September 14, 2021

FSRA Policy Division
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Delivered by e-mail

Dear FSRA Policy Team,

RE: Response to FSRA's Draft Rule 2021 – Capital Adequacy Rule (CAR)

Thank you for the opportunity to provide comments to FSRA's Draft Capital Adequacy Rule ("Draft Rule" or "Rule"). We sincerely appreciated FSRA's time and interest in Alterna's views during our recent meeting of August 26th. As promised, what follows is our written comments which we kindly ask you consider as you work towards the final draft of the Rule.

Alterna supports FSRA's journey towards principles-based regulation, and we feel we are uniquely positioned to provide comments on the Draft Rule given our subsidiary bank is regulated under a principles-based regime. Over the long term, we believe that this model will enhance prudential management of a credit union's capital adequacy and will strengthen both idiosyncratic and systemic resiliency.

Alterna's comments are summarized below:

1. **Section 7: Credit Risk- Standardized Approach (Table 2: Asset Risk Weightings)**

We understand that FSRA is going to publish a revised Table 2 that will provide much needed clarification with respect to asset definitions and associated risk-weightings. However, until such time, Alterna is concerned that current asset definitions are too limited and that all other investments not otherwise defined in Table 2 may be assigned a punitive risk weighting. Under the Draft Rule a portion of Alterna's current (and planned) investments would attract a 1250% risk weighting, a significant increase from the current weighting of 100%.

While we acknowledge the Draft Rule's staggered approach to the risk weighting of Fintech investments (100% on the portion < 1% of capital and 1250% on the portion >1% of capital), we would like to emphasize the importance of such investments to FSRA. Credit unions rely on Fintech investments to help them analyze and assess certain financial technologies that can help them remain competitive without having to make direct investments themselves. As a result, Alterna finds the proposed 1% threshold problematic. Additionally, it would be our view that the threshold doesn't consider the negative capital treatment associated with fair market value gains on these investments, which may push the value of the investment over the 1% threshold (e.g. fair market value gains which are beneficial for credit unions may end up attracting punitive capital treatment on a relative basis).

Alterna does not believe it helps the credit union sector to have to re-risk weight investments in shares of Central 1 (from 100% to 1250%). Central 1 plays a critical and unique role within the Credit Union sector, which includes providing access to wholesale market funding, facilitating clearing and settlement of payment transactions and leveraging economies of scale lacked by many credit unions to access products and services efficiently. Investments in Central 1 promote overall sector financial stability and resilience. A 1250% default risk weighting as per the Draft Rule would not be in the best interest of the sector and would not promote a level playing field or foster long-term sector growth.

Similarly, when dealing with corporate investments/claims, we presume that the intention is not to risk weight such assets at 1250%. We look forward to seeing more clarity with respect to these types of investments.

Section 7(3) permits the Chief Executive Officer ("CEO") of FSRA to specify a risk weighting for investments and asset categories not otherwise included in Table 2. We believe clear guidance is required for as many asset categories that are currently not included in Table 2 as possible to minimize exception approval from the CEO. This will ensure an efficient and effective process for both FSRA and the sector. Guidance around decision making criteria and approval turnaround time is important given the competitive market landscape that may lead to a small window of opportunity available for credit unions to make investment decisions.

As mentioned in our meeting on August 26th, we suggest that FRSA consider providing credit unions with updated templates to help facilitate the sector's required capital filings under the Draft Rules. This would give credit unions a more transparent methodology to quantify the full impact of the changes being proposed. This would also help reinforce the need for a more appropriate transition period for implementation. Alterna would be happy to assist in developing any such templates.

We recommend clearer language around the risk weighting of additional asset categories and that risk weightings be more closely aligned with OSFI guidance. For example, we recommend the following specific risk weightings:

- **Other financial and non-financial assets: 100%**
- **Corporate bonds and short-term commercial paper: leverage Table 4 Credit Ratings Table based on issuers' credit rating (% ranges from 20% to 150%)**
- **Equity investments in Central 1: 100%, given Central 1's prevalence and connectedness in the Credit Union environment**

- **All investments including equities, alternative investments, funds, real estate should be aligned with OSFI guidance. This includes a general requirement to account for non-publicly listed equity exposures at a 400% risk weighting, and publicly listed equity exposures at a 250% risk weighting**
- **Fintech investments up to 5% of capital are given a risk weighting of 100%**
- **Assets deducted directly from Tier 1 and Tier 2 capital (e.g., goodwill, acquired intangible assets, deferred tax assets): 0% (note that language should be added that all items deducted from capital should also be excluded from the exposure measure in calculating leverage ratio, consistent with OSFI guidance)**
- **Assets that are exempt from direct deduction from Tier 1 and Tier 2 capital up to an aggregate maximum (e.g., deferred tax assets arising from temporary differences and computer software up to 1% of Tier 1 capital): 100%**
- **Residential mortgage loans exceeding 80% LTV: 75%**

2. **Section 4: Tier 1 Capital (Securitization and equity capital)**

4(4)(iv) states that "*any increase in equity capital resulting from securitization transactions*" is deducted from Tier 1 capital. There is currently a lack of guidance around the intent of this requirement and its scope of application, including what the definitions of "increase in equity capital" and "securitization transaction" mean. We strongly believe that gains arising from off-balance sheet CMHC sponsored securitization transactions (e.g. sale of interest-only strips of single-family residential mortgage pools and sale of Multi-Unit Residential Building or MURB mortgage pools) should not be a deduction from Tier 1 capital given the crystalized nature of these gains with no variability in future cash flows. Furthermore, we do not believe that this practice is consistent with OSFI regulated entities.

