Three New Rules for Credit Unions and Caisses Populaires

FSRA
Financial Services Regulatory Authority of Ontario

Date: June 24, 2021
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Introduction

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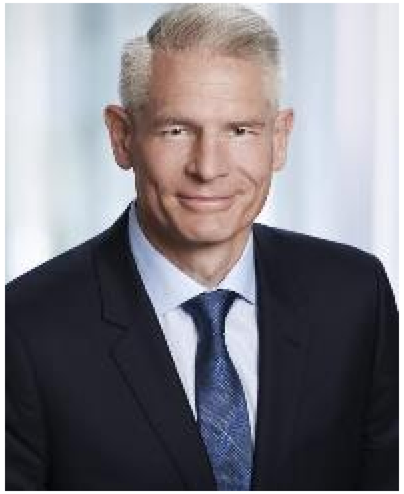
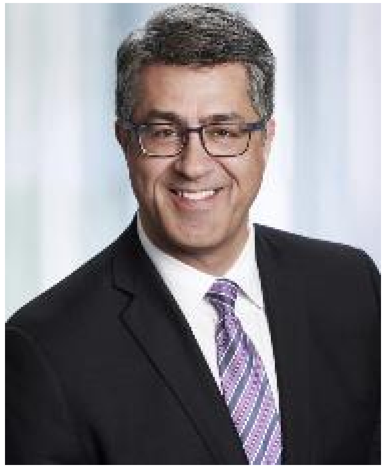
Speakers

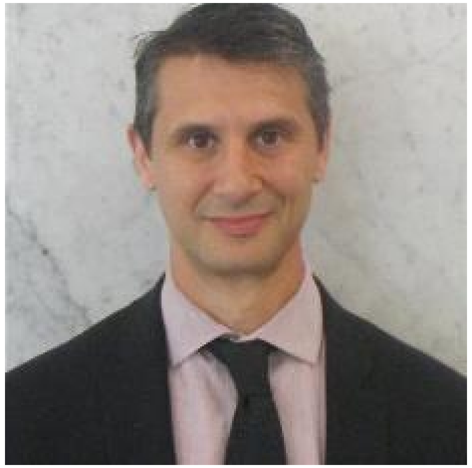


Mark E. White, Chief Executive Officer

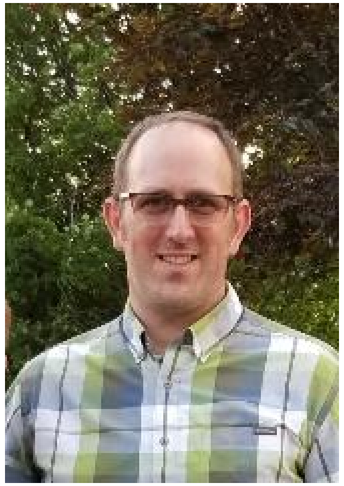


Guy Hubert, Executive Vice-President, Credit Union & Prudential

Alena Thouin, Director, Credit Union & Prudential



Daniel Padro, Director, Policy, Credit Union



Bradley Hodgins, Senior Manager, Credit Union & Prudential

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Agenda

1. Introduction
2. Background
3. Sound Business and Financial Practices
4. Question Period #1
5. Capital Adequacy and Liquidity Adequacy
6. Question Period #2

Background

Background

- The Financial Services Regulatory Authority of Ontario (FSRA) is updating the regulation of Ontario's credit unions and caisses populaires (credit unions).
- On December 8, 2020, the updated *Credit Unions and Caisses Populaires Act, 2020* (CUCPA 2020) received Royal Assent. The Proposed Rules will be made under CUCPA 2020 once proclaimed to come into force.
- The Rules advance FSRA's cross-sectoral transition to principles-based regulation:
  - **Principles-based standards**: Decreases FSRA's reliance on prescriptive legal requirements
  - **Greater flexibility:** Greater flexibility in protecting and serving members, enhanced authority and responsibility for directors and managers
  - **Collaborative regulatory model**: Credit unions work harmoniously with FSRA to achieve desired regulatory outcomes
- Consultation drafts of the three Proposed Rules were released on FSRA's website on **June 14, 2021**. Feedback accepted until **September 14, 2021**.

