to a particular class of shares, and allows the shareholder the option to purchase more shares of that class at some future date.

Surplus

Retained Earning

Retained earnings represent the income earned by a credit union that has not been paid out to members in the form of dividends. Retained earnings are calculated as the accumulated net balance of income less losses arising from the operation of the business, after taking into account dividends and any refundable taxes.

Reserves

Reserves is an amount that has been appropriated from retained earnings or other surplus. The reserve may be established at the discretion of management for some future purpose, such as a reserve for a future branch expansion. A reserve may also be appropriated as a requirement of a statute or trust indenture (such as a sinking fund reserve set aside to pay off a debt).

Contributed Surplus

Contributed surplus usually represents an amount of capital invested by a member, but for which the member did not receive any shares in return, and usually arises in the context of gifts by a member to a credit union.

Other Forms of Capital

Subordinated Debt

Debt that is legally subordinated to the rights of depositors and other creditors of the credit union also represents a form of capital. Common forms of this include loans from a league or stabilization authority.

Minority Interests

The minority investment by a credit union in one of its subsidiaries is, under certain conditions, considered a form of capital, as it recognizes the equity interest the credit union has in that subsidiary.

Adequate Levels of Capital

Credit unions that are adequately capitalized maintain a measure of financial stability and are able to withstand an economic downturn, unfavourable rate mismatching, or unusually high loan costs. Adequate capital can also provide a competitive advantage, as a well capitalized credit union is better positioned to offer competitive loan and deposit rates, superior dividends, and to introduce valuable services or pursue growth opportunities. Most importantly, adequate capital protects members' deposits. Capital policy establishes the minimum levels of capital the credit union will maintain. Although minimum surplus and capital requirements are prescribed through the Act and Part V of Regulation 76/95 (i.e. capital ratios of five per cent of total assets and eight per cent of risk weighted assets), capital policy should encourage the pursuit of adequate levels of equity, which may be higher than the regulatory minimum, or even the credit union's current capital level.

It is the job of the board to determine the adequate level of capital to be maintained by the credit union, beyond the minimum required by regulation (prescribed in section 12 of Regulation 76/95). For every additional dollar of capital, the credit union is able to hold an additional 20 dollars of earning assets, thereby increasing the contribution to revenue. .The amount of equity needed by a credit union will generally vary with the degree of risk inherent in the credit union's operations, its assets, liability and its environment. Schedule 4.4 provides a list of some of the risks that should be considered in determining the appropriate level of capital for the credit union. The greater the risk, the greater the amount of capital that should be maintained. Finally, additional levels of capital need to be accumulated and maintained by credit unions to finance future growth opportunities and/or business mergers.

Capital policy may prescribe specified tiers of capital within the overall ratio of capital to assets that will be maintained. For example, given that retained earnings is an inexpensive form of capital funding, capital policy may stipulate that retained earnings comprise a large percentage of total capital (e.g. 70 per cent). Alternately, policy may specify that Tier I capital (which has more permanence than Tier II capital by definition) be maintained at 70 per cent of total capital. At a minimum, the amount of Tier I capital cannot fall below the amount of Tier II capital, in accordance with FSCO's Capital Adequacy Guideline. Boards should establish a balance Tier I and Tier II capital that is appropriate for the credit union.

Schedule 4.4
RISK ASSESSMENT: CAPITAL

- The credit portfolio is generally exposed to higher levels of risk (e.g. character lending, unsecured lending).
- The credit portfolio is exposed to a high level of concentration risk (i.e. concentration in either a particular locality, industry or product).
- The credit union's loan limit represents a significant proportion of capital.
- A significant proportion of the investment portfolio is in instruments whose principal is not guaranteed.
- The credit union is exposed to significant interest rate risk.
- The quality of internal controls or level of management expertise are not yet at a level satisfactory to the board.
- The risk inherent in the credit union's bond of association.

Earnings Distributions - Dividends

Section 65 of the Act permits the board of directors of credit unions to declare, and the credit union to pay, dividends (both on membership shares and non-membership shares), subject to their own by-laws. Dividends may be paid in the form of money or property, or in the form of fully paid shares (also known as stock dividends).