We wish to stress the importance to Alterna of having access to CMHC sponsored securitization programs as part of a more diversified and low-cost funding activity given the limited funding alternatives available to Alterna outside of traditional retail deposit-taking. Our ability to serve members that require insured and insurable mortgage products at a market competitive rate is contingent on the ability to continue to receive appropriate capital treatment. In addition, Alterna's (and the credit union sector's) participation in the funding and sale of insured MURB mortgages to CMHC securitization programs adds appropriate depth and liquidity to the market while serving the important purpose of ensuring affordable housing continues to be available for renters, seniors and students.

We recommend providing clear definitions and interpretation guidance regarding the Draft Rule and how terms are to be used and understood. For instance, how would FSRA define a "securitization transaction"? And would "securitization gains" in connection with a CMHC sponsored securitization program be defined as equity gains that would be deducted from equity capital? And if so, over what period?

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3. **Section 4: Tier 1 Capital**

We appreciate that FSRA has indicated that investment shares will continue to qualify as Tier 1 capital under 4(4). We wish to clarify the capital treatment of dividends on existing and future investments shares issued in the form of additional investment shares of the same class and series. The Draft Rule is currently silent and subject to interpretation.

We recommend that share dividends receive the same capital treatment as the related underlying investment share series. Given our limited capabilities in raising capital outside of investment share issuance, exempting share dividends to be treated as new issuance requiring a new holding period of 5 years will ensure the unique factors and limitations facing our sector is fully recognized.

4. **Minimum Capital Ratios/Capital Conservation Buffer**

As we understand the Draft Rule, the intent is to include a Capital Conservation Buffer of 2.5%, on top of a minimum 8% total capital ratio and this buffer is a standard that will apply to all credit unions.

We recognize that this 2.5% capital buffer more closely aligns FSRA's standards to international and domestic standards (Basel III and OSFI). Yet, we question whether such a buffer is necessary for co-operatively owned financial institutions. Further, it does not reflect the broad differences in the size and complexity of members in the credit union sector and, as such, could be viewed as arbitrary, not risk-based and a "*one-size fits all*" approach to the sector without accounting for a credit union's unique business strategy, risk appetite or risk profile.

We continue to support a risk-based approach to evaluating capital adequacy and believe the current Internal Capital Adequacy Assessment Process (ICAAP) is sufficient in ensuring management considers Pillar 1, Pillar 2 and stress testing requirements on capital. This approach also ensures that the unique circumstances of individual credit unions are considered rather that a "*one size fits all*" approach as suggested by instituting a general 2.5% capital buffer.

5. **Transition Period**

FSRA has stated that, according to its own analysis, all Ontario credit unions already comply with the capital adequacy requirements set out in the Draft Rule. Consequently, FSRA assumes that no formal transition period is required other than the requirement for individual credit unions, that find themselves below requirements for minimum Tier 1, minimum Capital Conservation Buffer and/or minimum total supervisory capital, must apply to the FSRA CEO for approval of an individual transition plan.

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The lack of clarity with respect to securitization gains, the precise definitions to be applied to various types of loans/investments and respective risk weightings and the future treatment of investment shares (e.g. dividends-in-kind) make it difficult for Alterna (and we would argue the credit union sector) to fully assess the impact that the new Rule will have on the adequacy of regulatory capital.

Additionally, Alterna also notes that credit unions execute short-term tactical business plans along with medium-to-longer term business strategies and capital plans. Material changes to capital adequacy requirements and risk-adjusted returns on such capital take significant lead time to implement, assess and ultimately optimize. For example, significant lead time is required to change product offerings and pricing, or to make changes to future strategic investment strategies (e.g. Fintech). Lead time will also be required to integrate the Draft Rule into the organization's capital plans and stress testing regime (ICAAP).

Accordingly, an inadequate transition period may lead credit unions to make sub-optimal business decisions and ultimately jeopardize the success of the entire sector including the member base it serves.

If FSRA concludes that a capital conservation buffer is considered prudent, we recommend a gradual step-up approach to phase in the additional 2.5% capital requirement over a period of 5 years.

We trust that our comments are constructive and helpful. Thank you once again for the opportunity to share our thoughts, and for the constructive dialogue on this matter. Please feel free to reach out to us if you would like to discuss our recommendations in greater detail.

Best Regards,

Rob Paterson, President & CEO

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