FSRA Policy Team

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Delivered Electronically to Bradley Hodgins

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To the Readers,

Meridian, Alterna, FirstOntario, DUCA and Libro (hereafter referred to as “We”) appreciate 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 we have collectively determined to be of the highest 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 at all cost.

**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 a number of 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 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 where most Credit Unions 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 collective 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.

**Appendix A**

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

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| **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](https://fin.gov.on.ca/en/consultations/cu-cp/moclf.html#toc_9).

**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.
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**Section 7 Credit Risk – Standardized Approach**

**Table 2: Asset Risk Weightings**

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| **Section** | **Comments / Unintended Consequences / Impact** |
| Table 2(zz) | **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.
	+ 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%
* 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.
	+ 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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| Table 2(vv) | **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 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.
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| Table 2(mm) | **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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| 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.
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**Section 4: Tier 1 Capital**

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| **Section** | **Comments / Unintended Consequences / Impact** |
| 4(5)(iv) | **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.
* 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.
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| 4(4) | **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.
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