

We are pleased to present this year's final edition of the *Policy and Advocacy Report*. As the next edition of the Report will not be issued until mid-January 2009, this version of the Report is lengthier, examining several policy matters of interest to the system.

We wish to thank all the contributors to the Report and look forward to providing you with more coverage next year on what promises to be an interesting period from both a political and policy perspective.

On The Policy Front

Prescriptions for Financial Reform – No. 1

Rob Martin, Director of Research, CUCC

As the extreme financial market turmoil of recent months recedes, financial market policy makers, politicians and academics are considering how to redress the global economy and avoid similar situations in the future. In fact, the crisis appears to have spawned a “bubble” in economic and financial prescriptions emanating from national regulators and international organizations such as the Financial Stability Forum, the International Monetary Fund, the World Bank, and the Bank for International Settlements, the OECD. These debates and associated policy prescriptions will play a major role in influencing the future development of financial markets and the regulation of financial institutions. With that in mind, this article marks the first in a series intended to provide a synopsis of significant contributions to these ongoing debates.

This first article focuses on a recent address by David Dodge, former Governor of the Bank of Canada, to the Richard Ivey School of Business entitled *Rebuilding the*

Global Financial System: A Question of Leadership. Dodge's discussion is a comprehensive review of the factors contributing to the recent financial crisis that spares no one in terms of blame. Dodge also makes a large number of policy prescriptions that range from the global macro-economic level to the micro-level focusing on financial institutions themselves. This synopsis will largely leave aside Dodge's discussion of

the macro-economic aspects of the current crisis except to note that considerable blame is placed on the loose U.S. fiscal and monetary policy that facilitated “excessive leveraging” by financial institutions in America.

In regard to the macro-financial level, Dodge argues that as problems were emerging institutions and regulators paid little attention to the growing leverage in the financial system **as a whole** and supervisors focused prudential regulation on regulated institutions rather than “the system”. This narrow focus was inadequate and is likely the result of the fact that regulatory agencies had “...no (or little) macro-financial analytic capacity and there was a general lack of coordination between financial stability arms of central banks and the activities of other regulators (both prudential and market conduct).”

On the regulatory front, Dodge believes that regulators were relatively lax in terms of ensuring that financial products were understandable to investors and consumers. At the same time prudential supervisors did not pay adequate attention to systems of liquidity management to determine whether they were robust.

Finally, in relation to firm management, Dodge argues that - in part as a result of compensation and incentive structures - financial institutions failed to adequately assess risk over the *entire* credit cycle and were lax in terms of a firm-wide approach to risk management leaving some key risks (i.e. liquidity risk) poorly managed.

Based on his analysis Dodge then discusses actions that need to be undertaken to deal with the current situation. Dodge makes some wide-ranging macro-economic prescriptions that won't be touched on here but in regard to the macro-financial front, Dodge recommends that the orientation of central banks be modified somewhat so that they pay greater attention to rapid asset price inflation and if necessary respond with modest increases in the Bank Rate. This would be a significant departure from the “hands off” approach currently practiced by central bankers. Dodge also argues that central banks need to devote resources to monitoring and assessing financial market

developments - including systemic and institutional liquidity issues.

In regard to financial market regulation Dodge highlights three areas that need to be addressed to reduce pro-cyclical financial movements. First, in the area of regulation of securities Dodge recommends more meaningful disclosure to investors to ensure that they can adequately assess credit risks and reduce tendencies toward pro-cyclical “exuberance” during times of rapid growth. Second, accounting standards need to be looked at to ensure they do not enhance pro-cyclicality in expansions and declines. In particular, Dodge criticizes “mark-to-market” accounting for creating incentives for excessive risk-taking in upswings and excessive contractions in downswings. Third, concerning capital standards, Dodge criticizes the Basel II framework as overly complicated and for being pro-cyclical. He argues that capital standards need to allow for capital level adjustments to counter upswings and downswings. To conclude, Dodge also endorses control of raw leverage ratios such as OSFI's 20 to 1 maximum ratio as a crucial mechanism for maintaining financial stability.