Patronage Returns

Under section 66, the board may also declare patronage returns, subject to the credit union's by-laws. A patronage return is similar to a dividend, except that it is paid based on the amount of business done by each member with or through the credit union, and not on the amount of shares held. A patronage return rewards a member for using the services of the credit union. Patronage returns may be paid in the same form of dividends, as described above, but may also include a rebate of interest paid by members in respect of loans during the fiscal year.

Prohibition and Director's Liability

Section 67 of the Act prohibits the payment of any dividend or patronage return where there are reasonable grounds for believing that the credit union is, or the payment would cause it to be, in contravention of the capital adequacy and liquidity adequacy requirements (which are prescribed under Part V of Regulation 76/95). Directors are required by the Act not to declare prohibited dividends and will be held jointly and severally liable to the credit union for any illegal dividend paid (see section 153(2) of the Act).

Additionally, credit unions which do not meet the minimum legislated capital levels may become subject to intervention through one of DICO's Depositor Protection Programs (i.e., Supervision or Administration).

Planning

Annually, the management and board of directors of the credit union must develop an annual business plan, summarizing its goals and objectives for the coming year.

This annual business plan includes a strategic financial plan that addresses each area of risk management, including capital. As part of the strategic financial plan, management and the board must set financial targets and plans for capital management. The elements of a capital plan are set out in Chapter 1 on Planning, and should be referred to for planning purposes.

Risk Measurement and Board Reporting

It is recommended that the credit union measure the performance and risk level of the capital portfolio, and report these findings to the board.

Risk Measurement

The following are minimum risk and performance measures of capital, required by sound business and financial practices:

- periodic measurement of net income and total capital;
- periodic projection of year end capital levels;
- tracking of forthcoming capital maturities, where appropriate;
- comparison of capital levels to regulatory requirements, to ensure compliance;
- any other measurements of capital required by the Act or Regulations.

The credit union must also meet any capital measurement requirements set out in the Act and Regulations. The credit union may track other measures of capital as they see fit.

These measurements should be compared to financial targets in the annual business plan and the budget, so that management can determine whether the credit union is meeting its goals. Management can also assess whether there are material variances from the plan which need to be addressed.

Comparison of these measurements against historical performance, where possible, can also identify significant trends which may need to be addressed by management.

Risk Management Techniques

Subsection 4403 provides techniques for measuring the adequacy of the credit union's capital position.

Board Reports

The above measurements should be reported to the board of directors, so that they can monitor capital management and ensure adherence to regulatory requirements and to the annual business plan. Material negative variances from plan, and their causes, as well as management's plan to correct the variance should also be included in the report.

Frequency

Management should provide the board with a report on capital for each board meeting.

Form

Schedule 4.5 illustrates a Sample Board Report on Capital, which can be used by management to track capital adequacy, ensure regulatory compliance and report findings to the board. The report compiles and compares all the volumes, targets and policy limits required to properly manage the credit union's capital position. This report can be adopted or amended for use by the credit union.

Information contained in the report can be expressed on a periodic basis (monthly, quarterly), or on a year-to-date, or both, depending upon the preferences of the board and the frequency of reporting.

The frequency, form and content for board reporting should be set out in capital policy.

Schedule 4.5 *SAMPLE BOARD REPORT ON CAPITAL*					
Part I: Capital Adequacy					
	Actual	**Per Plan**	**Minimum Per Policy**	**Statutory Requirement**	**Variance from Plan**
Net income (year to date) expressed in dollars ($):	$	$			%
Total capital expressed in dollars ($):	$	$	$		%
Leverage ratio (as a % of total assets) (see section 12 of Regs.)	%	%	%	%	%
Risk weighted ratio (as a % of risk weighted assets (see section 12 of Regs.)	%	%	%	%	%
Total tier I capital (as a % of total assets): (see FSCO *Capital Adequacy Guidelines*)	%	%	%	%	%
total tier II capital (as a % of total assets): (see FSCO *Capital Adequacy Guidelines*)	%	%	%	%	%
Variances should be calculated as a percentage of the corresponding figure stated in the business plan.					

