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Delivered Electronically to Bradley Hodgins

September 14, 2021

To the Readers,

DUCA Financial Services Credit Union (hereafter referred to as “DUCA” or “we”) appreciates the opportunity to comment and respond to the public consultation surrounding FSRA’s Capital Adequacy Requirements for Credit Unions and Caisses Populaires or Rule 2021-005 (hereafter referred to as “the Proposed Rule”). FSRA’s willingness to have a conversation around the concerns that we share is helpful and we appreciate your openness for dialogue.

Below is a summary of general themes and key issues that DUCA has determined to be of the greatest importance and require further dialogue and revisions to the Proposed Rule. Our current perception is that certain provisions of the Proposed Rule do not fully take into consideration factors unique to the Credit Union sector or may impose burden, cost, or operational challenges resulting in unintentional consequences such as inadvertent non-compliance to the Proposed Rule by the sector or placing the sector at an unfair competitive position vis-à-vis other regulated financial institutions.

General Themes

Within our review several themes emerged that we wanted to highlight within the response.

Theme #1: Important distinction between Rule vs. Guideline

Draft Rule replaces Capital Adequacy Guideline for Ontario’s Credit Unions and Caisses Populaires published in Dec. 2013. Rules are legally binding and carry a higher level of importance as direct non-compliance with Rules will have far more negative consequences. It is therefore critical that the Proposed Rule embodies clear language that reflect accurately the intent of the regulation. Ambiguity that leaves room for interpretation should be avoided as an imperative.

Theme #2: Alignment with OSFI while recognizing factors unique to the Credit Union sector

We appreciate efforts made to align the Proposed Rule with guidance issued by OSFI and believe further alignment is required in key areas before the Proposed Rule can be finalized to ensure a level playing field with OSFI regulated financial institutions including federally regulated Credit Unions. Key areas of inequitable misalignment with OSFI standards include: risk weighting of various asset classes, treatment of off-balance sheet insured mortgage securitizations, and qualifications for deductions in capital. While alignment with OSFI is desirable generally, there are instances where the size, complexity and restrictions unique to Credit Unions require considerations to tailor the Proposed Rule. The key differentiation of the Provincial Credit Union sector from other financial institutions is the lack of alternate capital raising capability and the resulting heavy reliance on the issuance of investment shares. Another key differentiation is the Credit Union sector's dependency on Central 1 and other partners including FinTech for reasonably cost-effective access to essential treasury and banking services and technological innovations. This is particularly acute for Credit Unions that currently lack the economy of scale or financial resources to carry out on their own. The capital treatment of investments in these entities need to appropriately reflect these differences.

Theme #3: Assumption that Proposed Rule will not result in additional material costs for Credit Unions is premature

The Proposed Rule raises minimum total supervisory capital ratio from 8% to 10.5% with no transition period based on the assumption that "almost all of Ontario's Credit Unions currently either meet or exceed the requirements specified in the Proposed Rule". This presumption may be inaccurate as it has not considered the full impact of several material changes to capital adequacy. Examples of areas of significant reduction in capital include a new requirement to deduct increases in equity derived from securitization transactions, consolidation of subsidiaries, and a large number of asset classes falling into the punitive 1250% risk weighting, to name a few. In addition, internal management minimum capital ratios will require review and may lead to upward revision due to higher regulatory minimum requirements. There needs to be consideration given to business plans and growth strategies in progress within individual Credit Unions that require significant lead time to plan and execute, necessitating a much longer transition period.

Key Issues

In keeping with the key themes, Appendix A lists details of key issues arising from our review with proposed recommendations where applicable.

We look forward to engaging with FSRA around our comments, with the goal to enhance the Proposed Rule for all Credit Unions and members.

Best Regards,

Yan Xu
CFO, DUCA Financial Services Credit Union Ltd.

Douglas S. Conick

Doug Conick
President & CEO, DUCA Financial Services Credit Union Ltd.

Appendix A (in the order they appear in the Proposed Rule)

Section 2: Scope

Section	Comments / Unintended Consequences / Impact
2(2)(ii)	**Commentary** • 2(2)(ii) states that the Proposed Rule applies to every Credit Union in determining whether it has adequate and appropriate forms of capital, and requires the assets and liabilities of the Credit Union, its affiliates and its subsidiaries to be considered on a consolidated basis, except for any subsidiary that is, (i) an insurer, or (ii) a financial institution, the leverage of which, in the opinion of the Authority, is not appropriate for a Credit Union. • We seek further clarification on the definition of "financial institution" and examples of financial institutions for which leverage is not appropriate for a Credit Union. Additional guidance on what is not considered appropriate will ensure compliance by all Credit Unions.