Sound Business and Financial Practices

Rationale

- The Proposed Sound Business and Financial Practices Rule (SBFP Rule) will replace By-law No. 5, a key element of the credit union regulatory framework.
- In line with FSRA's transition to a principles-based supervisory approach, it sets explicit outcomes-focused requirements for:
  - Governance – Members and Board of Directors
  - Senior management
  - Operational management
  - Oversight functions – Internal audit, compliance, finance and risk management
  - Enterprise risk management
  - Subsidiary governance

The new sections and requirements are discussed in more detail on Slide 10.

Overview of Recommended SBSF Rule

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Principles-Based	Supports a principles-based supervisory approach that is outcomes-focused and flexible. By-law No. 5 and related prescriptive guidance will be phased out.
Proportional	Will be applied proportionally, enabling a credit union to comply with the requirements in a manner that is reflective of their nature, size, complexity, and risk profile.
Addresses Current Gaps	Explicitly addresses topics that are only implicit or do not exist under By-law No. 5 (e.g., composition of the Board, oversight functions, internal audit, subsidiary governance, etc.). It is better able to accommodate broader scope of business and investment activities that credit unions may undertake in the future.

Factors Considered – New in SBFP Rule

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Key areas of governance and oversight that are increasingly important are not explicitly addressed under By-law No. 5.

Governance Matters Related to Members	• Clear and transparent communication about member participation and democratic rights
Composition and Responsibilities of the Board	• Consistent with international co-operative principles • Obligations regarding size and structure, as well as roles and responsibilities
Ethical and Responsible Action	• Requirements for ethical and responsible action (incl. whistleblower policy, code of market conduct, etc.)
Oversight Functions	• Requirements for internal audit, risk management, compliance, and finance functions
Subsidiary Governance	• For boards to meet their enterprise-wide oversight responsibilities

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SBFP Rule – Proposed Structure

The Proposed Rule addresses the following 15 areas:

1. Co-operative Principles
2. Governance Matters Related to Members
3. Composition of the Board
4. Responsibilities of the Board
5. Responsibilities of Senior Management
6. Ethical and Responsible Action
7. Integrity in Reporting and Disclosure
8. Fair and Responsible Compensation
9. Status, Authority and Independence of the Oversight Functions
10. Internal Audit Function
11. Risk Management Function
12. Compliance Function
13. Finance Function
14. Subsidiary Governance
15. Operational Management

Outcomes-Focused Requirements

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1. **Co-operative Principles**
2. **Governance Matters Related to Members**
3. **Composition of the Board**
4. **Responsibilities of the Board**
5. Responsibilities of Senior Management
6. Ethical and Responsible Action
7. Integrity in Reporting and Disclosure
8. Fair and Responsible Compensation
9. Status, Authority and Independence of the Oversight Functions
10. Internal Audit Function
11. Risk Management Function
12. Compliance Function
13. Finance Function
14. Subsidiary Governance
15. Operational Management

- Board and senior management must operate, manage, and govern consistent with international co-operative principles.
- All activities and communications relating to member meetings must be fair and transparent; Democratic rights of members (e.g., participation in meetings, etc.) must be identified in communications.
- Board composition and skill set must correspond to the credit union's nature, size, complexity, and risk profile.
- Board is responsible for providing independent oversight of senior management and policies, processes, and procedures for the credit union and subsidiaries.

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Outcomes-Focused Requirements, Continued

1. Co-operative Principles
2. Governance Matters Related to Members
3. Composition of the Board
4. Responsibilities of the Board
5. **Responsibilities of Senior Management**
6. **Ethical and Responsible Action**
7. **Integrity in Reporting and Disclosure**
8. Fair and Responsible Compensation
9. Status, Authority and Independence of the Oversight Functions
10. Internal Audit Function
11. Risk Management Function
12. Compliance Function
13. Finance Function
14. Subsidiary Governance
15. Operational Management

- Senior management responsible for creating and implementing board-approved policies, providing reports, analysis, and proposals for the board; and day-to-day management of the credit union's operations.

- Policies and procedures must be consistent with the credit union's values, ethics, and code of market conduct, and credit unions must adopt and comply with a whistleblower policy.

