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A Passport to Success: How Credit Unions Can Adapt to the Urgent Challenges They Face

Most credit unions outside of Quebec are falling behind when it comes to making the very significant investments required for the next decade. Technology and scale will be required for the most basic loans and deposits, as well as new products currently being developed.

Those that don't act quickly to acquire the required scale will be left behind.

David O'Neill Losier

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THE STUDY IN BRIEF

Banking is the bedrock supporting all other Canadian industries. Without a robust, healthy banking industry, liquidity and investment in other industries will dry up. Stability is therefore a key pillar of financial sector policy.

Regulatory barriers to entry have to a significant degree insulated the banking industry from competition from high-tech firms that transformed other industries such as newspapers, travel and entertainment. Instead, we have witnessed a much more gradual integration of technology within the banking industry, which has also contributed to the stability of the Canadian banking sector.

This is likely to change. The technological evolution in banking is going to speed up exponentially. The difference this time is that the very infrastructure, systems and regulations upon which the movement of money in Canada depends is being pressed to join the 21st century. Billions are being spent by incumbent financial institutions and big technology companies. These changes will be unlike any we have seen in the past. The future of Canadian banking is about open banking, application programming interfaces (APIs) and artificial intelligence.

Most credit unions outside of Quebec are falling behind when it comes to making the very significant investments required for the next decade. Technology and scale will be required for the most basic loans and deposits, as well as new products currently being developed. Those that don't act quickly to acquire the required scale will be left behind.

Outside of Quebec, credit unions run their operations on a myriad of different banking systems and serve their members through a wide range of partnerships, relationships and affiliates. They also have their own by-laws, regulations, policies and guidelines, which have been shaped and influenced by different provincial regulators. This fragmented system built around tight geographic borders is affecting the ability of provincial credit unions to acquire the required scale the industry will need to compete.

This paper shows that most credit unions cannot shift from provincial to federal regulation and operate across the country, as permitted by 2012 legislation, and will be challenged to compete effectively as technology continues to grow. Is there a better way to adapt?

An alternative path forward would be for provinces to institute a passport system. Such a system would allow credit unions to operate, serve members and grow across provincial boundaries. This would allow credit unions to gain similar benefits as those of going federal, while adjusting and harmonizing the regulatory environment in response to the particular risk profile of credit unions. The provinces could look at the passport systems in place in the Canadian securities industry and in European banking for inspiration and lessons learned on how to implement a similar regime for their credit unions.

An opening of borders with a new cooperative approach to oversight, as well as efforts to harmonize regulations and thus reduce the likelihood of regulatory arbitrage, will allow credit unions and regulators to find the right balance between member services and efficient oversight.

Policy Areas: Financial Services; Credit Union Regulation.

Related Topics: Competition in the Banking Industry; Open Banking; Digitalization.

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In a country where the top six banks control 76 percent of the combined loans of federally and provincially regulated financial institutions, “second-tier” financial institutions become critically important for providing competition and choice.

In Canada, credit unions play a significant role in this regard. In fact, in addition to their important role within the Canadian economy, the industry can be assessed as critically important in at least four provinces (Quebec, Manitoba, Saskatchewan and British Columbia). The ability of credit unions, therefore, to adapt to the technological evolution happening in financial services in an efficient and sound way is a crucial policy concern.

As this paper will show, credit unions are financially sound and responsible for many innovations in the banking sector. They provide significant competition and choice in the Canadian financial services market. However, despite an impressive track record, they are losing ground in areas where they were once much stronger and their lack of scale means they require collaboration, unlike anything seen so far in the industry, to face the digital revolution that is currently underway.

In the meantime, there have been concerns that the fragmented regulatory system in place for Canadian credit unions is inadequate to ensure the ongoing safety and soundness of large credit unions. The federal response to these concerns has been to set up a regulatory regime that allows credit unions to operate nationally under the *Bank Act*. The expectation is that those credit unions that want

to expand nationally would need to do so under supervision by OSFI (Office of the Superintendent of Financial Institutions), a world-class regulator. On the surface, this appears to be a fair trade-off. Why then has the federal option attracted so little attention? Only two of the 449 credit unions, representing 4 percent of credit union assets in 2020, have completed this journey. These credit unions represent less than 1 percent of Canadian credit unions.

Fundamentally, the *Bank Act* option doesn't just involve being overseen by OSFI, it also means moving to a very different regulatory framework. Despite these two federal credit unions leading the way, moving from one prudential regulatory framework to another is a very significant investment and time commitment; resources most credit unions either don't have or prefer to allocate elsewhere. More importantly, this paper identifies numerous reasons why, although some large or very large credit unions may choose this route, federal regulation just doesn't “fit” most credit unions.

There needs to be an alternative path to satisfy financial sector policy priorities of stability, efficiency and utility and allow the industry to continue to thrive and grow.

Key Concept Explainer

Credit Risk:

The most important and significant risk being managed by all financial institutions is credit risk. A way of comparing the level of credit risk assumed by various financial institutions is by studying their loss ratios. Those ratios show the amount a financial institution has been unable or is not expected to recover from their loans, compared either to their total assets or their total loans. These ratios are an effective measure of credit risk, and the leverage ratio allows us to assess how much capital as a percentage of total assets a financial institution has accumulated to weather the inevitable economic headwinds.

The data indicate that credit unions have healthy leverage ratios while taking on appropriate credit risk. This can be expected as most credit unions rely on retained earnings and cannot readily access capital markets.

Another measure is the loan loss provision coverage ratio, a measure of the ability to cover losses from earnings (the higher the better). Credit unions over the past five years have maintained a loan loss provision coverage ratio of 5.4 times, meaning that annual losses would have to be multiplied by 5.4 before credit unions would incur a net loss in any given year.

ABOUT THE CANADIAN CREDIT UNION INDUSTRY

Credit unions are financial institutions organized as co-operatives. Although they provide essentially the same retail and commercial financial services as banks, as co-operatives their customers are also their owners and are called members. Each member has one share in the credit union and is entitled to one vote regardless of wallet size. Members can use their vote to elect the members of the board of directors, adopt by-laws, and decide on other matters in accordance with their respective legislation.

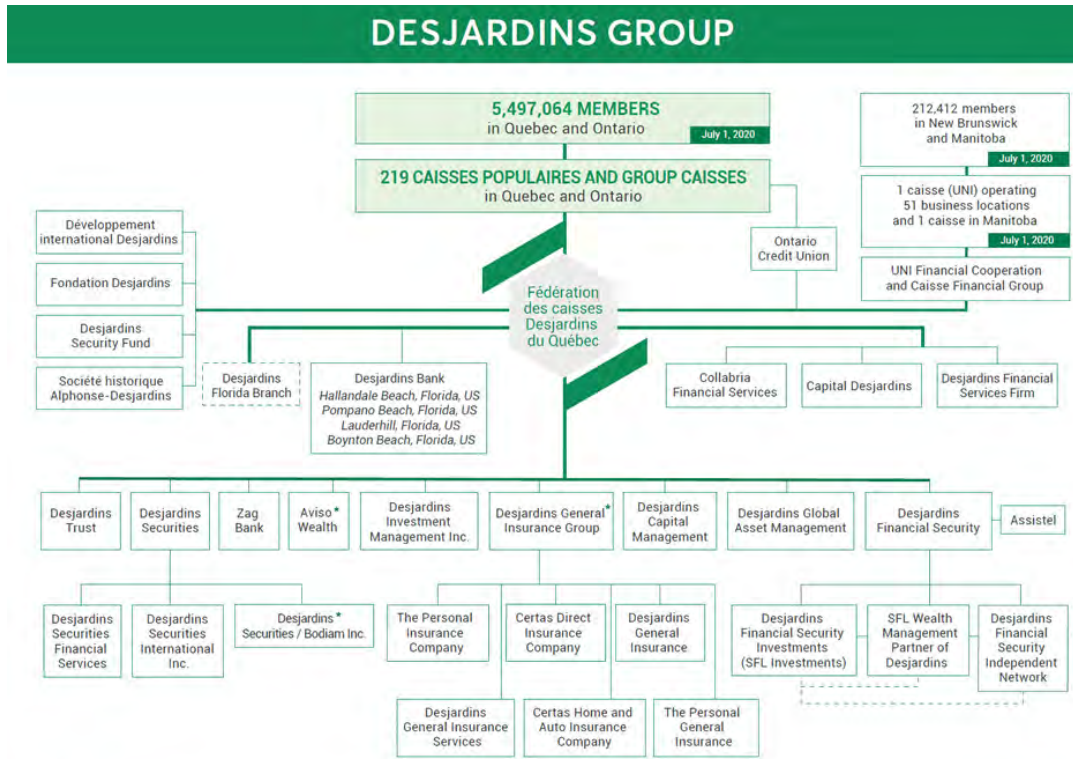
Provincial regulation also requires that credit unions be part of a central organization (Centrals). Centrals are responsible for managing and supporting significant risks for their credit unions. Not only do they help facilitate payments and hold statutory liquidity, in most cases they also help their member credit unions with loan underwriting, compliance, operational risk and many other risk management processes that credit unions have decided are most efficiently provided by their Central. Within the credit union system, many of the important risks to be managed by a financial