Section 4: Tier 1 Capital

Section	Comments / Unintended Consequences / Impact
4(2)(vi)	**Commentary** • 4(2)(vi) specifies that accumulated net after tax unrealized loss on available-for-sale equity securities reported in other comprehensive income should be included in the calculation of Tier 1 Capital. • FSRA should consider amending the available-for-sale equity securities reference as it is no longer an IFRS compliant terminology. • We recommend consistency with OSFI guideline 2(3) where all Accumulated Other Comprehensive Income (AOCI) regardless of gain or loss is included in the calculation of Tier 1 Capital.
4(3)(viii)(a)	**Commentary** • 4(3)(viii)(a) states that "Investment shares can only be redeemed or purchased for cancellation by the Credit Union if the shares are replaced with shares that qualify as Tier 1 Capital and are of the same quality or of better quality than the shares they are replacing". • We recommend the Proposed Rule to be consistent with OSFI guidance 2(12)(5)(c) which states that "an institution may not exercise the call unless it replaces the called instrument with **capital** of the same or better quality, including through an increase in retained earnings…" • The proposal to align definition with OSFI allows for more flexibility and recognizes other forms of equal of higher quality capital such as retained earnings.
4(3)(xv)	**Commentary** • 4(3)(xv) states that for investment shares to qualify as Tier 1 Capital, it must not have been purchased by the Credit Union or any subsidiary or affiliate of the Credit Union or with funding provided directly or indirectly by the Credit Union. • We wish to clarify the capital treatment under a scenario where the Credit Union facilitates movement of investment shares otherwise qualify as Tier 1 Capital between members who wish to purchase and sell their shares. In this case, when the Credit Union temporarily purchases the shares from a member

<table>
<tr><td></td><td>in order to facilitate a sale to another member, we believe 4(3)(xv) does not apply and the shares should continue to qualify as Tier 1 Capital.
Given the redemption restrictions for investment shares in any given year, there is a real need for members who may wish to sell their shares for emergency and other reasons and a corresponding market demand for members who wish to invest due to the attractive yields on investment shares. Credit Unions can play an important role in facilitating these transactions to create liquidity and should not be penalized inadvertently.
The same commentary applies to 4(6)(viii)(a) regarding Tier 2 Capital.</td></tr>
<tr><td>4(4)</td><td>Commentary
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 Proposed Rule is currently silent and subject to interpretation.
We believe that share dividends should receive the same capital treatment as the related underlying investment share series. Given limited capabilities of Credit Unions 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. This approach also significantly reduces onerous tracking and reporting that is required.</td></tr>
<tr><td>4(5)(ii)</td><td>Commentary
4(5)(ii) excludes from Tier 1 Capital “deferred tax assets, except those arising from temporary differences”.
We recommend that FSRA aligns definition of deferred tax assets (DTA) with OSFI definition under 2(58) particularly around the ability to net DTAs with deferred tax liabilities (DTLs). The additional guidance available under OSFI related to this section will provide helpful guidance and ensure a level playing field with OSFI regulated financial institutions.</td></tr>
<tr><td>4(5)(iv)</td><td>Commentary
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 scope of application including definition of “increase in equity capital” and “securitization transaction”. 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.
In addition, current OSFI guidance (CAR Chapter 7 paragraph 3) states that “for greater clarity, and to ensure consistency with paragraph 5 below, all exposures to mortgage-backed securities that do not involve tranching with associated subordination of credit risk (e.g., NHA MBS) will not be considered securitization exposures for risk-based capital”.
We are aware of current practice under OSFI regulated entities where securitization exposures under the NHA MBS/CMB programs receiving 0% risk weighting and related securitization gains are not deducted from capital.</td></tr>
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	• We wish to stress the importance to the Credit Union sector of having access to CMHC sponsored securitization programs as part of a more diversified and economical funding channel given limited funding alternatives available to the sector outside of the traditional deposit-taking funding sources. • 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, Credit Unions' participation in the funding and sale of MURB mortgages to CMHC securitization programs add appropriate depth and liquidity to the market while serving an important purpose of ensuring affordable housing continues to be available for renters, seniors and students. • We would appreciate the opportunity to preview any additional guidance and details to be added to the Proposed Rule prior to finalization. **Unintended Consequences and Impact** • Close alignment with OSFI guidance is strongly recommended to ensure a fair and level playing field for the Credit Union sector. Without ensuring a level playing field in this area, it is unlikely Credit Unions will be able to effectively compete in segments of the insured market, such as originating MURB mortgages.
4(5)(ix)	**Commentary** • 4(5)(ix) excludes from Tier 1 Capital "the amount of a reverse mortgage loan that exceeds a LTV of 85%". • The Proposed Rule is silent on the capital treatment of reverse mortgage with LTV less than 85%. • We propose alignment with OSFI guidance 2(91) which specifies the portion of reverse mortgage not exceeding 85% LTV be risk weighted at 100%.
4(6)	**Commentary** • 4(6) states that a Credit Union may exclude in the calculation of Tier 1 Capital deduction the following assets up to an aggregate amount equal to 1% of the Credit Union's Tier 1 Capital: i) mortgage servicing rights ii) DTAs arising from temporary difference and iii) computer software assets included in intangible assets. • We note that OSFI guidance 2(85) allows for each of the items in scope to be compared to 10% of CET1. The closest equivalent of CET1 under the Proposed rule is retained earnings. 10% of retained earnings would result in a larger aggregate amount eligible for exclusion from capital deductions. • We believe alignment with OSFI guidance will ensure a fair and level playing field for Credit Unions.