Part II: Tracking Capital Maturities

Provide details of any capital maturing within the next 12 months:

Form of Capital	**$ Amount**	**% of Assets**	**Maturity Date**

Part III: Corrective Action/Strategies for variances and maturing capital

Variance	**Corrective Action/Strategy**

Risk Measurement Techniques

Measuring Capital Levels and Capital Costs

For purposes of board reporting, capital levels should be segregated by their regulatory classification in accordance with FSCO's Capital Adequacy Guideline, e.g. Tier I capital, Tier II capital, non-qualifying Tier II capital (where applicable). Refer to Schedule 4.6 for a sample presentation of capital levels and associated costs. The capital measurement and reporting should segregate amounts relating to retained earnings, and unencumbered reserves. It should also confirm that capital ratios meet regulatory minimum requirements. The two ratios, leverage and risk weighted assets, are calculated as part of the illustration in Schedule 4.6.

Credit unions may raise more share capital than qualifies as regulatory capital. This may occur when some portion of non-membership shares or other instruments increase Tier II capital to a level that exceeds 100 per cent of Tier I capital. Under FSCO's Capital Adequacy Guideline, Tier II capital cannot exceed 100 per cent of Tier I capital. Therefore, such excess capital would not count for regulatory purposes. If a credit union is raising capital only to meet the regulatory minimum requirements, it would likely not be interested in acquiring capital that does not qualify as capital for regulatory purposes. However, many fully capitalized institutions which require financing to grow may need to issue non-regulatory capital and should measure its volume and cost.

Measuring Costs of Capital

The accrued or historical cost of each form of capital is useful information that can be calculated and disclosed. With respect to membership shares, for example, if dividends are not paid until year end, the planned rate of member share dividend should be accrued relative to year-to-date earnings and disclosed as the cost of this capital.

Schedule 4.6
SAMPLE BOARD REPORTING ON CAPITAL LEVELS AND CAPITAL COSTS

	In $000s	Average Cost
Tier I Capital:		
Membership Shares	200	4%
($50 per 4,000 members)		
Retained Earnings	1,340	0%
Total Tier I	1,560	
Tier II Capital:		
Fixed rate 5 year debenture	300[1]	5%
• face value of debenture is $500,000		
• 3 years until maturity - include 60%1		
Total Regulatory Capital	1,860	
Non-qualifying Capital Instruments	0	
(excess Tier II capital)[4]		
Total Capital	**1,860**	

Leverage Ratio = total capital divided by total assets
= 1,860 / 31,631[2] = 5.9%

Leverage Ratio of 5.9% exceeds 5% regulatory requirement

Risk Weighted Ratio = total capital divided by risk weighted assets
= 1,860 / 19,969[3] = 9.3%

Risk Weighted Ratio of 9.3% exceeds 8% regulatory requirement

1 Tier II capital amortized in accordance with FSCO's *Capital Adequacy Guideline.*

2 Total assets are $31,631,000.

3 Total risk weighted assets are $19,969. See calculation (in accordance with FSCO's *Capital Adequacy Guideline*) illustrated in Schedule 4.7.

4 Excess Tier II capital cannot be included as capital for regulatory purposes, but should be included as capital for accounting purposes. Excess Tier II capital is defined as:

max. (0, total Tier II capital - total Tier I capital)

Schedule 4.7 *SAMPLE SUMMARY CALCULATION OF RISK WEIGHTED ASSETS*				
Total Assets are $31,631,000		**$000's**	**Regulatory Risk Weight**	**Risk Adjusted Assets**
Cash	$ 663 x		0=	0
Liquid Assets (league deposits)	4,198 x		0=	0
Other Instruments (government securities)	1,273 x		0=	0
Fixed Assets	497 x		1=	497
*Loans:				
Personal Loans	14,909 x		0.8 =	11,927
Residential Mortgages	5,091 x		0.5 =	2,546
Commercial Mortgages	2,500 x		1 =	2,500
Other Commercial Loans	2,500 x		1 =	2,500
Total Risk Adjusted Assets				**$19,969**
*Assume for illustration, none of the above loans have government guarantees/ security which would reduce risk weightings. Readers should refer to section 15 of Regulation 76/95 for further details.				

Profitability Analysis and Projected Year End Capital

Key measures of capital management include profitability and annual growth in retained earnings after dividend pay-outs on all classes of shares. The capital measures when analyzed against plan and historical performance will identify areas requiring remedial follow up. Calculation of a projected year end capital position is useful whenever interim profit targets are below plan and there is a possibility that minimum regulatory requirements cannot be met by year end.

