September 14, 2021

**BY EMAIL TO** Mehrdad.Rastan@fsrao.ca and Helen.Thomas@fsrao.ca

Helen Thomas

Relationship & Risk Management

Credit Union & Prudential Division

25 Sheppard Avenue West, Suite 100

Toronto, ON M2N 6S6

Dear Ms. Thomas,

**Re: MCU comments on the Proposed Rule – Capital Adequacy Requirements for Credit Unions**

FSRA has requested a response to the Proposed Capital Rules, including answering the four questions raised in the Notice provided to credit unions dated June 14th. The following outlines areas that we are seeking clarification as well as specific additions to the requirements that are either vague or missing.

**Specific Questions FRSA has provided:**

1. **Does the Proposed Rule reflect effective, clear, and appropriate capital adequacy rules for Ontario’s credit unions?**

Overall the Proposed Rule provides appropriate capital adequacy rules which are consistent with Basel III requirements. However, there are numerous concerns and various areas that require clarifications before we would endorse this Rule. The Proposed Rules include increased buffers on existing capital requirements while also introducing new requirements that will require credit unions time to change board policy limits, potentially alter long-term growth plans, as well as adjust capital planning to accommodate the Rules. Therefore, MCU would propose a minimum 5-year transition period for the Proposed Rules to be implemented with the Capital Buffer to be phased at the maximum pace of 0.50% per year. This would allow credit unions sufficient time to adjust policy, planning and if required raise tier 1 capital.

When we consider OSFI’s past practice, under paragraph 34 of [2018 Capital Adequacy Requirement (CAR)- Chapter 1- Overview (osfi-bsif.gc.ca))](https://www.osfi-bsif.gc.ca/Eng/Docs/CAR18_chpt1.pdf) , there was a 4 year phase-in period from 2016 to 2019 for the full implementation of the capital conversation buffer The phased increments were as follows:



Furthermore, OSFI had a lengthy period of discussions with banks on the arrangement of the phased-in period and additional time prior to the implementation (2013 to 2015) to allow for the banks to prepare for the requirement. It would be prudent for FSRA to consider a similar approach as OSFI as the capital conservation buffer would have significant impact as MCU would have to reconsider its internal capital targets, strategic plans including growth plans to adapt to new regulatory capital constraints, and potentially raise additional capital to minimize impact to business.

1. **Is there any major topic that should be addressed by the Proposed Rule that is currently not included?**

Yes.Included in the table below are seven specific asset classes that the Proposed Rule did not specifically include, all of which OSFI has specific guidelines and risk weightings in their own guideline. MCU would propose that FSRA include specific guidance on the risk weighting of each of these asset classes in accordance with current OSFI guidelines.

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| **Item** | **Current Treatment** | **Proposed Treatment** | **Recommendation** |
| **1. Other assets:****a) Corporate Bonds** **b) Equity Investment in Funds** **c) Corporate Exposures (linked to 1b)****d) Bank Preferred Shares** **e) League Shares** **f) Other Assets in MCU balance sheet not addressed by FSRA capital framework****g) Other Assets from new business activities in the future**  | All items: 100% RW | Items 1a, b, c, f, g: 1250% RWItems 1d, e: Regulatory Deduction from Tier 1 capital | **1a:** Adopt Section 3.1.7 *Claims on Corporates Approach from* [Capital Adequacy Requirements (CAR) - Chapter 3 – Credit Risk – Standardized Approach (osfi-bsif.gc.ca)](https://www.osfi-bsif.gc.ca/Eng/Docs/CAR19_chpt3.pdf). Specifically, FSRA should incorporate appropriate risk weights based on credit risk rating. **1b:** Adopt Section 3.1.18 *Claims on Equity Investment in Funds* from [Capital Adequacy Requirements (CAR) - Chapter 3 – Credit Risk – Standardized Approach (osfi-bsif.gc.ca)](https://www.osfi-bsif.gc.ca/Eng/Docs/CAR19_chpt3.pdf). Specifically, FSRA should incorporate the Look-Through Approach (LTA) and Mandate-Based Approach (MBA).**1c:** Adopt Section 3.1.19 *Other Assets* from [Capital Adequacy Requirements (CAR) - Chapter 3 – Credit Risk – Standardized Approach (osfi-bsif.gc.ca)](https://www.osfi-bsif.gc.ca/Eng/Docs/CAR19_chpt3.pdf). Specifically, FSRA should incorporate the following:* non-significant equity of holdings of non-financial entity: 100% RW
* real estate and other investments (including non-consolidated investment participation in other companies): 100% RW
* significant investment of commercial entity: 1250% RW (Section 2.3.4 *Items subject to 1250% RW* from [Capital Adequacy Requirements (CAR) - Chapter 2 – Definition of Capital (osfi-bsif.gc.ca)](https://www.osfi-bsif.gc.ca/Eng/Docs/CAR19_chpt2.pdf)