institution are managed co-operatively through their respective Centrals.

Until 2012, all credit union regulation occurred at the provincial level, by entities created under provincial regulations. In 2012, the federal government enacted legislation that enabled credit unions the option of continuing federally. Thus far, as mentioned, there has been limited pickup, with only two credit unions completing the journey, (UNI Financial Cooperation in 2016 and Coast Capital Savings in 2018).

In most cases, regulations are quite similar across provinces. Where there is a clear distinction is between the regulatory structure that exists in Quebec vs any other Canadian province. The quest for a strong made-in-Quebec financial institution has been a shared goal of both the Desjardins Movement and the provincial government. Although each of the 218 Desjardins credit unions in Quebec (“caisses populaires”) is a distinct legal entity under Quebec laws, the regulatory framework in Quebec gives the Federation (their Central) very significant powers over those credit unions and full authority over capital and investment. Desjardins is

Figure 1: Desjardins Group



Source: Desjardins. At <https://www.desjardins.com/ressources/pdf/d05-organigramme-07-2020-e.pdf?resVer=1598449875000>

thus recognised by rating agencies and regulators as a single entity.¹

Desjardins’ service centres are exclusively in Quebec, other than 51 branches of the Desjardins Ontario Credit Union, which is an affiliate member of Desjardins, regulated under the laws of Ontario. Although Desjardins is regulated in Quebec, the Desjardins Group also includes several subsidiaries that operate across the country and the United

States, some of which are federally regulated, and others provincially regulated.

For purposes of this paper, we will include Desjardins when we consider the impact credit unions have on the Canadian economy, but we will be focusing on credit unions outside of Quebec when we speak of the benefits that could be generated from a passport system.

1 Section 547.17 of the “Loi sur les coopératives de services financiers” in Quebec stipulates that the Desjardins Federation is responsible for risk management and the financial well-being of their consolidated group. Other sections stipulate the Autorité des marchés financiers (AMF) ensures the Federation has appropriate processes in place to supervise their group.

Table 1: 2020 Consolidated Share of Loans – Banks, Credit Unions and Caisses Populaires

	Domestic Loans (\$Millions)	Share of Loans (percent)
Royal Bank of Canada	548,215	19
The Toronto-Dominion Bank	484,244	17
The Bank of Nova Scotia	399,952	14
Canadian Imperial Bank of Commerce	343,677	12
Bank of Montreal	275,242	10
National Bank of Canada	149,986	5
Total Tier 1 Financial Institutions	2,201,316	76
Credit Unions and Caisse Populaires	422,599	15
All other Canadian Banks	253,668	9
Total Tier 2 Financial Institutions	676,267	24
Total Financial Institutions	2,877,583	100

Note: These are the total domestic loans held by 449 credit unions and caisses populaires. Shown together in this table to provide an indication of the size and scale of the Canadian credit union and caisse populaire system.

Sources: 2020 annual reports for banks and Desjardins except for National Bank where data come from supplemental information. Canadian Credit Union Association (CCUA), Fourth Quarter 2020 National Sector Results.

The Scale of the Credit Union Industry In the Canadian Economy

Credit unions underwrite a very significant portion of the Canadian economy. Table 1 shows that credit unions and caisses populaires have provided \$423 billion in loans to Canadians, representing 15 percent of all loans in Canada (half occurring outside Quebec, and half within).

Credit unions are important, but are they “systemically” important? Systemic importance relates to a financial institution’s size, its complexity, its interconnectedness, the lack of readily available substitutes for the financial infrastructure it provides, and its global (cross-jurisdictional) activity. In Europe, it is not uncommon for groups of credit unions to be designated as systemically important within their jurisdictions, the most notable being Crédit Agricole and Groupe BCPE in France, which have both been designated as global systemically important banks, and Rabobank which

has been designated as systemically important in the Netherlands. In Canada, Central1 in British Columbia has been designated as systemically important in that province as well as Desjardins in Quebec. Most provincial regulators are also considering provincial designations for the largest credit unions in their respective provinces.

Although the ties that bind those foreign groups of credit unions may be different than the ties between credit unions in Canada, for the purposes of this paper, it is useful to at least recognize the relative importance credit unions have in each province. Table 2 lays out the case for the critical importance of the credit union industry to individual provinces, based on its GDP.

Excluding federal credit unions (FCUs) from the equation provides a measure of the relative importance from a provincial regulator’s perspective. In this case, in at least four provinces (Quebec, Manitoba, Saskatchewan and British Columbia),

Table 2: Provincial Credit Union System in Relation to the Provincial Economy

	2019 GDP	2019 CU Assets	Assets to GDP Ratio	Adjusted for Federal Credit Unions
	(\$Millions)		(percent)	
British Columbia	309,059	86,280	27.9	21.2
Alberta	352,884	26,862	7.6	7.6
Saskatchewan	82,917	24,742	29.8	29.8
Manitoba	73,814	34,494	46.7	46.7
Ontario	891,811	70,376	7.9	7.9
Quebec	460,357	305,686	66.4	66.4
New Brunswick	38,236	5,579	14.6	2.0
Nova Scotia	46,586	2,964	6.4	6.4
Prince Edward Island	7,523	1,270	16.9	16.9
Newfoundland	35,349	1,295	3.7	3.7
Territories	12,178	-	0.0	0.0
Total Canada	2,310,714	559,548	24.2	23.1

Sources: Statistics Canada 2019 Provincial GDP in current prices. CCUA 2019 National Sector Results. Desjardins 2019 Annual Report.

provincial credit union assets are equivalent to more than 20 percent of provincial GDP and the industry may be considered critically important, in particular for certain sectors and communities of provincial economies. For example, for small and medium-size businesses in 570 rural communities² that have no local substitutes, the critical importance of credit unions is stark. Without financial boots on the ground near these rural businesses and agricultural operations, the ability of those businesses to grow, invest and expand would be significantly hampered, with knock-on effects for the economy.

ABOUT THE REGULATORY SYSTEM OVERSEEING PROVINCIAL CREDIT UNIONS

Except for the two federal credit unions (UNI Financial Cooperation and Coast Capital Savings), the other 447 Canadian credit unions are regulated by provincial acts and regulations. Each province has delegated oversight of the laws governing their structure and operations to a provincial superintendent or equivalent. Each province has its own deposit insurer who also has the powers to establish prudential guidelines on their credit unions. Finally, each province also expects credit

2 From Desjardins' "Quick facts about Desjardins" (183 CPs) and CCUA's 2019-2020 Credit Union Community & Economic Impact Report (387 CUs).