Schedule 4.8 illustrates a list of the key financial variables affecting profitability. These measures should be routinely calculated and the explanations of performance trends should be documented for periodic review by management and the board.

Schedule 4.8 *FINANCIAL VARIABLES AFFECTING PROFITABILITY*	
Financial Margin	**Other Income**
• Loan Interest Income • Investment Income • Interest Expense on Deposits • Interest Expense on Borrowings • Loan Costs: Provisions For Impaired Loans	• Fees and Commissions
Operating Expenses	**Other Factors**
• Salaries and benefits • Occupancy • Computer, office & other equipment • Advertising & communications • Member security • Administration	• Non-recurring gains/losses • Extraordinary gains/losses • Income Taxes/Recovery • Capital Taxes/Recovery • Dividends

Accrued Dividends

Net profit earnings reported should include all dividends payable on credit union shares; these are considered to be a form of current period interest expense that should be included in the calculation of financial margin and net profit when declared.

Monitoring Capital Maturities

In cases where a credit union has issued non membership shares or debentures to finance its operations, it should diarize the maturity of these instruments and analyze whether, at the date of these maturities, new capital instruments are required.

Risk Management

An important activity in the effective management of risk is management's timely response to unauthorized risk or poor performance developments. As a follow up to the capital risk measurements taken by the credit union (and discussed in the previous section), management should investigate all significant performance variances relative to the annual business plan and to historical performance. Corrective action should by taken by management to respond to unacceptable variances. Management must similarly respond to any contravention of board policy or regulatory requirements, or other unauthorized risk.

Given that the principal policy objective relating to capital management is maintaining appropriate levels of capital, Sections 4501 to 4502 discuss procedures for correcting and improving capital levels, which include:

- methods for raising new sources of capital or preserving existing capital;
- procedures for issuing non-membership capital.

Raising New Sources of Capital

In order to raise new capital (or preserve existing capital levels), a number of alternative methods or procedures may be selected. These are summarized in Schedule 4.9, and discussed in depth below.

Schedule 4.8 *IMPROVING THE CAPITAL POSITION*	
Mechanism	**Strategies**
Build Retained Earnings	• Improve profitability. • Limit cash dividends
Increase Share Capital	• Raise minimum share investment. • Issue a second tier of non voting shares (e.g. voluntary share capital)
Downsize Assets	• Sell assets. • Lower deposit interest rates

Build Retained Earnings

Retained Earnings (or surplus) is an inexpensive form of capital for the credit union, as it does not require the payment of dividends, or carry the contingency of having to redeem membership shares on demand.

Retained earnings can be built-up in two ways. The first approach is through improved profitability. Credit unions can review their profitability by examining the elements that contribute to profit, including financial, operational, and human resource performance factors.

Another method for building retained earnings is to reduce cash dividends to members. While reducing cash dividends may not be popular with members, it may be necessary to prevent capital reserves from dropping below regulatory or policy minimums. In fact, it is a contravention of the Act for a credit union to declare or pay out dividends that would put capital or liquidity adequacy ratios below regulatory minimums (see section 67 of the Act).

Alternatively, a credit union may choose to temporarily reduce cash dividends to allow capital to grow to a level sufficient to finance a new project, such as an investment in new technology.

In either case, the key to successfully reducing cash dividends is by achieving consensus (or at least understanding) from the membership. This can be achieved through effective communication with the membership, and by educating or informing them of the importance of increasing (or preserving) capital levels.

Raise Minimum Share Investment

Another method of increasing capital is to increase the amount of share capital invested in the credit union by its members. This is done by increasing the dollar amount of the minimum share investment required by members. This would be especially effective in credit unions where the current minimum share investment has remained at nominal values for some time (e.g. $10 or $20). The minimum investment in membership shares could be increased so that share financing will represent a significant amount of capital (e.g. $50 per member).

The board should be careful not to set the minimum required investment level too high, and unintentionally discourage new membership, or lose existing membership. The board should consider conducting a member survey to determine the amount of an increase members are willing to bear. As with dividend reductions, the key to success is effective communication with the membership, to promote understanding and consensus.