**1d:** Adopt Paragraph 74-76 *Non-significant investments in the capital and/or Other TLAC Instruments of banking, financial, and insurance entities* from [Capital Adequacy Requirements (CAR) - Chapter 3 – Credit Risk – Standardized Approach (osfi-bsif.gc.ca)](https://www.osfi-bsif.gc.ca/Eng/Docs/CAR19_chpt3.pdf). Specifically, FSRA should incorporate the following:* Holdings greater than 10% of Common Equity Tier 1 (CET1) threshold: regulatory deduction from capital
* Holdings below 10% of CET1 threshold: 100% RW (Section 3.1.19 *Other Assets* from [Capital Adequacy Requirements (CAR) - Chapter 3 – Credit Risk – Standardized Approach (osfi-bsif.gc.ca)](https://www.osfi-bsif.gc.ca/Eng/Docs/CAR19_chpt3.pdf))

Alternatively, FSRA can maintain status quo of the treatment of bank preferred shares at 100% RW. **1e:** Credit unions are encouraged to hold central/league shares to support centralized services that would not be otherwise possible given the small scale of credit unions compared to banks. It is not the intention of credit unions to hold league shares to inflate its capital position. Thus, league shares should be treated separately from non-significant investment of capital instruments of other financial institutions (discussed in Item 1d above). FSRA should maintain status quo of 100%, which is also like other similar provincial credit unions jurisdictions (i.e. B.C., Saskatchewan, Alberta). **1f:** Adopt Section 3.1.19 *Other Assets* from [Capital Adequacy Requirements (CAR) - Chapter 3 – Credit Risk – Standardized Approach (osfi-bsif.gc.ca)](https://www.osfi-bsif.gc.ca/Eng/Docs/CAR19_chpt3.pdf). Specifically, FSRA should incorporate the following:* Unrealized gains and accrued receivables on foreign exchange and interest rate-related off-balance sheet transactions where they have been included in the off-balance sheet calculations: 0% RW
* Premises, plant, equipment and other fixed assets: 100% RW
* Accrued Interest and Other Receivables: 100% RW
* Prepaid expenses such as property taxes and utilities: 100% RW
* Deferred charges such as mortgage origination costs: 100% RW
* Right-of-use (ROU) assets where the leased asset is a tangible asset: 100% RW

There are other Accounting Items on MCU not captured by above categories which should also be given 100% RW. Some examples are:* Collection Costs Recoverable
* Floorplan customer fee