Table 3: Credit Union Regulators and the System they Regulate (2020)

Juris-diction	Regulatory Oversight		Number of Credit Unions	System Assets (\$Millions)	Average Assets per Credit Union (\$Millions)	# of CUs Holding 50% of System Assets
CA	Gov. branch:	Department of Finance (Canada)	2	25,669	12,834	1
	Regulator:	Office of the Superintendent of Financial Institutions				
	Dep. Insurer:	Canadian Deposit Insurance Corporation				
	Central:	Bank of Canada				
BC	Gov. branch:	Ministry of Finance (B.C.)	40	71,031	1,776	2
	Regulator:	BC Financial Services Authority				
	Dep. Insurer:	Credit Union Deposit Insurance Corporation (B.C.)				
	Central:	Central 1 and Stabilization Central CU of BC				
AB	Gov. branch:	Ministry of Treasury Board and Finance	16	28,238	1,765	1
	Regulator:	Alberta Superintendent of Financial Institutions				
	Dep. Insurer:	Credit Union Deposit Guarantee Corporation (Alta)				
	Central:	Credit Union Central of Alberta				
SK	Gov. branch:	Ministry of Finance (Sask.)	39	26,537	680	2
	Regulator:	Financial and Consumer Affairs Authority of Saskatchewan				
	Dep. Insurer:	Credit Union Deposit Guarantee Corporation (Sask.)				
	Central:	Credit Union Central of Saskatchewan				
MB	Gov. branch:	Department of Finance (Man.)	24	37,592	1,566	4
	Regulator:	Financial Institutions Regulation Branch				
	Dep. Insurer:	Deposit Guarantee Corporation of Manitoba				
	Central:	Credit Union Central of Manitoba				
ON	Gov. branch:	Ministry of Finance (Ont.)	62	78,622	1,268	4
	Regulator:	Financial Services Regulatory Authority				
	Dep. Insurer:					
	Central:	Central 1				

Table 3: Continued

Juris-diction	Regulatory Oversight		Number of Credit Unions	System Assets (\$Millions)	Average Assets per Credit Union (\$Millions)	# of CUs Holding 50% of System Assets
QC	Gov. branch:	Ministre des Finances (Que.)	218	353,569	1,622	Data not available
	Regulator:	Autorité des Marchés Financiers				
	Dep. Insurer:					
	Central:					
NB	Gov. branch:	Department of Finance (N.B.)	9	1,285	143	2*
	Regulator:	Financial and Consumer Services Commission				
	Dep. Insurer:	New Brunswick Credit Union Deposit Insurance Corporation				
	Central:	Atlantic Central				
NS	Gov. branch:	Department of Finance (N.S.)	23	3,364	146	2
	Regulator:	Office of the Superintendent of Credit Unions				
	Dep. Insurer:	Nova Scotia Credit Union Deposit Insurance Corporation				
	Central:	Atlantic Central				
PE	Gov. branch:	Department of Finance (P.E.I.)	7	1,505	215	2
	Regulator:	Credit Union Deposit Insurance Corporation (P.E.I.)				
	Dep. Insurer:	Credit Union Deposit Insurance Corporation (P.E.I.)				
	Central:	Atlantic Central				
NF	Gov. branch:	Department of Finance (N.L.)	9	1,413	157	2
	Regulator:	Credit Union Deposit Guarantee Corporation (N.L.)				
	Dep. Insurer:	Credit Union Deposit Guarantee Corporation (N.L.)				
	Central:	Atlantic Central				

* In 2016, New Brunswick's largest credit union became a federal CU reducing the assets overseen by the regulatory team in NB by 80 percent.

unions to be part of a Credit Union Central. Table 3 provides a breakdown of this regulatory structure for Canada's 447 credit unions.

In 1985, provincial regulators outside of Quebec regulated on average 150 credit unions with an average asset size of \$12.5 million. At the end of 2020, they regulate an average of 25 credit unions with an average asset size of \$1.1 billion.³ With consolidation comes increased complexity and most provincial regulators have modernized their regulations, enhanced their guidelines, increased their expectations and their oversight.

Throughout these years of consolidation, the system and the regulatory organizations overseeing them have become stronger. Today, most provinces are overseeing one, or a few, larger credit unions representing most of the sector's provincial assets. However, with a few large credit unions continuing federally, some of the stakeholders in this fragmented regulatory system are facing, or about to face, some very existential challenges.

An example of the existential challenge faced by regulators is the experience in New Brunswick. On July 1, 2016, the 15 caisses populaires in this province, representing 80 percent of New Brunswick credit union system assets, merged and became one federal credit union. As a result, although the province has transferred the responsibility for overseeing the risk to the federal government, the provincial regulator now has to cope with overseeing the remaining provincial credit unions with a significantly smaller asset base on which to recover costs, or rely on the use of public funds.

We have another example to draw upon in British Columbia. On November 1, 2018, Coast Capital Savings, British Columbia's second largest credit union, became a federal credit union. Coast

Capital Savings represented 25 percent of BC's credit union system assets. Another BC credit union (First West Credit Union) has expressed interest in becoming a federal credit union,⁴ which means the provincial regulators in BC will see a further reduction of 18 percent of the system assets they oversee.

Although large credit unions may be testing the waters of federal regulation, there remain only two who have undertaken the journey. Moreover, given the costs involved of switching from one prudential framework to another, small and mid-size credit unions are very unlikely to continue federally. Even if all large credit unions (greater than \$2 billion in assets) do go federal, this would imply that 90 percent of credit unions representing only 25 percent of the system's assets will likely remain provincially regulated for the foreseeable future. Regulators must find a way to maintain the strength and stability of the remaining provincial industry they oversee with dwindling resources. Pathways to greater collaboration between regulators, such as the passport system this paper will investigate, could help face the challenge.

OUTCOMES OF PROVINCIAL REGULATION AND OVERSIGHT

The following subsections takes a closer look at the outcome of provincial regulation based on the three core policy objectives outlined by Finance Canada in its 2016 Federal Financial Sector Framework: stability, efficiency and utility.

Stability (is the sector safe, sound and resilient?)

As discussed earlier, the stability of the Canadian financial sector is perhaps the overriding policy objective of the federal government. Is the sector

3 Drawn from Deloitte paper: "21st century co-operative" and CCUA data.

4 As reported in First West's 2018 annual report.

Table 4: Average Leverage and Loss Ratios

	2016-2020 5-yr Average 10 Large CUs*	2016-2020 5-yr Average Desjardins	2016-2020 5-yr Average All Banks
	<i>(percent)</i>		
Leverage ratio (total capital / total assets)	6.90	8.74	5.94
Loss ratio (percent of assets)	0.12	0.15	0.22
Loss ratio (percent of loans)	0.15	0.24	0.35

*The 10 large credit unions used in the study have a 47 percent share of total system assets in 2020.

Sources: Credit union and Desjardins audited financial statements (2016-2020) and OSFI Financial Data for Banks.

strong enough to withstand economic disruption and shocks to ensure Canadian businesses have access to liquidity to get through downturns and recovery in short order? Answering yes means the sector has a complete understanding of their risks, those risks are properly assessed, mitigated, monitored and reported on.

The most important and significant risk being managed by all financial institutions is credit risk. A way of comparing the level of credit risk assumed by various financial institutions is by studying their loss ratios. Those ratios show the amount a financial institution has been unable or is not expected to recover from their loans, compared either to their total assets or their total loans. These ratios are an effective measure of credit risk, and the leverage ratio allows us to assess how much capital as a percentage of total assets a financial institution has accumulated to weather the inevitable economic headwinds.⁵ Table 4 shows the average leverage and loss ratios of the largest 10 Canadian credit unions

outside of Quebec, as well as Desjardins, and all federally regulated Canadian banks for the purposes of level setting.

The results indicate that credit unions have healthy leverage ratios while taking on appropriate credit risk. This can be expected as most credit unions rely on retained earnings and cannot readily access capital markets.

Table 5 looks at the loan loss provision coverage ratio, a measure of the ability to cover losses from earnings (the higher the better). The table shows that credit unions over the past five years have maintained a loan loss provision coverage ratio of 5.4 times, meaning that annual losses would have to be multiplied by 5.4 before credit unions would incur a net loss in any given year.

The table further shows that the resilience of Canada’s two largest credit unions held true during the financial crisis when their loan portfolios and Desjardins’ showed strong resilience.