A by-law amendment is needed for an increase in minimum share investment. (Although the board can approve them, by-laws are not effective until confirmed by two-thirds of the credit union membership at a general meeting. For more information on passing by-laws, see section 105 of the Act).

Issue Non-membership Shares

Section 53 of the Act allows a credit union to provide for additional classes of shares beyond the traditional membership shares. These shares are generically referred to in the Act as non-membership shares (also referred to as participation shares of voluntary capital). Non membership shares are distinguished from membership shares in that a member does not hold them as a condition of membership, but for other purposes; mainly, to support the credit union, and to receive a competitive return on investment.

Depending upon the level of management experience, member wealth and loyalty, and other factors (discussed later), non-membership share issues can raise significant amounts of capital for the credit union. Several successful large issues were undertaken by Ontario credit unions in 1997. Non-membership share issues are discussed in more depth in Section 4502 of this Reference Manual.

Downsize Assets

By reducing its asset base, a credit union can increase its ratio of regulatory capital to assets (and to weighted assets) and improve its capital position. A credit union may adopt such a strategy when it is concerned it may soon fall below regulatory capital adequacy requirements.

Possible strategies for reducing the asset base include:

- reduce interest rates on deposits to discourage new business;
- sell off part of the loan portfolio, while continuing to administer it, and reduce deposits by a corresponding amount;
- contact large depositors directly and request they place their deposits elsewhere.

It is important to be aware, however, of the negative impact these strategies may have on the credit union's reputation among existing members and potential customers.

Issuing Non-Membership Capital

Before a credit union begins to undertake a non-membership share offering (also known as a voluntary share offering or participating share offering), it is essential to establish a business case for the offering. There must be a clear need for increased capitalization to meet regulatory requirements, to expand or open a new branch, or to invest in improvements in the credit union's technology. Other less expensive methods of raising capital should have been exhausted (such as those discussed in the Section 4501). Furthermore, it must be feasible for the credit union to undertake the offering. The credit union must have the resources, the membership must have sufficient wealth to purchase the offering, and management should have the required expertise to carry out the offering (although some assistance can be obtained from external counsel, financial advisors, the league and FSCO).

It is best that a share offering be controlled internally, by one officer or by a steering committee. It is important that these projects have an internal champion, someone to foster and promote internal support. This person can also ensure that the offering statement process never loses sight of the financial needs of the credit union. Where projects are undertaken mainly by external advisors, there is the possibility that the objectives of the project are lost sight of, and not carried through.

Ontario Securities Act

Generally, under Ontario law, when any person (individual or corporation) offers securities for sale, they must comply with the Ontario Securities Act.

Section 75(1)(a) is a special exemption from the requirements of the Ontario Securities Act established specifically for credit unions. A credit union is exempted from the additional requirements of the Securities Act, as long as it meets certain conditions under that Act. In order to qualify for this exemption when issuing non-membership shares, the credit union must prepare an offering statement, and must obtain a receipt from FSCO for that offering statement.[1]

Offering Statements

An offering statement is a comprehensive document which summarizes the details of a credit union's non-membership share issue. The document includes the price of the security, rights and conditions of the class of shares, as well as providing "full, true and plain disclosure" of the credit union's operations. An offering statement must be prepared, issued a receipt by FSCO, and made available to members and prospective purchasers before a credit union may offer non-membership shares to its members.

A credit union's offering statement must comply with the requirements set out in the Act, Regulation 76/95, and FSCO's Guideline on Offering Statements. Although less complex than a prospectus, the preparation of an offering statement will require significant time and effort, as well as the assistance of legal counsel and accounting experts. The offering statement must be in a form approved by FSCO, and must meet a high standard of disclosure and accuracy. Finally, the offering statement must be accompanied by a disclosure certificate signed by the credit union's chief executive officer, chief financial officer and chairperson of the board.

[1] This exemption is not relevant to the issuance of membership shares, dividend shares and patronage shares. These are automatically exempt from the Securities Act, even without the preparation of an offering statement (see section 75(2) of the Ontario Securities Act.)

FSCO has the discretion to refuse to grant a receipt where the offering statement (or any documents accompanying it) fail to comply in any substantial respect with the requirements set out in the Act, Regulations, FSCO's Guideline on Offerings Statements, or if it contains a false, deceptive or misleading statement or promise, or if it conceals or omits any material facts. Other reasons for refusal of a receipt are listed in section 78.