Dodge is one voice in these discussions yet his past role as a senior central banker and government policy maker is reason to lend weight to his views. If the prescriptions of Dodge were to be followed by policy makers the landscape of financial regulation would change significantly as we would likely see:

- A strengthening of the capacity of financial regulators to regulate financial institutions but also a new capacity and willingness to analyze and respond to developments in financial markets as a whole;
- An expanded role for the central bank in terms of managing asset price movements through the interest rate mechanism. This could attenuate booms and busts in real estate markets for example;
- Far greater attention paid to structures of liquidity management to ensure they are able to withstand significant stress; and
- A reconsideration of financial market rules and practices (i.e. accounting, capital standards and disclosure) to ensure they are not excessively “pro-cyclical.”

Mr. Dodge's address can be obtained at:

http://www.ceocouncil.ca/publications/pdf/test_a062f2b071d4b0e5588d6188c16e20b1/Rebuilding_The_Global_Financial_System_A_Question_of_Leadership_November_25_2008.pdf

On The Money Laundering Front

FINTRAC Releases 2008 Annual Report

Rob Martin, Director of Research, CUCC

The 2007-08 Annual Report of the Financial Transactions and Reports Analysis Centre of Canada (FINTRAC), Canada's financial intelligence unit specialized in money laundering and terrorist financing, notes that in 2007-08 FINTRAC received 21,626,007 reports from across all reporting sectors including financial institutions. This figure is up from 17,615,233 in 2006-07. Approximately 75% of the total reports received by FINTRAC were electronic funds transfer reports.

Despite having received 21,626,007 reports from regulated entities, FINTRAC made only a total of 210 case disclosures to Canadian agencies and law enforcement units and foreign financial intelligence units. Of the 210 disclosures, 171 were associated with money laundering while the remainder were predominantly associated with terrorism and other threats to Canada.

An examination of sample cases under investigation reveals that 65% of them originated from voluntary information proffered to FINTRAC – most likely from law enforcement whereas only 9% of cases under investigation originated from Suspicious Financial Transaction Reports submitted by regulated entities.

The annual report highlights emerging areas of money laundering and terrorist financing threats including:

- The use of prepaid cards to launder funds;
- The exploitation of the global securities industry to facilitate drug trafficking, stock manipulation, and fraud;
- The emergence of unregulated digital precious metal operators as conduits for money laundering; and

- The growing use of investment and trust companies as fronts to disguise the laundering of money.

The full FINTRAC Annual report can be obtained at:
<http://www.fintrac-canafe.gc.ca/publications/ar/2008/ar-eng.pdf>

Coming Into Force...AML Administrative Monetary Penalty Regime

Jan Hopper, Senior Policy Advisor, Consumer Affairs, CUCC

The *Administrative Monetary Penalties Regulation* under the *Proceeds of Crime (Money Laundering) and Terrorist Financial Act* comes into effect December 30..

The administrative monetary penalties can be up to \$1,000 for “minor” violations. An example of a “minor” violation is failing to ascertain the identity of a person in order to keep prescribed records for that individual. “Serious” violations incur penalties up to \$100,000 and “very serious” offences relating to suspicious transaction reporting violations may trigger penalties of up to \$500,000.

While FINTRAC has stated that it will continue to take a cooperative approach to compliance with reporting entities, this does not preclude the possibility of penalties being levied.

Compliance with the new regulation requiring the identification of “Politically Exposed Foreign Persons” (“PEP”) was facilitated through use of automated solutions. Central 1 Credit Union offers the VCAMLO Service, which provides an end to end solution for anti-money laundering compliance. This service includes automated list checking against a PEP list. Such lists may contain up to 500,000 names so an automated solution is preferred. Central 1 in BC has negotiated a volume pricing arrangement for credit union access to this service. Another provider of risk management services, Verafin, has enhanced its AML compliance solution to provide PEP list checking to its credit union clients. You may contact Dave Barker, Director, Risk Management at Central 1 Credit Union for further information about the VCAMLO service – dbarker@cucentral.com or 604-737-5976.

CUSOURCE® Credit Union Knowledge Network on-line training program and webinars for both staff and compliance officers will be available to credit unions by year-end. Further information can be found on the

CUSOURCE website at:
<http://www.cusource.ca/cusource/>

For Your Information

Refunding Taxes Withheld In Error From Non-Residents

Gary Rogers, Vice-President, Financial Policy, CUCC

In 2008, a number of credit unions and other financial institutions withheld non-resident tax, in error, from payments of interest to non-resident members. Errors arose because income tax legislation was passed late in 2007, providing an exemption from this tax, beginning January 1, 2008. The new exemption was not well publicized.