5 Using risk weighted assets (RWA) is often preferred when you look at individual institutions, but they are not publicly available for most credit unions nor are they comparable across institutions that are using different methods of calculation. By comparing leverage ratios to loss ratios (which both use the same denominators for all institutions) they are comparable.

Table 5: Loan Loss Provision Coverage Ratio

	2016-2020 5-yr Average 10 Large CUs*	2016-2020 5-yr Average Desjardins	2016-2020 5-yr Average All Banks	2007-2010 4-yr Average 3 Large CUs**	2007-2010 4-yr Average Desjardins	2007-2010 4-yr Average All Banks
Pre-tax return on assets	0.54%	0.94%	0.97%	0.69%	0.81%	0.81%
Loss ratio (percent of assets)	0.12%	0.15%	0.22%	0.13%	0.14%	0.29%
Loan loss provision coverage ratio	5.4	7.2	5.4	6.4	6.8	3.8

* The 10 large credit unions used in the study have a 47 percent share of total system assets in 2020.

** The three large credit unions used in the study have a 23 percent share of total system assets in 2020.

Sources: Credit union and Desjardins audited financial statements (2016-2020) and OSFI Financial Data for Banks.

Data would suggest that provincial regulation has been successful in developing a stable and resilient second-tier financial system for Canadians through credit unions. As they continue to grow, enter new markets and assume greater risks, risk management expertise in credit unions will need to be enhanced. New regulations and augmented oversight will follow.

Efficiency (is the sector competitive, distributing efficiency gains to customers, innovative and contributing to economic growth?)

Another government priority for the sector is efficiency. This speaks to the contribution Canadian financial institutions make to national productivity, which in turn is a key ingredient to economic growth. Competition is widely viewed as a driver of efficiency. If this efficiency is returned to customers, those customers will deliver economic gains.

In Canada, the big six banks dominate domestic banking. Table 6 shows how they control 76 percent of the domestic lending market and 81 percent of the domestic deposit market. Second-tier financial institutions are therefore very

important to providing competition and choice to Canadian consumers.

One of the most important things financial institutions do is lend money to stimulate growth and innovation. This is what generates economic activity. How efficient banks and credit unions are at moving liquidity from depositors to lenders is an important consideration. Both banks and credit unions have close to 6 percent more deposits than they do loans on a national basis (Table 7, banks 5 percent, credit unions 7 percent). When we consider regulations around liquidity that both banks and credit unions must follow, there is an expectation that financial institutions would hold more deposits than the loans they have made.

Although banks and credit unions combined have 6 percent more deposits than they do loans on a national basis, bank loans in each province, other than Ontario, exceed available deposits. As shown in Table 7, there are a lot of bank deposits to be had in Ontario, which is likely the result of having many corporate head offices in this province. This has a significant impact on the business models of credit unions that operate exclusively in their home province as opposed to banks that operate from coast to coast and abroad. It is quite easy to

Table 6: Share of Loans and Deposits (2020) by Various Market Participants

	Domestic Loans (\$Millions)	Share of Loans (percent)	Domestic Deposits (\$Millions)	Share of Deposits (percent)
Royal Bank of Canada	548,215	19	747,734	20
The Toronto-Dominion Bank	484,244	17	660,545	18
The Bank of Nova Scotia	399,952	14	541,589	15
Canadian Imperial Bank of Commerce	343,677	12	418,361	11
Bank of Montreal	275,242	10	407,926	11
National Bank of Canada	149,986	5	195,730	5
Total Tier 1 Financial Institutions	2,201,316	76	2,971,885	81
Credit Unions and Caisse Populaires	422,599	15	451,189	12
All other Canadian Banks	253,668	9	249,892	7
Total Tier 2 Financial Institutions	676,267	24	701,081	19
Total Financial Institutions	2,877,583	100	3,672,966	100

Sources: 2020 Annual reports for six big banks and Desjardins, National Bank supplemental information. Canadian Credit Union Association (CCUA), Fourth Quarter 2020 National Sector Results. OSFI Financial Data for Banks for all other banks.

find GIC rates online for credit unions that are significantly higher than rates offered by the big banks. Table 7 shows that banks have been able to leverage significant Ontario deposits to lend more in other provinces regardless of available deposits. For credit unions, tighter provincial markets for deposits have likely led to higher interest rates

being paid by credit unions⁶ which would have benefited depositors; however, it would also have a negative effect on the ability of credit unions to efficiently finance their respective provincial economies. This could have a material effect on economic development in rural areas that are predominantly serviced by credit unions.

6 Per the *Globe and Mail*, Rob Carrick: A realist's guide to getting the best return on savings and GICs in a painfully low-rate world. October 1, 2020. "There are roughly a dozen alternative banks, trust companies and credit unions offering 1.5 to 1.8 per cent on savings right now. The big banks aren't in the game any longer, and that's starting to stress their clients."

Table 7: Total Loans and Deposits, 2020 (Banks and Credit Unions combined)

	Bank Deposits	Credit Union Deposits	Bank Loans	Credit Union Loans	Bank Deposits / Loans	Credit Union Deposits / Loans
	(\$Millions)				(percent)	
British Columbia	309,245	79,552	379,167	72,595	82	110
Alberta	211,322	23,301	298,553	23,692	71	98
Saskatchewan	42,433	22,900	50,758	19,530	84	117
Manitoba	41,540	34,000	49,781	29,610	83	115
Ontario	1,595,598	62,176	1,246,267	63,480	128	98
Québec	343,342	218,436	364,308	204,621	94	107
New Brunswick	20,569	5,057	27,199	4,511	76	112
Nova Scotia	34,925	3,058	46,201	2,369	76	129
Prince Edward Island	5,310	1,389	6,192	1,125	86	123
Newfoundland	21,176	1,320	22,025	1,066	96	124
Territories	6,080	-	5,518	-	110	N/A
Total Canada	2,631,540	451,189	2,495,968	422,599	105	107

Sources: Statistics Canada: Chartered banks, regional distribution of selected assets and liabilities 2020 and CUA Fourth Quarter 2020 National Sector Results.

Table 8: Profits vs Interest Paid to Customers

	2016-2020 5-yr Average 10 Large CUs*	2016-2020 5-yr Average Desjardins	2016-2020 5-yr Average All Banks
	(percent)		
Pre-tax return on assets	0.54	0.94	0.97
Cost of funds (interest paid / deposits)	1.44	1.10	1.13

* The 10 large credit unions used in the study have a 47 percent share of total system assets in 2020.

Sources: Credit union and Desjardins audited financial statements (2013-2017) and OSFI Financial Data for Banks.

Table 9: Provider of Debt Financing to SMEs

Canadian SMEs	# of employees	Provider of Debt Financing (Canada)	
		Banks (percent)	Credit Unions (percent)
Smallest	1 to 4	69.0	24.0
Smaller	5 to 19	69.3	24.2
Small	20 to 99	70.5	23.2
Medium	100 to 499	86.3	12.6
Agriculture	1 to 499	52.2	33.4

Sources: Statistics Canada 2017 Survey on Financing and Growth of Small and Medium Enterprises.

Table 8 shows that credit unions have a lower pre-tax return on assets (row 1), which partly reflects the higher rates credit unions pay to members on deposits (row 2) as well as significantly less revenue than banks from affiliates such as insurance, wealth products and capital markets. This means credit unions need to find greater efficiency to fund their continued growth. It also might imply that the efficiency gains from competition are being returned to customers.

Within many Canadian provinces, competition is driven by credit unions vying against each other as well as the big six banks. For banking customers who require financial services across provincial borders – frequently large corporate clients – credit unions have the potential to provide an important alternative which isn't currently available. A regulatory framework that would allow more credit unions to operate across provincial borders would provide a competitive alternative to the big six banks for customers who want to deal with a single financial institution operating across the country.