Once the receipt is issued, the securities may be sold by directors, officers and employees of the issuing credit union (or of the issuing league), and/or by a person registered under the Ontario Securities Act as a securities dealer, investment dealer or broker.

Key Success Factors

Membership Support

A key factor for success in non-membership share offerings is member loyalty. Where a credit union has a strong bond of association, members are often eager to support such ventures of the credit union. The stronger the bond and loyalty, the greater the support that can be expected from the membership. This loyalty factor can be maximized by associating a particular need to the offering; for instance, communicating to the membership that an offering will be made to finance a new branch, or an infusion of capital to improve the technological base of the credit union and improve service.

It is equally important to understand which segment of the membership will support the offering. Historic experience with credit union share offerings has indicated that the primary market for any credit union tends to be higher income net savers; those members that hold term deposits or RRSP's. Usually, these members have portfolios large enough so that a $5,000 investment in non-membership shares would not represent a significant portion of their investment portfolio. These investors are also relatively sophisticated, and are aware of other investment options in the financial market.

Membership studies may assist in identifying this segment, and the size of it within the membership. Focus group studies (with small groups of members) can also provide information as to investment needs and preferences, and assist in pricing an offering. A very supportive membership may be willing to assume a somewhat lower rate than comparable investments in order to assist the credit union.

Pricing the Offering

The pricing of the share offering is a critical element in the success of any offering; pricing mainly refers to the return, or dividends, offered by the shares. Return is usually the primary consideration when making an investment. Therefore, it must be carefully selected. When pricing such an investment, it is important to scan the financial environment to see the return offered by investments of similar term and similar risk, such as five year GIC rates, and five and ten year bond rates of companies with equivalent bond ratings (this may require management to estimate what bond rating they might be given from a bond rating service).

The denomination of shares is an important factor, and should reflect the purchasing power of the target investors. A $1,000 minimum purchase is generally an appropriate denomination, as it is competitive with denominations for GIC's and Bankers Acceptance Notes.

Dividends

As well, the structure of the return can be an important factor in meeting investors' expectations. Returns can be fixed, or can be tied to some external benchmark such as the prime rate, or market indices. The former might appeal to an investor who wants a guaranteed rate or return, the latter to an investor who is speculating interest rates will rise. A greater perception of fairness may be created when dividends are tied to an outside index or instrument (as opposed to an internal instrument rate), since the credit union would then be unable to manipulate the dividend rate.

Where the credit union can benefit from Tier II capital, cumulative dividends can be offered, thereby giving the investor greater assurance that they will receive their dividend, if not in the current year, then when the credit union has sufficient funds.

Investors may be attracted by a bonus, such as a one year interest bonus (i.e. a higher rate of interest for the first year) or a share bonus (i.e. a member is issued an extra 100 shares for every 1,000 shares purchased). Bonuses, however, should not be too generous, otherwise they may have the potential of draining retained earnings in favor of raising new capital. This could in turn be prejudicial to existing members who did not participate in the share offering. Generally, bonuses should be limited to one year.

Timing

Timing is another critical factor in a share offering. When a share offering is made in a period of low interest rates, the shares dividend rate will accordingly be low; the overall cost of the funds to the credit union would be significantly less than if the offering was made during a period of high interest rates. Examine the maturity profile of the deposit portfolio for the credit union; a share offering would be more successful if launched during a period where many term deposits are coming due.

Sales Force

The preparation of front-line staff is an important final step to a successful offering. They should be provided with all the details of the share offering (return, term, structure, incentives, etc.), as well as with the profile of the target market (so that they know which customers to promote the product to). Certain details of the offering cannot be provided to members until the offering statement has been approved, and a receipt issued, by FSCO. (Refer to section 8.1 of Regulation 76/95 for details regarding the type of which may be given to members prior to the issuance of a receipt by FSCO).

For further information on non-membership share offerings, credit unions should contact their leagues and their legal counsel.

Redemption

It is important that the redemption and maturity of non-membership or investment shares is appropriately addressed in capital management policy. Considerations should include the impact on capital from projected redemptions and maturities.