4711 Yonge Street
Suite 700
Toronto ON M2N 6K8
Telephone: 416-325-9444
Toll Free 1-800-268-6653
Fax: 416-325-9722

4711, rue Yonge
Bureau 700
Toronto (Ontario) M2N 6K8
Téléphone : 416 325-9444
Sans frais : 1 800 268-6653
Télécopieur : 416 325-9722

Ontario
Deposit Insurance Corporation of Ontario
Société ontarienne d'assurance-dépôts

Capital Adequacy Guideline

for Ontario's Credit Unions and Caisses Populaires

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The *Credit Union and Caisses Populaires Act, 1994* and Ontario Regulation 237/09 incorporates by reference this *Capital Adequacy Guideline for Ontario's Credit Unions and Caisses Populaires*. Compliance to this Guideline is therefore required in the same manner as compliance to the incorporating Act and Regulation.

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Total Assets – other amounts to be deducted [s. 16(1)]

Under the Regulation, the total assets of a credit union is calculated by adding all of the credit union's assets and then subtracting the amounts listed in the Regulation including the amounts set out in this Guideline. Amounts to be deducted from total assets are:

- After-tax fair value gains (losses) on own-use property on conversion to the International Financial Reporting Standards (IFRS), where the cost model is used;
- Accumulated net after-tax revaluation loss on own-use property accounted for using the revaluation model; and
- The amount of any defined benefit pension fund that is an asset on the balance sheet of the credit union or league.

Total Assets - Equity Method of Accounting [s.16 (2) 3]

Under the Regulation, a credit union must calculate an investment in the shares of a subsidiary using the equity method of accounting described in this Guideline.

Under the equity method of accounting, the credit union initially records its investment in the subsidiary at the original cost of the investment. The recorded value of the investment is then adjusted to include the credit union's pro-rata share of the net income earned (or loss incurred) by the subsidiary since the date of the acquisition, less the amortization of goodwill and dividends received from the subsidiary.

Credit unions with investments in subsidiaries are required to ensure that all asset and liability values of subsidiaries are determined in accordance with generally accepted accounting principles for each reporting period and that any impairment in values is properly reflected in investment carrying values.

ACQUISITION COST	$XXX
PLUS: Post acquisition pro-rata share of net income (loss) including other impairment losses of the subsidiary at the reporting date	XXX
LESS: Amortization of goodwill	(XXX)
Dividends Received from Subsidiary	(XXX)
VALUE OF INVESTMENT IN SUBSIDIARY	$XXX

Tier 2 Capital [s. 17(3) 6]

The Regulation provides that the calculation of Tier 2 Capital is to include any other amount set out in this Guideline. The following amount is to be deducted from Tier 2 Capital:

- Accumulated actuarial losses for any defined benefit pension fund liability included on the balance sheet of the credit union or league where the losses have been accounted for through accumulated other comprehensive income (AOCI) and have not been deducted from retained earnings.

Value attributed to off balance sheet exposures [18(3) 6, 18(4) 3, 18(5) 4, and 18(6) 5]

In order to determine the value attributed to any off balance sheet exposure relating to assets listed in each of the risk weight categories in subsections 18(3) to 18(6), the face amount (notional principal amount) of the exposure must be first multiplied by an appropriate credit conversion factor. The credit conversion factors are listed below.

100% Conversion factor

- *Direct credit substitutes*, as described in Appendix 1 to this Guideline
- Acquisitions of risk participation in bankers' acceptances and participation in direct credit substitutes (for example, standby letters of credit)
- Sale and repurchase agreements
- *Forward asset purchases*, as described in Appendix 1 to this Guideline

50% Conversion factor

- *Transaction-related contingencies* as described in Appendix 1 to this Guideline
- *Commitments*, as described in Appendix 1 to this Guideline, with an original maturity exceeding one year, including underwriting commitments and commercial credit lines
- Open-ended *commitments* that are cancellable by the credit union at any time subject to a notice period

20% Conversion factor

- *Trade-related contingencies*, as described in Appendix 1 to this Guideline
- *Commitments,* as described in Appendix 1 to this Guideline, with an original maturity of one year or less

0% Conversion factor

- *Commitments,* as described in Appendix 1 to this Guideline, that are unconditionally cancellable at any time by the credit union without prior notice or that effectively provide for automatic cancellation due to deterioration in the borrower's creditworthiness. This includes undated or open-ended commitments, such as unused credit card lines, personal lines of credit, and overdraft protection for personal chequing accounts that are unconditionally cancellable at any time.

Example:

A credit union has an off-balance sheet exposure consisting of a commitment expiring in less than one year of a $500,000 agricultural loan.