As already mentioned, the role of credit unions in delivering such gains can be particularly

important for both small businesses and rural economic development. Although as seen in Table 1, credit unions and caisses populaires have an overall 15 percent market share of Canadian loans, Statistics Canada's survey of small and medium-size businesses – businesses with fewer than 100 employees, where 70 percent of Canadians employed in the private-sector work – shows that this number jumps for small businesses, and in particular for agricultural businesses (Table 9).

The data from tables 6 through 9 suggest that provincial regulation of credit unions has fostered an environment for the development of a competitive credit union sector, distributing efficiency gains to customers, providing funding to a wide array of businesses, and contributing to economic growth.

Utility (meets the needs of an array of consumers and their interests are protected)

The third objective of financial sector policy is "Utility." In other words, does the sector provide valuable services? It includes the degree to which

Table 10: Diversification of Income

	2016-2020 5-yr Average 10 Large CUs*	2016-2020 5-yr Average Desjardins	2016-2020 5-yr Average All Banks
	<i>(percent)</i>		
Diversification of Income (Other Income / Total Income)	24	58	46

*The 10 large credit unions used in the study have a 47 percent share of total system assets in 2020.

Sources: Credit union and Desjardins audited financial statements (2016-2020) and OSFI Financial Data for Banks.

the sector places the needs of customers at the forefront of their operations, and it speaks to their integrity and transparency, their market conduct and consumer protection.

Credit unions, as shown in the previous section, have been successful at providing regional competition in lending and deposits. However, credit unions outside of Quebec have a significant “other income” gap with banks as shown in Table 10. This means that although credit unions are providing essential banking services (payments, deposits and loans) to the Canadian public and small and medium-size enterprises (SMEs), credit unions outside of Quebec have not been able to generate the same level of success meeting consumer needs in other important areas such as insurance, wealth management, capital markets, consumer loans and payments.

These five very important areas of financial services generate significant fee income (recorded as other income in Table 10) and would allow credit unions to reduce their reliance on net interest income and increase their utility. These areas require significant scale and investments that credit unions outside of Quebec have been unable to achieve within their current regulatory structure.

As technology and innovation moved consumer lending from branches to point of sale, credit unions have seen their market share in these areas shrink significantly. Credit union utility could be

enhanced by providing a regulatory environment that allows them to achieve the required scale to efficiently integrate those missing financial services and national coverage in their offerings. This ability is critical as the banking sector enters a new era of automation.

The technology side of things is also an important consideration with respect to utility. Technology has revolutionized most service industries including news media, movies and music. It has been a slower go in financial services, in part because policy has reflected the understanding that economies cannot afford massive disruption in an industry that is the bedrock of all other domestic industries. However, the next evolution in banking will happen soon. Payments modernization will usher in the future of banking, which will include open banking, artificial intelligence, biometrics and distributed ledger technology.

With so-called “open banking,” Canadians can expect the artificial intelligence algorithms built into applications that have been designed to use data from banking sources, information sharing protocols, and “API” software that allows apps to interact to completely change how they view banking. Canadians will soon expect their mobile device to provide advice on which products best meet their needs and a one-click option to execute on the recommendations. Further, they will expect their mobile device to track in real-time their

progress towards their financial objectives and expect their applications to react to adverse market trends and make appropriate recommendations.

What makes the coming changes different from any previous technological developments is the fact that the very infrastructure within which banking data are shared is being modernized. Until now, the infrastructure used to move money between institutions, the heart of the banking system, rested on technology developed in the 1980s and 1990s. Payments Canada is now making required investments in new payments systems that will move money in real time. Using the ISO 20022⁷ standard will simplify the exchange of information and foster innovation. Combined with new regulations many new participants will find it a lot easier to get in on the action. Payments modernization will change the game for banking.

This time is different and large Canadian financial institutions and Desjardins in Quebec are preparing by investing billions. Canadian credit unions (outside of Quebec) are challenged to keep pace, without the necessary scale.

POSSIBLE WAYS FORWARD

The Status Quo

As this paper has shown, provincial regulatory oversight has coincided with successful, stable, and efficient second-tier financial institutions. Credit unions have been able to provide quality products and technology for their members while maintaining a significant physical presence and accumulating the necessary levels of capital to face risk.

A few credit unions have increased their digital presence going after business in other provinces

either through federally regulated bank affiliates or simply through a digital brand operated directly by the credit union. Although this provides a vehicle to develop business out of province, this structure doesn't allow credit unions to operate branches out of province or merge with out-of-province credit unions, thus limiting the potential for scale.

Will the status quo for regulation be adequate in the future?

As new technological breakthroughs make their way to market, Canadians will continue to require conventional banking services. Trust will have to be built, new technology must be learned, risks must be understood, and human advice will still be needed. Unless credit unions are directly involved in the development of the new digital offerings, they will be left behind, depriving Canadians of important competition in the financial services sector.

In the late 20th century and early 2000s, scale and efficiency were required to meet new capital targets, adapt to new compliance requirements, and to fund required expertise for commercial banking and wealth management. Scale in the credit union industry was achieved through mergers. However, as we saw earlier, these mergers were insufficient to generate the scale required in other areas such as insurance and capital markets.

In order to face new challenges, credit unions are now able to continue federally and thereby merge and expand nationally. However, as we saw above, only two credit unions have continued federally. This begs the question whether federal regulation can create the same continued stability, efficiency and utility the industry achieved under provincial regulation?

7 See International Organization for Standardization: ISO 20022 Financial services – Universal financial industry message scheme: Business Transactions and Message Sets complying with ISO 20022 can be used for electronic data interchange among any industry participants (financial and others), independently of any specific communication network.

How About Federal Credit Unions for All?

In 2012, the federal government adopted regulation allowing credit unions to become Federal Credit Unions. Federal CUs are the only option right now for CUs to operate nationally.

As noted, two credit unions (UNI Financial Cooperation and Coast Capital Savings) have become federal credit unions in the past six years. And at least two others have started down that path.⁸ Those four CUs represent 15 percent of credit union assets and include two of the top 10 largest credit unions in Canada. One of the primary reasons behind the change was the ability to serve their members, their families and their businesses regardless of where they live or move in Canada, as well as to acquire greater scale and to better manage risk.⁹ Unfortunately, for most credit unions, there are many reasons why the federal option just doesn't fit.

Provincial regulators understand cooperation and cooperatives

Federal regulations recognize the need for federally regulated entities to outsource certain activities. These regulations outlined in OSFI's Outsourcing Guideline¹⁰ require that each financial institution (including federal credit unions) retain ultimate accountability for all outsourced activities. Although this sounds perfectly reasonable, provincial regulation, on the other hand, is built around a principle of cooperation where credit union Centrals and affiliates exist to support their credit

unions with liquidity, risk management and shared services. Over time, those shared services have evolved, through Centrals or affiliates, and now usually include technology, payments and wealth management.

This business model cannot be effectively reproduced under federal regulation. Most credit unions (81 percent of credit unions have less than \$1 billion in assets) do not have the scale required to go federal without a Central or affiliate assuming a significant portion of their risk management and compliance responsibilities. The federal regulatory framework does not fully allow this structure.

With the advent of larger extra-provincial credit unions, some harmonization of provincial regulation with particular attention to the role of Centrals, deposit insurers and other system partners will be important to consider as a prerequisite to a passport system.

The squeeze is on provincial regulators

Ultimately, if only smaller credit unions are regulated provincially, there will be a significant challenge for those provincial regulators to upgrade their own regulatory regimes, with a much smaller system available to justify the costs. In BC, the second-largest credit union (Coast Capital) has become a federal credit union and the third largest (First West) is making plans to move as well. Combined, BC's credit union regulator and deposit insurer will have to manage a 35 percent reduction in the size of their system. The New Brunswick

8 From First West Credit Union's 2018 annual report: "First West took an important step to serve our members' interests beyond the borders of British Columbia by submitting the initial information required for becoming a federal credit union to the Office of the Superintendent of Financial Institutions (OSFI)." From Innovation Credit Union's 2018 annual report: "We submitted our formal application to be a federal credit union to the Office of the Superintendent of Financial Institutions (OSFI) and we continue to review our application with OSFI to ensure we are ready to make the transition."

