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Mr. Bradley Hodgins,
Senior Manager, Policy & Research
Financial Services Regulatory Authority

Dear Mr. Hodgins,

The Canadian Credit Union Association is the trade association for Ontario's credit unions and caisses populaires. Following extensive discussion with our membership – we make the following response to Rule 2021-005 – Capital Adequacy for Credit Unions and Caisses Populaires. Our response is structured in two parts. We begin by directly responding to the questions posed in the consultation. We then make four general points of concern and recommend remedies.

Part I – Response to questions

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

Yes, overall, the Proposed Rule provides appropriate regulatory capital adequacy requirements for Ontario credit unions that is consistent with Basel III. However, we have some concerns and a list of specific elements that require clarification, confirmation and/or adjustment before we can fully endorse the Rule.

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

While broadly defined in Section 1(1) and applicable risk weightings suggested in Table 2 (vv and zz), we strongly suggest that the approach and limits applicable to Financial Technology (FinTech) and local community investments be amended to “allow credit unions to compete effectively while taking reasonable risks”.

3. Is the Proposed Rule sufficiently clear to ensure compliance with its requirements? If not, please specify what is unclear and add clarifying language that should be considered.

One of our main concerns is Section 4(4) regarding the “grandfathering” of classes and series of Investment Shares already outstanding (including those yet to be issued prior to the Rule coming into effect). We are seeking assurances regarding the longevity of the grandfathering



provisions as they relate to how Ontario credit union currently administer redemption requests for such shares and the applicable calculation of Investment Shares qualifying as Tier 1.

Additionally, we recommend several individual Rule elements (aside from Investment Shares) where text and language can be clarified and/or our understanding and interpretation confirmed in the next section.

4. Are there compliance costs that would be associated with the Proposed Rule which FSRA has not considered? If so, please describe and quantify these costs.

The precise definitions to be applied to various types of loans and the associated risk weights may lead to additional compliance costs. Until these definitions are known and risk weights assigned, it is impossible to quantify these costs.

There is also the potential for *indirect* and/or *intangible* costs of compliance that may arise from the Rule in its final form when it comes into effect. Such costs include:

- Lower member-owner loyalty or share of wallet should loan costs or collateral requirements be higher resulting from higher loan risk weightings for Ontario credit unions than those applicable to our competitors.
- Lower market share and/or foregone lending and investing opportunities due to capital requirements if they should prove more restrictive than for our competitors.
- Reduced agility to bring new products and services to market in a timely manner and maintain competitiveness if strategic FinTech investments become prohibitively expensive due to excessive capital requirements (1250% punitive risk weighting).
- Reduced member-owner loyalty, public regard and reputation and staff/board commitment should the credit union fail to demonstrate professed and desired community leadership if investment in local social benefit enterprises and undertakings (“local community investment”) be excessively restricted by punitive risk weightings.

Part II – further comments.

Investment shares

Section 4(4) of the Proposed Rule provides “grandfathering” of current Investment Shares as Tier 1 capital. More specifically,

“Shares issued by a credit union prior to this Rule coming into force that were Tier 1 capital of the credit union pursuant to paragraph 5 of the definition of “E” in subsection 17(2) and subsection 17(4) of Ontario Regulation 237/09 are investment shares for the purposes of paragraph 4(2)(v).”



This section of the Rule must more comprehensively spell out the terms of that grandfathering provision to provide Ontario credit unions with the certainty necessary to underpin longer term strategic and capital planning.

We seek specific assurance and suggest that there are sufficient safeguards (listed below) that, for Investment Shares issued both before and after the Proposed Rule comes into effect, those shares issued as payment of dividends, may be available for redemption at any time after expiry of the minimum initial holding period for originally purchased shares as specified in the applicable Offering Statement for that Class and Series (normally five years as suggested by Proposed Rule Section 4(3)vi).

Specifically, we suggest the following:

“Shares issued prior to this Rule coming into force, including shares subsequently issued after this Rule comes into force but issued in the same series and classes as those shares issued prior to this Rule coming into force ...”

Also, for greater clarity text similar to the following should be included:

“Shares issued as dividends on investment shares are exempted from the five-year holding period requirement applicable to issuance of new series and classes.”