- Board and senior management must implement reporting processes and controls, present assessments and disclosures, and maintain a reporting system which provides timely, accurate, and reliable information, including material risks residing in subsidiaries.

Outcomes-Focused Requirements, Continued

1. Co-operative Principles
2. Governance Matters Related to Members
3. Composition of the Board
4. Responsibilities of the Board
5. Responsibilities of Senior Management
6. Ethical and Responsible Action
7. Integrity in Reporting and Disclosure
8. **Fair and Responsible Compensation**
9. **Status, Authority and Independence of the Oversight Functions**
10. **Internal Audit Function**
11. **Risk Management Function**
12. **Compliance Function**
13. **Finance Function**
14. Subsidiary Governance
15. Operational Management

- Remuneration policies for directors and senior management must be disclosed to members and meet certain outcomes consistent with the Financial Stability Board's Principles of Sound Compensation Practices.
- Must establish and maintain appropriate oversight functions within the credit union or through outsourcing arrangements:
  - Must have sufficient resources, status, authority, and independence.
  - If head of oversight function is employed by a third-party, a member of senior management must be accountable.
- Must implement board-approved enterprise risk management (ERM) framework (head must be appointed by board)

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Outcomes-Focused Requirements, Continued

1. Co-operative Principles
2. Governance Matters Related to Members
3. Composition of the Board
4. Responsibilities of the Board
5. Responsibilities of Senior Management
6. Ethical and Responsible Action
7. Integrity in Reporting and Disclosure
8. Fair and Responsible Compensation
9. Status, Authority and Independence of the Oversight Functions
10. Internal Audit Function
11. Risk Management Function
12. Compliance Function
13. Finance Function
14. **Subsidiary Governance**
15. **Operational Management**

- Required to have adequate oversight over subsidiaries so board can meet its enterprise-wide oversight responsibilities.
- Senior management required to implement board-approved operational management and control system framework.

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Live Q&A Session

Capital Adequacy

Rationale

- The existing framework is detailed in the regulation, the Capital Adequacy Guideline, and the Internal Capital Adequacy Assessment Process (ICAAP) Guidance.
    - Regulation outlines criteria and calculations for determining if a credit union is maintaining adequate capital;
    - Guideline provides additional details for determining adequate capital; and
    - ICAAP sets requirements for credit unions to assess their risk as it relates to capital adequacy.

- The current capital framework is not reflective of current international standards.

- The proposed Capital Adequacy Rule (CAR) made under the *Credit Unions and Caisses Populaires Act, 2020* (CUCPA 2020) would replace the existing capital regime and be:
    - More closely aligned with current international standards and best practices (i.e., Basel III framework), in a manner appropriate for cooperatively owned financial institutions; and
    - Aligned with FSRA's transition to principles-based supervisory approach and new Risk-Based Supervisory Framework (RBSF) that is being developed.

Factors Considered for Developing the Capital Adequacy Rule

Current Risk

- The current capital adequacy regime does not include buffers and higher quality capital.
- The CAR is based on Basel III framework, which is more risk-sensitive than the current regime and will enhance credit union resiliency.

Stakeholder Feedback

- Feedback from the 2015 review of the CUCPA 1994 and 2017-18 Ministry of Finance consultation on capital adequacy requirements is incorporated into the proposed CAR.
- FSRA has undertaken targeted stakeholder engagement via a working group of 13 credit unions and feedback has been generally supportive.

Research and Jurisdictional Scan

- In developing the CAR, FSRA considered topics covered under capital adequacy frameworks in other Canadian and international jurisdictions.

Factors Considered for Developing the Capital Adequacy Rule, Cont'd

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Collaborative Regulatory Model

- Some elements of the CAR will be principles-based and outcomes-focused, such as the ICAAP.
- A principles-based and outcomes-focused framework facilitates a collaborative regulatory model, whereby Ontario's credit unions work with FSRA to achieve desired regulatory outcomes.
- More prescriptive elements of the proposed CAR, such as the minimum capital ratios, have been agreed upon with the sector and align with international standards.

Potential Costs

- The requirements outlined in the proposed CAR will not result in any additional material costs for the sector, as almost all credit unions currently meet or exceed requirements.
- The CAR will require that credit unions hold adequate capital to protect depositors and the Deposit Insurance Reserve Fund (DIRF) from the risks incurred by credit unions, while enabling institutions to remain competitive and able to meet member needs.