Section 5: Tier 2 Capital

Section	Comments / Unintended Consequences / Impact
5(2)(v)	**Commentary** • 5(2)(v) states that Tier 2 Capital includes patronage shares that are redeemable within the following 12 month period. • Currently, the redeemable amount is the remaining shares that can be redeemed until the next audited financial statements are issued at which time the 10% limit is reset.

	• We seek clarification what is meant by "the following 12 month period", whether the Proposed Rule is consistent with current practice or whether the language refers to a rolling 12-month period. We believe clarity in the definition will ensure compliance and consistency amongst Credit Unions.
5(5)	**Commentary** • 5(5) states that a Credit Union must, in its financial statements and for each financial quarter, amortize any security that is included in the Credit Union's Tier 2 Capital on a straight-line basis in the five years prior to the date on which the security must be redeemed, repaid or purchased by the Credit Union. • We seek clarification the intent of this requirement as accounting for securities (whether accounted for as Tier 2 Capital or not) should follow applicable rules under IFRS.

Section 7 Credit Risk – Standardized Approach
Table 2: Asset Risk Weightings

Section	Comments / Unintended Consequences / Impact
Table 2(w)	**Commentary** • Table 2(w) states that "Interest rate contracts, including any current exposure and any potential future exposure on such contracts, with a central, Central 1 Credit Union, Federation des Caisses Desjardins du Quebec, a financial institution, Credit Union or another equivalent entity approved in writing by the Authority" is risk weighted 20%. • We request further clarification on the rationale for 20% risk weighting for this exposure. In addition, please provide detailed guidance on how the "potential future exposure" is calculated to avoid ambiguity and inconsistency amongst Credit Unions.
Table 2(bb)	**Commentary** • Residential mortgage loans receiving 35% risk weighting currently exclude non-owner-occupied properties (i.e., rental properties). Based on our previous discussions with the Ministry of Finance, we understand that there will be updates made to the Credit Unions and Caisses Populaires Act 2020 such that the definition in the Act will now include non-owner-occupied properties. Revisions to the Proposed Rule to reflect this anticipated change would also align well with OSFI guidance. **Unintended Consequences and Impact** • Currently Credit Unions apply a risk weighting of between 75% to 100% to non-owner-occupied residential properties depending on the size of the loan which is much more punitive. This is an area where close alignment with OSFI is important to ensure a level playing field for Credit Unions.
Table 2(cc)	**Commentary** • Table 2(cc) states that "MBS that are fully and specifically secured by residential mortgage loans, other than MBS guaranteed by CMHC receives 35% risk weight". • FSRA is silent on capital treatment of other types of MBS and the asset can fall into the default 1250% risk weighting that is more punitive. • We recommend alignment with OSFI guidance 3(37) to 3(39) where additional types of MBS and their risk weighting are specified. • This alignment will ensure a level playing field for Credit Unions.