The following discussion applies not only to interest paid on deposits but also to dividends paid on credit union shares, because credit union dividends are deemed by the *Income Tax Act* to be interest. However, there is no change to withholding tax requirements when amounts are withdrawn from a registered product, such as an RRSP or RRIF.

A non-resident can claim a refund of taxes withheld in error on Canada Revenue Agency form NR7. However, this form requires detailed information and verification by the payer financial institution. It would be burdensome for a number of individual recipients to prepare the form, obtain certification from their credit union, and individually await repayment by CRA. Use of NR7 is not recommended.

CRA officials in the International Tax Services Office in Ottawa have confirmed an easier procedure. CRA will refund, to credit unions, taxes withheld in error and remitted to CRA. A letter is required from each affected credit union specifying the amount of taxes requested to be refunded, the circumstances of the request, and a guarantee that the amounts refunded will be reimbursed to members from which the tax was withheld in error. A sample letter that will comply with CRA requirements is available on Canadian Central's website at http://www.cucentral.ca/Tax_11dec08 along with additional contact phone numbers for CRA.

A credit union may wish to reimburse members for these taxes before the end of 2008, even if the refund has not yet been received from CRA. This will ensure that the interest payment and the correct net tax withholding occurs in the same year and is reported on the same form NR4.

In 2008 and future years, form NR4 will still be required to report payments of interest to non-residents, even though no tax is withheld.

Minimum RRIF Withdrawals for 2008

Gary Rogers, Vice-President, Financial Policy, CUCC

The November 27 Economic and Fiscal Statement created more than political controversy. It also created news and some uncertainty for holders of RRIFs and the financial institutions that administer them.

For 2008 only, the required minimum withdrawal from RRIFs is reduced by 25%. Amounts not yet paid from a RRIF in 2008 can be reduced. Or if amounts have already been paid out of RRIFs, they can be re-contributed any time up to 30 days after the proposed legislation is enacted and be claimed as a 2008 income tax deduction.

On December 9, Canada Revenue Agency (CRA) posted a notice on its website at <http://www.cra-arc.gc.ca/whatsnw/tms/rf-fq-eng.html> confirming that individuals and financial institutions can act upon the proposals before the law is passed, if they choose to. It confirms the Government's intention to proceed with the RRIF proposal, regardless of the prorogation of Parliament. CRA promises no penalties if the proposal never becomes law. On the other hand, FIs that are cautious about adopting tax measures that are not yet law can continue adhering to the "old" rules, and subsequently accept repayments to RRIFs of the extra 25% in 2009, after the new legislation is passed.

Further, on December 11, the Minister of National Revenue issued a news release confirming this information. <http://www.cra-arc.gc.ca/nwsrm/rlss/2008/m12/nr081211-eng.html>

Credit unions and other financial institutions will need to weigh the practicalities of adjusting systems and procedures to accommodate these new rules before year-end. It may be more practical to continue paying out 100% of the minimum amount in 2008 and then creating new processes for 2009 to contact recipients of amounts from RRIFs, determine if they wish to pay back 25% of the minimum amount, and effect the transfer back to the RRIFs.

But there are public relations and communications issues. Credit unions should consider their response to a member who wishes to have their remaining payments reduced in December or wishes to repay before year-end the excess already received. From a

member's perspective, this is a preferred course because the individual would receive a T4RIF for the net, final amount in a timely fashion; would not have to delay filing their tax return while waiting for his/her credit union to accept repayment of the tax-deductible 25%; and would not have to remember to claim the separate deduction on the 2008 tax return. A knowledgeable member might cite CRA's position that this is acceptable or point out that the financial institution down the street is accepting requests for this treatment. Yet, as mentioned above, the credit union's systems or supplier simply may not be ready to accommodate this option so late in December.