Overview of Recommended Capital Adequacy Rule

Basel III	The CAR would more closely align with the Basel III framework but will omit requirements that are inappropriate for the sector (i.e., advanced approach). This is similar to approaches implemented by other regulators for non-internationally active and small to mid-sized financial institutions.
Sector Collaboration	The CAR incorporates sector feedback to ensure the capital requirements are reflective of international best practices in a manner appropriate for cooperatively owned financial institutions.
Proportional	The ICAAP outlined in the CAR would be applied proportionally, enabling a credit union to comply with the requirements in a manner that is reflective of their nature, size, complexity, and risk profile.

Capital Adequacy Rule Proposed Content and Structure

- Unlike previous capital regime, capital requirements will be consolidated in the CAR. Approach Guidance will be developed as part of the Risk-Based Supervisory Framework (RBSF), which will describe how FSRA will supervise against ICAAP requirements.
- The CAR addresses the following topics:
  - Section 3: Minimum Capital Ratios
  - Section 4: Tier 1 Capital
  - Section 5: Tier 2 Capital
  - Section 6: Risk Weighted Assets
  - Section 7: Credit Risk – Standardized Approach
  - Section 8: Operational Risk – Basic Indicator Approach
  - Section 9: General Market – Interest Rate Risk
  - Section 10: Capital Conservation Buffer
  - Section 12: Leverage Ratio
  - Section 13: Internal Capital Adequacy Assessment Process

Current Capital Regime vs. Capital Adequacy Rule

- The CAR updates existing requirements and introduces new requirements, including:

	Current Capital Regulation	vs.	Proposed Capital Adequacy Rule
1.	ICAAP detailed in Guidance	→	ICAAP outlined in the CAR
2.	Minimum Total Capital (Tier 1 + 2): 8% (Tier 1>Tier 2)	→	Minimum Total Capital (Tier 1 and 2): 8% (Tier 1 Min: 6.5%)
3.	Minimum Leverage Ratio: 4% (on balance sheet items only)	→	Minimum Leverage Ratio: 3% (on and off-balance sheet items)
4.	-	New	Minimum Capital Conservation Buffer: 2.5% (made up of Tier 1 quality capital)
5.	-	New	Minimum Retained Earnings: 3% (included in Tier 1). Not applicable to newly incorporated credit unions (first 6 years)
6.	-	New	1250% risk weight for high risk commercial entities and securitizations
7.	-	New	FinTech and Community Investments would receive 100% risk weight, capped at 1% of total capital. After 1% (combined), these investments receive a 1250% risk weight

Minimum Capital Ratios, Capital Conservation Buffer Ratio and Leverage Ratio

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- The CAR sets out the values for a credit union's minimum Tier 1 capital ratio, minimum total capital ratio, minimum capital conservation buffer ratio, minimum total supervisory capital ratio, leverage ratio, and minimum retained earnings ratio a credit union must comply with.

Components of Regulatory Capital, Capital Ratios, & Buffers	Ratios
Minimum Tier 1 Capital	6.5%
Minimum Retained Earnings (Component of Tier 1)	3.0%
Minimum Total Capital (Tier 1 and Tier 2)	8.0%
Minimum Capital Conservation Buffer (CCB)	2.5%
Minimum Total Supervisory Capital (Tier 1 + Tier 2 + CCB)	10.5%
Minimum Leverage Ratio	3.0%

Key Considerations and Desired Outcome:

- Capital ratios have been updated to be consistent with the Basel III framework, but modified to reflect the unique capital structure of Ontario credit unions.
- The addition of new buffers (capital conservation buffer) and capital requirements (retained earnings) are reflective of modern risk management processes.
- Updates align with feedback received from the 2015 review of the CUCPA and 2017-18 Ministry of Finance consultation.

Liquidity Adequacy

Rationale

- The existing credit union liquidity framework is detailed in the Regulation and Guidance documents.
  - Regulation requires that credit unions establish and maintain prudent levels and forms of liquidity;
  - Liquidity and Stress Testing Guidance sets requirements for credit unions to assess their risk as it relates to liquidity adequacy; and
  - Completion Guides detail the criteria for calculating the Liquidity Coverage Ratio (LCR), Net Stable Funding Ratio (NSFR), and Net Cumulative Cash Flow (NCCF).