**1g:** Adopt Section 3.1.19 *Other Assets* from [Capital Adequacy Requirements (CAR) - Chapter 3 – Credit Risk – Standardized Approach (osfi-bsif.gc.ca)](https://www.osfi-bsif.gc.ca/Eng/Docs/CAR19_chpt3.pdf). Specifically, FSRA should treat other assets as 100% RW. The appropriateness of the current proposed 1250% RW is dependent on the comprehensiveness of FSRA capital framework. FSRA would need to ensure its proposed capital framework captures all of the current and future business activities of credit unions to avoid the inappropriate classification of assets into 1250% RW category. This may not be possible given the increasing uncertainty and fast pace environment in the financial service sector. There are also unique accounting items (refer to item 1f above for current accounting items) that may not be classified into proposed RW categories that may be inappropriately subjected to 1250% RW. Although the CEO of FSRA may specify a RW for specific items not captured by the framework, assigning 1250% RW prior to this process would be overly punitive as all assets on the balance sheet of credit unions are assigned RW well below 1250%. This may deter credit unions from pursuing new business activities due to the punitiveness of 1250% RW and the uncertainty of appropriate RW through the regulatory application process with FSRA for new RWs. In addition, there may be operational disruption if new accounting items are inappropriately classified as 1250% RW. Thus, FSRA should align with OSFI and other similar provincial credit union jurisdictions (i.e. B.C., Saskatchewan, Quebec, Alberta) on the treatment of other assets at 100% RW. |

1. **Is the Proposed Rule sufficiently clear to ensure compliance within its objectives?**

More clarity around the 250 basis point capital conservation buffer ratio is required. Specifically how would FSRA’s response differ if a credit union was to drop below this buffer differ vs. if a credit union were to drop below any of the underlying capital ratios (tier 1, total capital)? Currently MCU sets policy and management limits with buffers above the required capital identified through our ICAAP process. Would the capital conservation buffer, which we see as a floor to the ICAAP pillar 2 requirement, intended to represent pillar 2 or pillar 1 capital?

Currently the Proposed Rule does not adequately address the following for MCU to endorse:

1. The treatment of deferred tax assets
2. The treatment of interest rate risk
3. The treatment of non-owner occupied residential mortgages

The following table outlines each of these areas and provides a recommended capital treatment as well as the rationale behind each:

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| **Item** | **Current Treatment** | **Proposed Treatment** | **Recommendation** |
| **1. Deferred Tax Asset (Temporary differences)** | 100% RW | Regulatory Deduction of DTA (excluding up to 1% of Tier 1 Capital of DTA arising from Temporary Differences) | Adopt Paragraph 58-59 *Deferred Tax Asset* and 84-86 *Threshold Deduction* from [Capital Adequacy Requirements (CAR) - Chapter 2 – Definition of Capital (osfi-bsif.gc.ca)](https://www.osfi-bsif.gc.ca/Eng/Docs/CAR19_chpt2.pdf). Specifically, FSRA should incorporate the following:* DTA (excluding Temporary Difference): regulatory deduction from capital
* DTA (Temporary Difference)
	+ Depend on future profitability: 100% RW
	+ Does not depend on future profitability
		- Exceed 10% of CET1 Capital Threshold: regulatory deduction from capital
		- Does not exceed 10% of CET1 Capital Threshold: 250% RW

Alternatively, FSRA should consider the following:* Reconsider the appropriateness of its proposed 1% of Tier 1 Capital threshold for DTA arising from temporary differences as it misaligned with the listed OSFI threshold above, OR