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<tr><td>Table 2(mm)</td><td>Commentary

Table 2(mm) states “commercial loans made to a person where the sum of all commercial loans made to that person and to any connected persons does not exceed the lesser of 0.0035% of the Credit Union’s total assets and $1.25 million”.
We believe the quantitative threshold of $1.25 million used for small business is dated and requires revision to reflect current market trends within this business segment.
There may be opportunities to harmonize with future direction of OSFI guidance where the size of a business is based on its revenue.
There is also currently an inconsistency with the small business definition in the Proposed Liquidity Adequacy Rule 1(1)(xliii) which states “a small business that is managed as a retail exposure by the Credit Union, provided that the total aggregate funding, excluding all residential mortgage exposures, provided by the Credit Union to the small business and connected persons to it is less than $1.5 million”.
We recommend the limit be increased to a range between $3-5 million and appropriately aligned between Proposed Capital and Liquidity Rules.

Unintended Consequences and Impact

Quantitative threshold that is too low may inadvertently lead to more loans being considered commercial loans with higher capital requirements (and correspondingly higher pricing) that may not be warranted given the risk profile. This could in turn lead to restricting growth in an important segment of our member base and a significant growth engine within the Canadian economy that is the small business and entrepreneur segment.
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<tr><td>Table 2(vv)</td><td>Commentary

Table 2(vv) states “financial technology investments and local community investments up to an aggregate maximum of 1% of the Credit Union’s capital in the Credit Union’s financial statements” receive 100% risk weighting with amounts in excess of 1% defaulting to 1250%.
The Credit Union sector will increasingly rely on partnership and investments in Fintech to analyze, assess and access certain technologies that can help us remain competitive by offering innovative products and services to members and driving operational efficiencies. This is especially important given the advent of open banking, payment network modernization and consumer trend and preference towards digital and online offerings.
Most Credit Unions do not currently have individual resources and capabilities to invest directly in these areas due to lack of economies of scale thus making investments in Fintech a viable and economical alternative.
Many Credit Unions also make socially oriented investments in support of their communities. Examples include specific ownership in real estate projects, investing in building naming rights, or supporting non-profit organizations.
A 1% capital limit, shared between Fintech and local community investments is too restrictive. In addition, the low limit means subsequent increase in fair value of these investments (e.g., mark to market gains) beyond the limit will attract a punitive risk weighting of 1250%.
We recommend separating Fintech investments from community investments and increasing the corresponding limit each to 5% of capital. We also recommend additional wording to be added to
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<tr><td></td><td>clarify any ownership requirements of investments that fall into this category. For example, does this category include both significant and non-significant investments, joint venture and majority ownership.

Unintended Consequences and Impact
Applying a 1250% capital treatment to portions of fintech investments exceeding 1% is too punitive and will severely restrict our ability to compete competitively with larger provincial and federal financial institutions.
We believe that these factors that are unique to Credit Unions warrant special considerations by FSRA to tailor an approach that is more conducive to enabling the long-term success of the sector.</td></tr>
<tr><td>Table 2(zz)</td><td>Commentary
Table 2(zz) states that “investments in entities, assets generated by business activities not otherwise included in Table 2” receives a risk weighting of 1250% which is the most punitive capital requirement category.
This category is too broad as it currently by default, includes:
public and other equities held as part of Credit Union’s liquidity and investment portfolios
investments in Central 1
alternative investments
investment funds including fund of funds
real estate investments
corporate bonds and short-term commercial paper
other financial assets (e.g., prepaids, other receivables)
other non-financial operating assets (e.g., land, building, leasehold improvement, right-of-use assets, equipment, deferred charges, software not classified as intangible assets)
residential mortgage loans exceeding 80% LTV
In addition, without clear guidance to state otherwise, assets that are direct deductions from Tier 1 and 2 Capital, and assets exempt from direct deductions from capital subject to an aggregate limit may also be interpreted to fall into the 1250% risk weighting by default which would lead to double counting of capital impact.
We recommend clearer language around risk weighting of additional asset categories and that risk weighting be 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.</td></tr>
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<li style="list-style-type:circle">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)
<li style="list-style-type:circle">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%
<li style="list-style-type:circle">Residential mortgage loans exceeding 80% LTV: 75%

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 that differs from the risk weighting specified in paragraph zz) of Table 2. We request clear guidance for as many asset categories as possible that are currently not included in Table 2 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.