- The current liquidity framework is largely aligned with current international standards and many elements have been migrated to the Proposed LAR to strengthen enforceability and further align with best practices in other jurisdictions.

- The new *Credit Unions and Caisses Populaires Act, 2020* (CUCPA 2020) would grant FSRA the authority to make a liquidity Rule once proclaimed to come into force. The LAR will replace the existing liquidity framework and be:
  - More closely aligned with international standards and best practices (i.e., Basel III framework) in a manner appropriate for cooperatively owned financial institutions; and
  - Aligned with FSRA's new Risk Based Supervisory Framework (RBSF) that is being developed.

Factors Considered for Developing the Liquidity Adequacy Rule

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Enhancing the Framework	• Alignment with other jurisdictions has been considered when developing the LAR to further enhance liquidity requirements.
Stakeholder Feedback	• FSRA has undertaken targeted stakeholder consultations via a working group in order to validate its recommended approach and topics for the Proposed LAR.
Research and Jurisdictional Scan	• In developing the LAR, FSRA considered topics covered under liquidity adequacy frameworks in other Canadian and international jurisdictions.

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Factors Considered for Developing the Liquidity Adequacy Rule, Cont'd

Collaborative Regulatory Model

- Elements of the LAR will be principles-based and outcomes- focused, such as the ILAAP. A principles-based and outcomes-focused framework facilitates a collaborative regulatory model, whereby Ontario's credit unions work with FSRA to achieve desired regulatory outcomes.
- More prescriptive elements of the proposed LAR, such as the liquidity metrics, have been agreed upon with the sector and align with international standards.

Potential Costs

- The requirements outlined in the proposed LAR are not expected to result in any additional material costs for the sector, as the substantive requirements are largely already in place through existing liquidity guidance. Almost all Ontario credit unions currently either meet or exceed the requirements specified in the LAR.

Overview of Recommended Liquidity Adequacy Rule

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Basel III and OSFI	The LAR would more closely align with the Basel III and OSFI frameworks.
Inputs	The LAR includes updates to inputs used for calculating liquidity metrics, which align with the Basel III and OSFI frameworks in a manner appropriate for cooperatively owned financial institutions.
Proportional	Adherence to the liquidity metrics and the ILAAP would be applied proportionally, enabling a credit union to comply with the requirements in a manner that is reflective of their nature, size, complexity, and risk profile.
Force of Law	Migration to the LAR would strengthen the enforceability of the liquidity framework over the existing regime, which is predominately detailed in non-binding guidance, providing greater certainty and predictability for the sector. FSRA will address the need to respond to unexpected events by building flexibility in its legal regime.

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Liquidity Adequacy Rule Proposed Content and Structure

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- Unlike the previous liquidity regime, liquidity requirements will be consolidated in the LAR. Approach Guidance will be developed as part of the Risk-Based Supervisory Framework (RBSF) which will describe how FSRA will supervise against ILAAP requirements.

- The LAR addresses the following topics:
  - Section 3: Proportionality
  - Section 4: High Quality Liquid Assets
  - Section 5: Liquidity Coverage Ratio
  - Section 6: Net Stable Funding Ratio
  - Section 7: Net Cumulative Cash Flow
  - Section 8: Diversification of Funding
  - Section 9: Reporting
  - Section 10: Internal Liquidity Adequacy Assessment Process

Current Liquidity Regime vs. Liquidity Adequacy Rule

	Current Liquidity Regime	vs.	Liquidity Adequacy Rule
1	Reflects best practices (Basel III) and is partially aligned with other jurisdictions	→	Reflects best practices (Basel III) and is further aligned with other jurisdictions
2	Guidance does not have the force of law	→	LAR has the force of law
3	Liquidity metrics detailed in Guidance	→	Liquidity metrics detailed in the LAR
4	Liquidity and Stress Testing Guidance	→	ILAAP
5		NEW	Updates to inputs for calculating liquidity metrics

Live Q&A Session

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Thank You