Maintain status quo of 100% RW on all DTA  |
| **2. Interest Rate Risk in Banking Book (IRRBB)** | Pillar 1 | Pillar 1 | Align with Basel ([Interest rate risk in the banking book (bis.org)](https://www.bis.org/bcbs/publ/d368.pdf)) and OSFI guideline B12 ([Interest Rate Risk Management (osfi-bsif.gc.ca)](https://www.osfi-bsif.gc.ca/Eng/Docs/b12.pdf) on the treatment of IRRBB under Pillar 2 (ICAAP) and not Pillar 1. Market risk under Pillar 1 should only cover market risk in trading book and not IRRBB. This has the impact of increasing Pillar 1 capital requirement and potentially ICAAP requirement as IRRBB is addressed a second time in Pillar 2. *
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| **3. Non-owner occupied residential mortgages (< 4 units)** | 75% or 100% RW  | 75% or 100% RW | Section 55 of Ontario Regulation 237/09 ([O Reg 237/09 | General | CanLII](https://www.canlii.org/en/on/laws/regu/o-reg-237-09/latest/o-reg-237-09.html)) defines a residential mortgage loan is a loan that is secured by a mortgage on residential property (up to 4 units) that is occupied by the borrower. As such, the capital treatment of non-owner occupied residential mortgages (< 4 units) are treated as commercial mortgages and risk weighted 75% or 100%. This is inconsistent with Section 3.1.9 Claims Secured by Residential Property from [Capital Adequacy Requirements (CAR) - Chapter 3 – Credit Risk – Standardized Approach (osfi-bsif.gc.ca)](https://www.osfi-bsif.gc.ca/Eng/Docs/CAR19_chpt3.pdf) which defines residential mortgages as “mortgages on residential property that is or will be occupied by the borrower, or that is rented, are risk weighted at 35%”. This is also inconsistent from other similar provincial credit union jurisdiction such as B.C. Specifically, the *Financial Institutions Act* of BC ([Financial Institutions Act -- CAPITAL REQUIREMENTS REGULATION (gov.bc.ca)](https://www.bclaws.gov.bc.ca/civix/document/id/loo64/loo64/315_90)) states residential mortgages can include “residential rental dwellings, consisting of not more than 4 units, ready for occupancy” without the condition for owner-occupancy. Due to difference from OSFI and other provincial jurisdiction, MCU recommends FSRA reconsider the definition of retail mortgages and whether non-owner occupied residential mortgages (<4 units) can be treated as residential and RW at 35%. Note: FSRA mentioned on its Q&A to the Capital Adequacy and Liquidity Adequacy Rules ([Webinars | Financial Services Regulatory Authority of Ontario (fsrao.ca)](https://www.fsrao.ca/industry/credit-unions-and-caisses-populaires/webinars)) that it does not have authority to change the definition of residential mortgages. However, clauses 10 and 11 of subsection 285(1) of the Credit Union Caisses Populares Act 2020 authorizes FSRA to make rules “regulating the maintenance, by credit unions, or adequate capital and adequate and appropriate forms of liquidity” and “respecting regulatory capital and the total assets of a credit union”. Under these provisions, FSRA should have the statutory authority to assign the appropriate RW.  |
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1. **Are there compliance costs that would be associated with the Proposed Rule that FSRA has not considered?**

Based on comments from FSRA in communication with credit unions, FSRA has maintained that all credit unions would currently comply with the proposed ratios and therefore costs to comply would be inconsequential. Regardless of the changes in the proposed rules as described already, the introduction alone of increased capital requirements through the 250 basis point capital conservation buffer does increase compliance costs for credit unions as they may need to raise capital to meet the increased requirements.

Generally with significant capital requirement changes proposed there is often a lengthy implementation timeline with phased-in periods. This includes the following:

* + OSFI’s 2018 discussion paper on *“The Implementation of the Final Basel III reforms in Canada”* (<https://www.osfi-bsif.gc.ca/Eng/Docs/biii.pdf> ) indicates that Basel III reforms with the exception of a few items (requiring longer implementation date) will be implemented at an effective date of January 1, 2022 (~4 year implementation period) with a 5 year transition period for the output floor of Model based RWAs.
	+ Bank of Canada’s 2014 discussion paper on *“Making Banks Safer: Implementing Basel III”* (<https://www.bankofcanada.ca/wp-content/uploads/2014/06/fsr-june2014-chouinard.pdf>) indicates that the Basel Committee on Banking Supervision (BCBS) previously agreed to phase in the new requirements over a six-year period ending in December 2018.
	+ As previously mentioned on Question 1 above, OSFI previously has a 4 year phase-in period from 2016-2019 for the full implementation of Capital Conservation Buffer.

We thank you for the opportunity to respond to the Proposed Rule and look forward to ongoing discussion of these items raised.

Sincerely,

**Tara Daniel**

Chief Financial Officer

Cc: Mehrdad Rastan, Relationship Manager, FSRA

 Gary Genik, Chief Executive Officer, Meridian