

**GUIDELINE FOR PRUDENT INVESTEMENT AND LENDING
POLICIES AND PROCEDURES
FOR ONTARIO'S
CREDIT UNIONS AND CAISSES POPULAIRES**

**Ministry of Finance
March 1, 1995**

Pursuant to subsection 191(2) of the Credit Unions and Caisses Populaires Act, 1994 all credit unions and caisses populaire shall ensure that their investment and lending policies and procedures (the "Standards") include the following standards, conditions and restrictions:

- 1 The Standards developed pursuant to s. 190 of the Act must be reviewed and approved by the credit union's board of directors and include written evidence of that approval.
- 2 The Standards must be effectively communicated to those persons responsible for their implementation.
- 3 The Standards must require regular (at least monthly) monitoring for adherence to risk management procedures, and establish a process for correcting any deficiencies found. The responsibility for the implementing and monitoring adherence to these Standards may be delegated only to those with appropriate levels of experience.
- 4 The Standards must require at least an annual review of risk management procedures by the audit committee to assess whether they are being followed and how effective they are.
- 5 The Standards must set out the objectives of a credit union's lending and investing programs and the levels of risk it is willing to assume in each area. They may also specify areas of risk the credit union is not prepared to enter.
- 6 The Standards must include written procedures for each significant area of risk to which a credit union may be exposed and describe, at least:

the levels of authority, responsibility and accountability to be delegated to individuals or committees to manage the different areas of risk, including the maximum amounts that these individuals are authorized to lend or invest

- the process for making the lending or investing decisions and the documentation of those decisions
- the process, frequency and format for reporting portfolio positions and the operating results in each area of risk

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the methods for valuing, recording and safeguarding investments and loans.

The Standards must specify limits and acceptable ranges of aggregate investments in different classes or types of instruments as prescribed by the regulations under the Act.)

8. The Standards must specify the acceptable level of quality of the instruments eligible for investment within the classes noted in paragraph 7. Credit unions may use ratings from recognized rating agencies to set quality criteria for their investments. Internal criteria should be set for non-rated investments.
9. The Standards must impose limits for investments based on concentrations of exposures, where appropriate,
 - in geographic areas and/or economic sectors
 - in foreign investments
 - in foreign currencies
 - to individual and connected persons as defined in the regulations under the Act.
10. The Standards must set exposure limits on investments in hedging products and other derivative instruments in accordance with Appendix I.
11. The Standards must set limit on aggregate lending, in any form, by class or type of loan, within the terms of the lending licence(s).
12. The Standards must establish limits, within the terms of the credit union's lending licence(s), on loans acquired through brokers and other external sources such as syndications.
13. The Standards must impose, within the aggregate and individual portfolio limits prescribed by the regulations under the Act, lending limits on concentrations of exposures based on the following criteria or categories:

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- counterparties in investment and lending transactions
 - to directors, officers and employees
 - to borrowers within credit rating bands.
- 14 The Standards must take into account the credit union's policies and procedures on interest rate risk management.
- 15 The Standards must, with appropriate modifications, apply to a credit union's subsidiaries.
- 16 The Standards must take into account the credit union's policies and procedures on restricted party transactions.

APPENDIX I

Definition

Derivatives are financial contracts whose values are derived from the value of an underlying asset or index such as : interest rates, exchange rates, commodities, equities and options.

Derivatives allow credit unions and caisses populaires to identify, isolate and separately manage the market risks in financial instruments for the purpose of hedging, speculating, arbitrating price differences and adjusting portfolio risks. The risks associated with derivatives include market risk (currency, interest rate risks and market price risk), credit risk and liquidity risk.

Credit union and caisses populaires may only use derivatives for hedging as part of their asset and liability management. Prior to entering into a derivative contract, credit unions and caisses populaires must identify these types of contracts in their written policies and procedures as a permitted investment and, as a minimum, address the following items:

The credit union/caisse populaire's policies and procedures for derivative products must specify that derivatives may only be used for hedging purposes. Hedging is defined as follows:

Hedging

In determining whether a position is a hedge, the credit union/caisse populaire must ensure that:

- the position to be hedged is specifically identified and exposes the credit union to risk of loss from price/interest rate changes;
- the instrument is specifically designated as a hedge as evidenced by the board minutes and management reports;
- it is clearly stated that changes in the fair value of the instrument designated as a hedge and opposite changes in the fair value of the position being hedged will correlate closely, so that the hedging instrument will be effective in eliminating or substantially reducing the risk of loss from the position being hedged.

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Note: Fair value is the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction.

Role of the Board of Directors

The board of directors or a subcommittee of the board should approve and annually review all significant policies governing a credit union's or caisse populaire's use of derivatives.

The policies should

authorize for specific individuals to transact and manage the level of risk exposure;

establish a process for such authorized persons to report on derivative transactions;

- specify the objectives and the risk exposure limits taking into consideration
 - the profitability and capital level of the credit union or caisse populaires;
 - the credit union/caisse populaire's business strategy
 - the volatility, marketability and potential loss from the derivative product,
 - the level of expertise of its management and trading staff.
- quantify the level of risk exposure based on clearly identifiable targets e.g. rates of return, entry/exit prices, etc.

describe appropriate corrective action when the credit union's use of derivative products contravenes approved policies and when the level of risk exposure exceeds approved limits.

The Role of Management

Management is responsible for identifying all potential risk associated with the derivative product (e.g. market, liquidity, price) and developing risk limit policies for approval by the board of directors. Management must also:

- actively monitor transactions and positions for adherence to policy limits.

develop analytical models and valuation systems to assess the level of risk exposure;

design hypothetical scenarios to measure the impact of market conditions that may adversely affect the financial position of the credit union/caisse populaire;
- review the performance of the derivative product in mitigating the identified risk;
- review the performance of analytical models and valuation systems against actual experience;

develop all other necessary operational procedures to ensure that appropriate systems and, controls are in place to safeguard the credit union's or caisse populaire's assets and that only authorized transactions are entered into;

regularly review the current and future information systems requirements for investments by the credit union or caisse populaire;

ensure compliance with regulatory, tax and legal requirements;
- report to the board at least monthly on all of the above items.

Disclosure

The credit union is responsible for

- establishing policies and procedures for recording and presenting derivative transactions;
- ensuring that the accounting practices for derivative products complies with the requirements of the Act, Regulations and Guidelines.