There is no official word yet on whether FIs must create new documentation to support a tax deduction by a RRIF-holder for a repayment to their RRIF in 2009. However, initial indications are that no T-slip or official receipt will be required. This would suggest that a taxpayer may be requested by CRA auditors to prove the deduction by producing financial statements etc, but no paper would have to be submitted with the T1 tax return.

Cheque Fraud: Still the Fraud Tool of Choice

Heather Mitchell, Policy Analyst, Fraud and Loss Mitigation, Credit Union Central of Canada

These days much of the buzz in the world of financial fraud relates to new methods of attack such as skimming, phishing and hacking. Of course, fraud is always evolving but there is one tried and true tool that remains the centre of many cases: fraud committed through altering and forging of cheques and counterfeit cheques. The Bank of Canada reports that, "Cheque fraud is one of the fastest-growing financial crimes today. Projections indicate that cheque fraud will grow by 25 per cent each year. Cheques remain the dominant form of payment in North America despite technological advances."¹

Traditional crimes such as "bad cheque" passing to purchase goods and fraudulent endorsements to obtain cash are decreasing. In their place newer schemes are emerging including "Mass Marketing Fraud" that most often involves a bogus cheque scam. In November 2007, the RCMP reported "the most common trend in (mass marketing fraud) is the use of counterfeit or altered financial instruments (i.e. cheques/money orders)."² The numbers are staggering. The anti-fraud call centre, Phonebusters,

¹

http://www.bankofcanada.ca/en/banknotes/fraud/fact_sheet_4.pdf

² http://www.rcmp-grc.gc.ca/publications/marketing_e.htm

reported that from January 2008 to September 2008 it received 4,405 reports of mass marketing fraud from Canadian victims and 5,504 calls from U.S. victims. Losses for that period were \$17.6 million in Canada and \$19.9 million in the U.S., (in US dollars).³ A large portion of those losses came from the use of counterfeit cheques.

Tools such as imaging reduce fraud. By replacing paper cheques with electronic images, the number of original cheques in the mail, and thus available for theft, is greatly reduced. Imaging also speeds up cheque reconciliation by account holders and allows faster identification of discrepancies, like cheque amount alterations. Imaging can also support a service called “positive pay”. Positive pay is software that allows business members to submit a file to the credit union with the details of issued cheques. When cheques are presented they are verified against the file and alterations to specific fields identified immediately. Other fraud identifying services, such as matching embedded or encrypted codes on cheques and signature verification are also available.

Since it is the frontline staff who will identify and stop most cheque fraud, investing in their education has obvious rewards. Training is available through credit union Centrals, CUSOURCE® Knowledge Network, and other agencies. To respond to this need to help protect credit unions, CUSOURCE® developed a course, along with Central 1 (Ontario) called Combating Cheque Fraud (see: www.cusource.ca for course details).

Cheque fraud may not be as newsworthy a crime as “phishing” or “hacking” but it remains the tool of choice for many types of fraud. Credit unions that train their staff to remain vigilant for the signs of cheque fraud not only protect themselves; they also provide a valuable service to their members and owners.

Statistical Report

Insolvencies Increase in Canada

Robert Martin, Director of Research, CUCC

In early December the Office of the Superintendent of Bankruptcy released its *Insolvency Statistics in Canada* report based on data available up to October 2008. The report indicates that after a long period of relative stability the number of bankruptcies and consumer

proposals in Canada is rising as the recession takes hold. For example, from October 2007 to October 2008 total bankruptcies in Canada rose by 21.1%. More interestingly, the number of bankruptcies increased by 7.2% in the one-month period from September 2008 to October 2008 suggesting that the economic downturn was taking hold and that the increase in the number of bankruptcies a year from now could be very high indeed. In regard to total bankruptcies British Columbia, Alberta and Prince Edward Island have seen the largest increases over the 12-month period, with rises of 37.4%, 50.9% and 70% respectively.

According to the bankruptcy superintendent’s statistics the damage was completely on the consumer side with consumers experiencing a 22.8% increase in bankruptcies over the 12 month period while total business bankruptcies actually fell by 3.3%. That said the total business bankruptcy numbers may be a lagging indicator of what is to come. To illustrate, when the business bankruptcy numbers are broken down by sector it is clear some sectors are starting to be hit with, for example, manufacturing bankruptcies up by 40.5% and construction by 32.9%.