9 December 14, 2016, press release by Coast Capital Savings.

10 OSFI B10 Outsourcing Guideline states "...this Guideline operates on the premise that FREs retain ultimate accountability for all outsourced activities."

Table 11: Impact of Business Model on Selected Key Ratios

	2016-2020 5-yr Average 10 Large CUs*	2016-2020 5-yr Average Desjardins	2016-2020 5-yr Average All Banks
	<i>(percent)</i>		
Pre-tax return on assets	0.54	0.94	0.97
Cost of funds (interest paid / deposits)	1.44	1.10	1.13
Diversification of Income (Other Income / Total Income)	24	58	46

* The 10 large credit unions used in the study have a 47 percent share of total system assets in 2020.

Sources: Credit union and Desjardins audited financial statements (2016-2020) and OSFI Financial Data for Banks.

regulator is currently dealing with an 80 percent drop in their system assets.

While regulators around the world need to keep up with emerging risks and oversee an increasingly interconnected industry, provincial regulators will be doing so with limited resources. This could lead to higher costs being borne by the remaining provincial credit unions, institutions for which going federal would not make sense.

Business models

Provincial regulators expect credit unions to maintain a 5 percent leverage ratio in each province except Ontario where the leverage ratio is set at 4 percent (Hessou 2016).¹¹ These ratios represent higher levels of capital than the 3 percent required federally, despite less complexity and simpler products at provincial operations. On the flip side, provincial regulators mostly provide higher deposit

insurance, simpler capital and liquidity calculations, simpler data requirements, and simpler recovery/ resolution requirements. Some provinces also allow CUs to market different types of insurance products. These different regulatory regimes have led to different business models which can be observed by comparing different metrics.

Table 11 shows that credit unions pay, on average, 31 basis points more on deposit accounts than do Canadian banks (1.44 percent - 1.13 percent). Credit unions are mostly able to offset this by not having to pay large dividends to shareholders.

Despite greater ability to market insurance products in some provinces, credit unions have not been able to diversify their revenue away from net interest income as much as banks have, as shown previously in Table 10. Credit unions generate roughly 24 percent of their income from sources other than net interest income. Banks, on the other

11 The Financial Services Regulatory Authority of Ontario (FSRA) is proposing a change which will reduce the leverage ratio requirement for Ontario credit unions to 3 percent to be effective once the new *Credit Unions and Caisses Populaires Act*, 2020 is proclaimed into force.

hand, generate 46 percent of their income from other sources.

Other than higher interest rates on deposits, credit unions also typically have a much stronger presence in rural areas, including the resources required for managing small business loans in areas underserved by banks. Part of this commitment to rural areas can be traced back to the origins of the credit union system. As well, the provincial regulatory regime in large part was built and evolved to balance the needs of members and their communities with the stability of the system.

Credit unions that chose to become federal expect that the change will have positive impacts on their members overall.¹² Others are concerned that impacts on deposit insurance, insurance networking, and reliance on Centrals and other system partners would have significant impacts on their business models. Many large credit unions may not want to put their current successful business models at risk by making the switch to federal regulation.

Financial Corporation Capital Tax

Many provinces (Saskatchewan, Manitoba, New Brunswick, Nova Scotia, Prince Edward Island and Newfoundland) apply capital taxes to large financial institutions. In these provinces, capital tax rates are applied to capital used in each respective province. In most provinces, the capital tax will apply to federal credit unions. For example, a federal credit union in Manitoba with 100 percent of their operations in that province would have to pay 6 percent of their capital in taxes every year, whereas

this tax doesn't apply to provincial credit unions. With higher relative levels of capital, this federal credit union will face a very significant annual capital tax expense. This situation will make it all but impossible for credit unions in those provinces to become federal credit unions.

Notably, the province of New Brunswick has amended its capital tax legislation to exclude federal credit unions, thereby facilitating the creation of the first Canadian federal credit union, UNI, which has substantially all its operations in that province.

Demutualization

The purpose of a credit union, like any cooperative, differs from public corporations, in that it focuses on serving members' needs. Demutualization, which credit unions can choose to do under federal regulation, changes their purpose from member needs to profit seeking. Provincial regulation, on the other hand, doesn't spell out the rules or expectations for demutualization.

Some credit unions may avoid federal regulation to ensure the credit union remains a cooperative. Credit unions don't have the same ability to raise capital as do Canada's larger banks.¹³ In a scenario where capital has been depleted, provincial credit unions typically rely on mergers or provincial stabilization funds to address their shortfalls. Federal credit unions will no longer have access to provincial stabilization and fewer potential partners for mergers. They may find the demutualization option very tempting to access required capital, as a change to profit-seeking will attract more investors.

12 "It is here, in New Brunswick, that we gave ourselves the means, as an institution, to increase our agility and better answer the needs of our members and customers." July 4, 2016, press release of UNI Financial Cooperation. "Becoming a federal credit union will allow Coast Capital Savings to serve members better, enter new markets, attract new members, better manage risk through diversification, and compete more effectively in a rapidly changing marketplace." Dec 14, 2016, press release of Coast Capital Savings.

13 Although Desjardins and other large cooperative banking groups have found ways to access outside capital, those strategies are beyond the scope of this paper.

Another scenario may be that OSFI determines that a federal credit union is no longer viable and cannot be restored, with the Canada Deposit Insurance Corporation (CDIC) potentially compelled to sell the assets of the credit union to a traditional bank. This would differ from a similar situation under provincial regulation. The protection of the cooperative purpose of credit unions isn't part of the mandate of federal regulators. Provincial regulators would use stabilization funds, which have been accumulated through premiums paid by credit unions, and mergers with other credit unions, as their preferred resolution mechanism, which keeps the assets in the provincially regulated credit union sector.

Effort required to become a federal credit union

Financial institutions, whether provincial or federal, are subject to very significant regulations, but they are different. Plus, those regulations evolve continuously. The usual process for new regulations begins with a declaration of intent by the government, followed by a consultation period, an expert committee, industry input, draft regulations, further consultations, transition periods, etc.

For example, the federal government first indicated their interest in exploring open banking when they presented their 2018 federal budget. In January of 2020, the advisory committee presented its first report and recommendations. A second phase then started with the advisory committee working with stakeholders to identify implementation considerations. A final report was tabled in April 2021 and the advisory committee is suggesting that the initial phase of open banking could be implemented in 18 months (January 2023), with nine months for design and nine months for implementation. The finalization of legislation and regulation is expected to take longer

than 18 months. Although those timelines may be quite ambitious, banks and other stakeholders have already been fully immersed in the project and they have been preparing. They have an idea of what to expect, and they have invested in the changes. When new regulations are introduced, they will be given additional time to become compliant. These changes will have a very significant impact on the industry and banks will have had somewhere around five to seven years to consider, assess, plan and implement the new regulations.

Credit unions making the switch to federal regulation not only have to comply to new regulations that are in the works, they also have to assess the impacts of over 3,000¹⁴ current federal bank regulation requirements and adjust their practices for all the differences to their current rules. Although many of these requirements already apply to credit unions, such as anti-money laundering (AML), *Foreign Account Tax Compliance Act* (FATCA) and Common Reporting Standards (CRS), most are different. It is one thing to integrate a revised guideline with 20 or 30 new requirements that have been in the works for two or three years. It is altogether different to assess 3,000 requirements all at once.

When we look at the history of Canadian credit unions, there is no evidence to suggest that current regulations need a complete overhaul to mitigate risks in the system. Remember, credit unions came through the 2008 financial crisis with barely a hiccup (Table 5). However, the requirement for wholesale change to policies and processes is the current cost of obtaining a national licence. Although some credit unions may decide it is a fair price to pay, many credit unions will find that the costs are unaffordable.

Aside from the cost, executives and board members of both existing federal credit unions,

14 Based on my experience with credit unions assessing the impact of federal requirements.

Coast Capital and UNI, have indicated that making the switch to federal regulation is also a very significant time commitment, up to 10 years between initial strategic consideration to continuance, full compliance and new normal. This is a 10-year allocation of executive and board attention drawing resources away from member services and responding to the threats from competition and technology.