Since a 20% conversion factor applies to commitments with an original maturity of one year or less, the value of this off-balance sheet exposure is determined by multiplying the face value of the commitment by a 20% conversion factor.

Example: Off-Balance Sheet Exposure

Face amount/Notional principal amount	$500,000
Conversion Factor	20%
Value of the off balance sheet exposure	$100,000

This value is then assigned a risk weight in the manner required by the Regulation as illustrated below:

Example: Off-Balance Sheet Exposure

Value of the off balance sheet exposure	$100,000
Risk Weight for Agricultural Loan as per 17(5) 5 of Regulation	75%
Risk weighted amount	$75,000

Credit ratings for commercial loans and securities [18(7)]

The Regulation provides that commercial loans are risk-weighted at 100 per cent or must be risk weighted in accordance with this Guideline if the person to whom the commercial loan is made has a credit rating described in this Guideline.

The following table sets out the risk weighting for a commercial loan made to a person who has received the indicated credit rating by an external credit rating agency. Credit unions should use the same rating agency for both risk weighting and risk management purposes. If a credit union chooses two ratings agencies whose rating corresponds to different risk weights, the higher risk weight should be applied.

Table 1: Credit Ratings

Risk Weight	External Credit Rating Institution		
	DBRS	**S&P/FITCH**	**Moody's**
20%	AAA to AA (low)	AAA to AA -	Aaa to Aa3
50%	A (high) to A (low)	A+ to A-	A1 to A3
100%	BBB (high) to B (low)	BBB+ to B-	Ba1 to B3
150%	CCC	Below B-	Below B3

Privately insured residential mortgages [18(8)]

Table 1 is to be used to determine the risk-weighting of the portion of the residential mortgage loan described in subsection 18(8) of the Regulation.

Liquidity [20(4)4.ii]

Table 1 also sets out equivalent ratings to the Dominion Bond Rating Service (DBRS) for the purposes of 20(4) 4(ii) of the Regulation.

Appendix 1

Further clarification on commitments etc.

1. Direct credit substitutes

Direct credit substitutes include guarantees or equivalent instruments backing financial claims. With a direct credit substitute, the risk of loss to the credit union is directly dependent on the creditworthiness of the counterparty.

Direct credit substitutes include guarantees or obligations of the member and include:

- Guarantees given by the credit union on behalf of members to satisfy a member's financial obligations should the member fail to do so, such as:

  - payment for existing indebtedness for services
  - payment with respect to a purchase agreement
  - lease, loan or mortgage payments
  - payment of uncertified cheques
  - remittance of (sales) tax to the government
  - payment of existing indebtedness for merchandise purchased
  - payment of an unfunded pension liability
  - reinsurance of financial obligations,

- Standby letters of credit or other equivalent irrevocable obligations, serving as financial guarantees for, or supporting, loans and securities
- Risk participation in bankers' acceptances and risk participation in financial letters of credit. Risk participation constitutes guarantees by the participating institutions such that, if there is a default by the underlying obligor, they will indemnify the selling institution for the full principal and interest attributable to them

2. Forward Asset Purchases

A forward asset purchase is a commitment to purchase a loan, security, or other asset at a specified future date, usually on prearranged terms, and includes financing facilities with certain draw-down.

3. Transaction-related contingencies

Transaction-related contingencies (for example, bid bonds, performance bonds, warranties, and standby letters of credit related to a particular transaction) relate to the ongoing business activities of a counterparty, where the risk of loss to the reporting institution depends on the likelihood of a future event that is independent of the creditworthiness of the counterparty. Essentially, transaction-related contingencies are guarantees that support particular performance of non-financial or commercial contracts or undertakings, rather than supporting customers' general financial obligations. Performance-related guarantees specifically exclude items relating to non-performance of financial obligations.

4. Commitments

A commitment involves an obligation (with or without a material adverse change or similar clause) of a credit union to fund its member in the normal course of business should the member seek to draw down the commitment. Normally, commitments involve a written contract or agreement and a commitment fee or some other form of consideration.

When determining the maturity of the commitment, the term should be measured from the date when the commitment was accepted by the customer until the earliest date on which the commitment is scheduled to expire or the credit union can at its option, unconditionally cancel the commitment.

5. Trade-related contingencies

These include short-term, self-liquidating trade-related items such as commercial and documentary letters of credit issued by the credit union that are, or are to be, collateralized by the underlying shipment. Letters of credit issued on behalf of counterparty with letters of credit of which the counterparty is a beneficiary ("back-to-back" letters) should be reported as documentary letters of credit. Letters of credit advised by the credit union for which the credit union is acting as reimbursement agent should not be considered as a risk asset.