The superintendent’s *Insolvency Statistics in Canada* report can be obtained at:

[http://www.ic.gc.ca/epic/site/bsf-osb.nsf/vwapj/Oct_EN.pdf/\\$file/Oct_EN.pdf](http://www.ic.gc.ca/epic/site/bsf-osb.nsf/vwapj/Oct_EN.pdf/$file/Oct_EN.pdf)

Preliminary Housing Start Data

Robert Martin, Director of Research, CUCC

The Canada Mortgage and Housing Corporation (CMHC) has released its December 2008 *Preliminary Housing Start Data Report*. The report adds to the string of bad economic news currently emanating from many sectors. Based on preliminary housing start data taken from population centres with 10,000 people or more, the CMHC reports that total Canadian housing starts fell 28% during the period from November 2007 to November 2008. Provinces west of the Manitoba border have been hit the hardest with British Columbia falling by 62%, Alberta by 52%, Saskatchewan by 39%. Manitoba is a bright spot on the Prairies with housing starts up by 19% during the same period. Ontario has experienced a more moderate decline of 28% while the Atlantic region has seen a drop of 18%. Big declines in housing starts were also seen in larger metropolitan areas including Vancouver (-65%), Edmonton (-74%), Saskatoon (-49%) and Oshawa (-78%). On a more positive note Winnipeg experienced a 23% increase in housing starts from November 2007 to November 2008 and Regina saw a small increase of 5% in the same period.

³

http://www.phonebusters.com/english/documents/MonthlyStats_001.pdf



A full copy of the CMHC report can be obtained at:
http://www.cmhc-schl.gc.ca/odpub/esub/64695/64695_2008_M12.pdf

National System Results – Q3 Results

Sandra Brizland, Research Analyst, CUCC

The national system results for the 3rd quarter of 2008 up to September 30 were recently released by Canadian Central. System assets, deposits, and loans all recorded solid gains, but at a slower pace than in recent previous quarters. Some key findings in the Q3 system results are:

- System assets are currently \$110.63 billion , compared with \$109.11 billion at the end of Q2;
- Loan growth has slowed to a 7.6% annual pace and loan volume stands at \$92.67 billion at the end of Q3; loans as a percentage of total deposits are currently 94.9%, down from 96.5% reported twelve months ago - a reflection of stronger growth in deposits over loans in recent months;
- Year-to-date net income is ahead of last year's record pace; combined earnings for the system after Q3 of 2008 reached \$461.37 million a 4.8% increase over the \$440.03 million reported a year ago;
- At the end of Q3, the number of credit unions stood at 444 (down from 449 at the end of Q2), the number of locations was 1,722 (down from 1,734 in Q2), and the number of members is 5,057,400 (an increase from 5,045,266 at the end of Q2).

Provincial News

We invite all Canadian Central members to contribute to this portion of the Report by submitting information on policy developments in their respective provinces. Submit comments to Brigitte Goulard, Vice President, Policy at goulardb@cucentral.com. Thank you in advance for your participation.

British Columbia

Darren Kozol, General Counsel, Central 1 Credit Union

On November 20, 2008, the British Columbia government introduced Bill 45, Economic Incentive and Stabilization Statutes Amendment Act (the "Act"). The intent of the Act is to bring into effect the Premier's 10-point economic plan. Provisions of the Act of interest to credit unions include amendments to the Financial Institutions Act that provide for:

- Unlimited deposit insurance for depositors with credit unions;
- Enhanced supervisory powers for the Financial Institutions Commission of British Columbia ("FICOM"). These enhanced powers include a greater reliance on FICOM's opinion when it decides if a credit union should be placed under supervision;
- Increased power to delegate powers from FICOM to the Superintendent of Financial Institutions, including the new powers; and
- The removal of the requirement that FICOM must delegate its powers to supervise a credit union, that has voluntarily entered into supervision, to Stabilization Central Credit Union of British Columbia.

The Act passed third reading and received Royal Assent on November 27, 2008. The provision bringing in unlimited deposit insurance became effective, retroactive to October 22, 2008, upon the Act receiving Royal Assent.

The *Policy and Advocacy Report* is published by Credit Union Central of Canada. For editorial or general inquiries please contact:

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