For all these reasons, at best it would take many years for the credit union system to gain the full advantages of a national market by using the federal credit union option. Federal regulation of credit unions works for some, but is an insufficient regulatory response for the continued stability, efficiency and utility of this very important industry. Therefore, we ask whether there is a better way.

PASSPORT SYSTEM: A NEW PATH FORWARD

A regulatory passport system like the one in Europe or in the Canadian securities industry may be a better path. Both of those groups rely on a passport system that allows entities licensed in one jurisdiction to operate in all other participating jurisdictions. Extra-provincial credit union legislation exists and has existed for 25 years or more in most provinces, and those laws could be viewed as the building blocks to a passport system. As it currently stands, no provinces allow extra-provincial credit unions to merge with a local credit union and continue operations in each province. However, in Ontario, Manitoba and Nova Scotia they could be close. In those provinces, legislation permits extra-provincial credit unions to register in multiple provinces provided agreements are in place for reciprocal rights for any purposes specified in the agreement. However, thus far, no substantive reciprocal rights have yet to be agreed to between any provinces.

Fully implementing such a model in the credit union sector would allow credit unions licensed

in one province to operate in all participating provinces. With reciprocal agreements in place, this system would allow credit unions to merge with credit unions in other provinces or open additional branches outside their home provinces, providing them with greater scale.

Not only will this allow them to invest in new technology and innovation for their members, it will also provide better diversification of their credit and liquidity risks. Scale also means more expertise and enhanced ability to market other products and services to their members, thereby increasing their utility and diversifying their revenue sources. A passport system would contribute to the credit union sector's stability, efficiency and utility.

Is the Passport System Just a Way to Avoid Federal Regulation?

Although most credit unions are regulated provincially rather than federally, provincial regulation covers the same issues as covered in federal regulation of banks such as prudential matters and market conduct. Credit unions are also subject to many federal regulations such as anti-money laundering, privacy, anti-spam legislation, the foreign account tax compliance act and others. Both provincial and federal regulatory regimes will continue to adapt to changes happening elsewhere. This paper suggests that the passport system proposed here is a better way to provide both the regulators and the credit unions the scale they need to adapt far into the future.

The passport system should be assessed based on the three public policy objectives outlined in federal government consultation papers on financial-sector reform, which, as described earlier in the paper, are stability, efficiency and utility. This paper suggests that those priorities are best met through the continued evolution of the regulatory regime for credit unions, in which the passport system could be the next step.

The Example of the Securities Industry¹⁵

Like the credit union industry, regulation of the securities industry is a provincial responsibility. Canada does not have a national securities regulator although there has been debate over the need for one for decades. Almost 20 years ago, in order to address some inefficiencies in the system, provincial regulators created the Canadian Securities Administrators (CSA). Although in existence prior to that, in 2003 they organized themselves more formally and started work on a passport system, the harmonization of regulation and the creation of national self-regulatory organizations to oversee the industry.

Having gained maturity as an industry, many members of the CSA were backing the creation of the Cooperative Capital Markets Regulatory System with the inclusion of the federal government as part of the cooperative structure. The expectation was that this initiative would better protect investors, enhance Canada's financial services sector, support efficient capital markets, and strengthen the management of systemic risk.¹⁶

Although execution of the plan remains quite challenging (implementation has been paused), in 2019 the Supreme Court of Canada ruled in favour of the constitutionality of the new structure despite provincial responsibility for the securities industry. In its decision it wrote that "The preservation of the integrity and stability of the Canadian economy is quite clearly a matter with national dimension, and one which lies beyond provincial competence." This decision effectively delineates between provincial and federal jurisdiction. A passport system in the credit union industry could ultimately involve a single

regulator overseen by the provinces with a certain level of systemic risk oversight by federal regulators.

Provincial regulators continue to have responsibility for the stability and the market conduct of the securities industry. The prudential standards for market participants and the conduct of the individuals selling securities and investment funds are governed by national standards and rules set by the CSA. Although in the securities industry those standards and rules are overseen by three (soon to be two) self-regulatory organizations (SROs), recent surveys¹⁷ suggest the public would have greater confidence in an organization governed by an independent body or regulators. This is the suggestion we would put forward for the governance of a cooperative organization overseeing the credit union industry.

In the securities industry, harmonized regulation and oversight enables market participants licensed in one province to have automatic access to the markets in other jurisdictions. The outcome of this approach is that it is much easier for investment and mutual fund dealers to have a national presence, strategy, and scale. In fact, most significant dealers have operations across many or all provincial borders.

Over the past few years, many credit unions such as First West Credit Union in British Columbia, Connect First Credit Union in Alberta and Alterna Savings in Ontario have been implementing multi-brand business models within their provincial borders in order to retain greater proximity to their members, all while providing greater scale for operating efficiencies and investment that also directly benefits their members. This operating model will likely work well in a national organization.

15 <https://www.securities-administrators.ca/aboutcsa.aspx>.

16 <http://ccmr-ocrmc.ca/>.

17 "What Canadian investors want in a modern SRO," September 8, 2020. <https://mfda.ca/news-release/invsro/>.

Lessons learned in the securities industry would be very valuable in developing a passport system that works for Canadian credit unions.

The Example of Eurozone Banking¹⁸

Another opportunity for a potential credit union passport system to imitate and amend based on lessons learned is the passporting of banking services in Europe, which began in 1993. The ultimate outcome, where European banks from one country can open branches or merge with a bank from another European country has been achieved.

However, despite the harmonization of some regulations from the outset such as capital and deposit insurance minimums, progress towards a truly harmonious prudential banking system in Europe has taken too much time. Furthermore, the 2007-2008 financial crisis exposed several weaknesses, including the willingness of inward looking home governments to stand by their banks in times of stress. It took the sovereign debt crisis beginning in 2010 to achieve significant progress on the harmonization of regulations. And, in 2014, the European Central Bank (ECB) became the principal regulator in Europe and a lender of last resort (LOLR) fund was established by it to assist with resolution of troubled financial institutions.

However, an agreement on deposit insurance schemes remains elusive. In Europe, the home country remains solely responsible for providing deposit insurance and must consider their own ability to secure deposits their financial institutions have accumulated in other countries. This will be critical to work out in Canada if a passport system here is to be considered.

Table 12 provides an overview of the key dates to the European banking union.

Implementation of a Passport System for Credit Unions

Theoretically, applying similar agreements to provincial credit unions in Canada would be much simpler than in Europe. Provincial regulatory authorities already share information and have similar guidelines. Fiscal policies and relative strengths of provincial economies are also arguably much more homogeneous here than in European countries.¹⁹ European countries didn't even have a common currency when they first opened their borders for banking services. The inherent risk of the exercise to domestic economies would also be significantly less: Canadian credit unions have a 23 percent Assets/GDP ratio, whereas European banks have a 176 percent Assets/GDP ratio. Having said that, it will be critically important that each province monitor its ability to assume the risks undertaken by their home province financial institutions and that there is a national assessment of systemic risk.

What could the implementation of a passport system in Canada look like? At least from a step by step perspective, the Eurozone banking model seems most appropriate. As stated above, one of the lessons learned is that change is difficult, and a crisis is often required to generate true transformation. Will the impact of the technological revolution in the financial services sector be sufficient for change? What about the impact of the COVID-19 pandemic on small and medium-sized businesses? Will that be sufficient to create the impetus for

¹⁸ <https://eba.europa.eu/about-us>.

¹⁹ While federal equalization has likely contributed to more homogenous economies, the gap in GDP (PPP) per capita in Canadian provinces is much narrower compared with Eurozone countries: \$40K to \$68K in Canada (source: Statistics Canada), versus \$24K (Bulgaria) to \$120K (Luxembourg) (source: IMF).

change for Canadian regulators and the credit unions they regulate? If the political will is there, this is a path that can be taken.