Unintended Consequences and Impact

This is an area where close alignment with OSFI in terms of risk weighting and guidance is important to ensure a level playing field for Credit Unions. Misalignment with federal guidance creates additional pricing pressures or inappropriate arbitrage between federal and provincial financial institutions.
We wish to further elaborate on our recommendation of 100% risk weighting for investments in Central 1.

<li style="list-style-type:circle">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 economy 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 Proposed Rule would not be in the best interest of the sector in promoting a level playing field and fostering long-term sector growth.

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<tr><td>Table 2(ccc)</td><td>
Commentary

Table 2(ccc) states that “The portion of a residential mortgage loan described in paragraph g) that does not have a backstop guarantee provided by the Government of Canada but is insured by an insurer with a credit rating specified in Table 4”.
This clause effectively assigns risk weighting of loans based on the credit rating of the underlying insurer. Where an insurer is rated by more than one rating agency, the lowest rating is selected.
Sagen is currently risk rated AA by DBRS and A+ by S&P/Fitch which will attract a 50% risk weighting under the Proposed Rule vs. 35% currently, while Canada Guaranty which is risk rated AA Low by DBRS will attract a 20% risk weighting under the Proposed Rule vs. 35% currently. It seems counter-intuitive that Sagen who is rated higher credit quality by DBRS will receive a more punitive risk weighting under the Proposed Rule.

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	• As Canada Guaranty is not rated by either S&P or Fitch, this creates an anomaly that should be reviewed by FSRA to minimize any unintended consequences of the Proposed Rule.
N/A	**Commentary** • There are a number of asset categories for which capital treatment is silent under the Proposed Rule which could be interpreted to receive the punitive 1250% risk weighting by default. These include: a) Amounts receivable resulting from the sale of mortgages under NHA MBS programs (OSFI guidance 3(37)) b) Repos, reverse repos and securities lending (OSFI guidance 3(42) to 3(46)) c) Purchased receivables (OSFI guidance 3(72)) • This is an area where close alignment with OSFI is important to ensure a level playing field for Credit Unions.

Section 9: General Market - Interest Rate Risk

Section	Comments / Unintended Consequences / Impact
9(10)	**Commentary** • 9(10) states that "A Credit Union must prepare a report at the end of each quarter of its fiscal year describing the Credit Union's management of its exposure to interest rate risk… The Credit Union must present the report at a meeting of the board of the Credit Union within 60 days after the end of the quarter for which the report is prepared". • We wish to highlight to FSRA that some board meetings may be outside of the 60 day window specified in the Proposed Rule. Given the importance of compliance with the Proposed Rule, we recommend the window to be changed to 90 days.

Section 11: Transition Rule for Minimum Capital Ratios and Capital Conservation Buffer

Section	Comments / Unintended Consequences and Impact
11(1)	**Commentary** • Currently no transition period is contemplated by the Proposed Rule despite adding a 2.5% capital conservation buffer which increases the minimum Tier 1 Capital ratio to 9% and minimum total supervisory capital to 10.5%. • We continue to support a risk-based approach in evaluating adequacy of capital and believe the current Internal Capital Adequacy Assessment Process (ICAAP) is sufficient in ensuring management considers Pillar 1, 2 and stress testing requirements on capital. This approach also ensures that the unique circumstances of individual Credit Unions are considered rather than a one size fits all approach via a 2.5% capital buffer. • In addition, the presumption that almost all of Ontario's Credit Unions currently either meet or exceed the requirements specified in the Proposed Rule may be inaccurate as a number of material new capital requirements still require clarification and potential revisions before Credit Unions can complete their assessment of impact.

	• In the event 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 10 years. There is also a long, established practice of provincial and federal regulators providing an even longer transition period. For example, Ministry of Finance previously proposed a 10 year transition period. See link.
	
	Unintended Consequences and Operational Impact
	• Credit Unions execute short-term operations and medium/long term business plans based on our understanding of capital adequacy requirements. Material changes to capital adequacy requirements take significant lead time to assess impact, make changes and execute.
	• Management requires time to review whether a higher minimum total supervisory capital necessitates a higher internal management limit in conjunction with ICAAP.
	• Significant lead time is required to assess, communicate with relevant stakeholders and execute:
	  ○ changes to product offerings and pricing;
	  ○ changes to existing and future strategic investments including investments in FinTechs and local communities; and
	  ○ changes to capital plans including altering the timing, terms and amount of planned earnings and capital share raises.
	• An inadequate transition period will lead Credit Unions to suboptimal business decisions and ultimately jeopardize the success of the entire sector including the member base we serve.