Short term (1 to 3 years)

In 1993, almost 10 years before Euro coins and notes started circulating, before any efforts towards harmonizing banking regulation, European banks were allowed to operate and merge across countries in the European Union. In Canada, since provinces already share a currency and have similar legislative and budgetary frameworks, allowing credit unions to merge and operate across provincial boundaries would be comparatively easy, and we should expect much of the heavy lifting to be done in the first one to three years.

Licensing and mergers could be allowed with a minimum set of standards such as capital and deposit insurance minimums agreed to from the outset. Those minimum requirements should include standards designed to mitigate any sovereign risk issues faced by out-of-province deposit holders such as minimum size of provincial ex-ante deposit insurance funds. Mergers would need to be approved by the home province regulator of the resulting credit union, with supervision and deposit insurance also provided by the home province. Credit unions would need to have clear signage in branches and digital channels identifying the entity providing their members with deposit insurance and brochures describing the coverage provided and contact details.

Deposits in credit unions are protected by provincial deposit insurance funds. If a credit union operating in multiple provinces fails, who pays? That is a critical question that must be addressed from the outset. This paper suggests the home province provides the deposit insurance. However, not all provincial deposit insurers have the same capacity nor do all provincial governments formally back up their deposit insurance funds. This would have to be addressed.

One possible path would be having credit unions that have exceeded a certain threshold (based on the financial capacity of their respective provinces) moved to CDIC and OSFI oversight, without changing their regulatory framework. If this is the chosen path, then OSFI would need to be a partner in the harmonization of regulation including those surrounding deposit insurance coverage.

Most Canadian provinces have regulations for credit unions that are similar to one another (the exception being Quebec). An interprovincially governed regulator established for overseeing the larger multi-provincial credit unions, with the authority to intervene, would be a logical second step. Providing provinces the choice to immediately opt in to this interprovincial regulator for oversight of all home province credit unions should also be considered.

Since Emergency Lending Assistance (ELA) funds are already a concern in many provinces, this should be a priority for the new interprovincial regulator. Troubled credit unions should provide collateral to cover advances of ELA funds, and the home province deposit insurer should also be guaranteeing the emergency lending assistance, which would only be provided to credit unions considered by the interprovincial regulator as solvent. In a rare case of insolvency, financial assistance, mergers, asset sales and liquidation would continue to be the tools used by provincial deposit insurers to resolve the matter.

Mid term (3-5 years)

Substantial harmonization needs to consider the impacts on credit union members and operations. Priority should be given to harmonizing regulations as it becomes practical to do so. Since most provincial regulatory frameworks are quite similar, substantial harmonization may be expected in a three to five year timeframe. This harmonization includes rules around deposit insurance. A single rulebook for Canadian credit unions might take a bit longer.

Table 12: Key Dates for Passporting and Single Rulebook in Europe

When	Banking Licence (passport)	Harmonization of Prudential Regulation	Prudential Supervision of Solvency and Major Risks	Harmonization of Resolution and Deposit Insurance Regulation	Lender of Last Resort (LOLR) or Emergency Lending Assistance (ELA) Funds	Deposit Insurance	Comments
Pre-1993	Home Country	None	Home Country	None	Home Country	Home Country	European banks can only operate in their home province.
1993	Europe	Some	Home Country	Some	Home Country	Home country	In 1993, the 1989 banking directive is in force and a bank licensed in one European country can operate in any other European country.
1999	Europe	Some	Home Country	Some	Some Euro, most home country	Home country	In 1999, the ECB declared that the intervention by the Eurosystem is explicitly recognized in the case of a liquidity crisis. But “constructive ambiguity” can limit the associated problem of moral hazard. So no additional clarifications should be forthcoming.
1999	Europe	Some	Home Country	Some	Some Euro, most home country	Home country	In 1999, European countries signed a multilateral MOU regarding information exchange and supervisory procedures about cross-border activities.
2014-2016	Europe	Most	Europe for significant FIs*, home country for others. Europe can decide to directly supervise any.	Most	Europe	Home country	
2020	Europe	Most	Europe for significant FIs*, home country for others. Europe can decide to directly supervise any.	Most	Europe	Home country	Nothing much has changed. A lot of discussion around a European deposit insurance scheme. Germany doesn't want it. They don't want exposure to other countries risks. European Central Bank (ECB) is pushing for it but politics are getting in the way.

* The decision on whether a bank is deemed significant is based on a number of criteria. There are currently 117 significant banks representing 82% of banking assets in the Euro area. They include all FIs with total assets in excess of €30 billion (\$46 billion Cdn).

Sources: De Rynck, Stefaan. 2014. “Changing Banking Supervision in the Eurozone: The ECB as a Policy Entrepreneur” College of Europe Department of European Political and Administrative Studies, Bruges Political Research Papers 38/2014; Canepa, Francesco, and Koranyi, Balazs. 2018. “Euro central bankers renew call for common deposit insurance”, Thomson Reuters. September 4, 2018; Vives, Xavier. 2001. “Restructuring Financial Regulation in the European Monetary Union”; Vives, Xavier, *Journal of Financial Services Research* 19:1 57-82, 2001.

Table 13: Possible Timeline for Credit Union Passporting

When	Banking Licence (passport)	Harmonization of Prudential Regulation	Harmonization of Market Conduct Regulation	Prudential Supervision of Solvency and Major Risks	Harmonization of Resolution and Deposit Insurance Regulation	Emergency Lending Assistance Funds	Deposit Insurance
Current State	Home Province	Some	Some	Home Province	Some	Home Province	Home Province
1-3 Years	Participating Provinces	Minimum Capital and Liquidity	Some	Interprovincial Regulator	Minimum Deposit Insurance	Interprovincial Fund	Home Province Minimum Fund Size
3-5 years	Participating Provinces	Most	Most	Interprovincial Regulator	Most	Interprovincial Fund	Home Province Minimum Fund Size
5 plus	Participating Provinces	Most	Most	Interprovincial Regulator	Most	Interprovincial Fund	Interprovincial Fund

Sources: Source: Author's compilation.

Longer term (5 years +)

A single deposit insurance scheme applying to all Canadian credit unions with a pooling of risks and claims will require a certain amount of time for the standardization to have taken effect and work its way through the individual credit unions. Until then, provincial authorities may be hesitant to accept risks that were taken under previous standards and regulations. Five years after substantial harmonization of rules and cooperative oversight might be a reasonable timeframe.

Following this rough schedule would mean Canadian provinces accomplish a goal European banking authorities have tried to reach for the past 30 years, in roughly 10. Considering the commonalities that exist between provinces, this should be feasible.

CONCLUSION

Credit unions play a very significant role in the Canadian economy. Canadians benefit from a robust credit union system providing competition and choice with deep roots in areas typically underserved by the largest Canadian banks.

Canadian financial institutions are investing billions in digital transformation, and if credit unions are to continue playing their very important role, they also need to prepare for the digital banking future.

Collectively credit unions have the capacity to scale up to make the necessary investments. However, they are constrained by the provincial regulatory system. Federal regulators have stepped up and provided a path for credit unions to become federal credit unions and thereby expand nationally.

Although some credit unions are choosing this route, for many this way forward is not viable.

This paper suggests that a passport system, like the one used for banking in the Eurozone and in the securities industry in Canada, is a better alternative. A passport system would allow provincial credit unions to operate in any participating province. It must balance the need to provide the necessary regulatory framework, while providing an important alternative for credit unions to achieve the scale required in today's environment. That scale could come either through extra-provincial mergers, through more effective collaboration, or through an extension of their current activities to other provinces. That scale is critical for facing new challenges and investing in the technology required in a world of open banking

and artificial intelligence. Setting up credit unions to respond to new challenges will ensure they continue to provide competition and choice to Canadians.

Moreover, a cooperative approach to oversight would give provinces the required resources to oversee this important second-tier financial services provider, pave the way for the harmonization of regulations, enhance oversight, improve their data gathering ability and may even lead to the merger of provincial deposit insurers.

The paper concludes that a passport system will help maintain and enhance stability, competition, innovation and choice to Canadians, particularly individuals and small businesses.

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