Ontario credit unions that have issued Investment Shares appreciate that FSRA has indicated that such shares will continue to qualify as Tier 1 capital under Rule 002 -- Capital Adequacy. We also understand and agree that New Classes of Investment Shares and New Series of Investment Shares within current classes, issued after the Proposed Rule comes into effect will need to fulfill the requirements of Section 4(3) of the Proposed Rule to qualify as Tier 1 capital.

During advance and informal consultations regarding Rule 002 in the spring and summer of 2021, however, FSRA presentation materials and responses to questions on this topic have prompted some concerns as to the specifics and longevity of the intended grandfathering provisions. Current Investment Shares outstanding were issued by credit unions following full prior regulatory review and receiving required permissions on the good faith understanding they would qualify and continue to qualify as Tier 1 capital. For many credit unions, they represent a portion of Tier 1 capital equally if not more significant than Retained Earnings.

Many credit unions with Investment Shares issue dividends on Investment Shares in the form of additional Investment Shares of the same class and series (as provided by the terms of the applicable Offering Statement and credit union Articles of Incorporation or Amalgamation). Since the first Investment Shares were issued in 1995, a substantial portion of Investment Shares currently outstanding represent those shares issued as dividends. Going forward, we seek specific assurance that Investment Shares issued after the Proposed Rule comes into effect but representing payment of dividends on Classes and Series of Investment Shares already outstanding prior to the Proposed Rule coming into effect will continue to qualify as Tier 1 capital under section 4(4) of the Proposed Rule.



Many Investment Shares have also been included as qualifying contributions to a Registered Retirement Savings Plan (RRSP). When the holder of such shares reaches the age specified by the federal *Income Tax Act* and regulations related to RRSP's for mandatory withdrawal (or conversion to applicable registered income fund, annuity or similar financial product), credit unions normally allow redemption of such shares before the five year holding period has expired. Such redemptions are combined with all other redemption requests and are subject to the approval of the Board of Directors and within the 10% per class per year limit and only if such redemptions will not cause the credit union to fall below required capital adequacy requirements. We seek specific assurance that continuing this practice is within the spirit and intention of the grandfathering provision and continued qualification as Tier 1 capital.

Safeguards: we note that, to preserve capital and the satisfy the notion of permanence within the context of cooperative and small/medium domestic financial institutions, the following provisions will continue to apply to Ontario credit union investment shares of all classes and series:

- Redemption provisions for each class and series will be as specified by the original Offering Statement for that class and series as reviewed and receipted by the applicable Ontario regulatory authority and as communicated to and understood by the purchaser prior to issuance;
- Credit unions may redeem only 10% of the shares outstanding in any class in any one year and those shares eligible for redemption during the following 12 months are deducted from Tier 1 calculations (and assigned to Tier 2, whether such redemptions actually occur or not);
- Redemptions (as well as declaration and payment of dividends) are at the discretion of the Board of Directors who have a fiduciary duty to allow only those redemptions consistent with the credit union maintaining capital adequacy provisions as required by the Act, Regulations and this Proposed Rule.

Fintech and Community Investments

Proposed Rule 002 suggests in Rule 7(2) Table 2"

- (vv) that "Financial technology investments and local community investments up to an aggregate maximum of 1 percent of the credit union's capital in the credit union's financial statements" should be risk weighted at 100%, and
- (zz) "Investments in entities or assets generated by business activities not otherwise included in Table 2" be risk weighted at 1250%.



We note the following:

- The 1250% risk weighting arises from provisions included in Basel III and also the Canadian federal Office of the Superintendent of Financial Institutions (OSFI) as generally applicable to large financial institutions operating internationally and/or at a domestically significant scale.
- Considering an overall 10.5% minimum risk weighted capital requirement (not including any internal Board policy and/or administrative buffers a credit union may choose for operational purposes), a 1250% risk weighting implies that the credit union must carry \$1.31 of capital for every \$1.00 of investment in this category ... a level we deem punitive for all but those ventures of the highest risk.
- The term “*financial technology investment*” is defined in Section 1(1) (ix) as “*an investment in an entity that has, as its purpose, the enabling of financial innovation using technology that could result in new business models, applications, processes or products with an associated material effect on financial markets and institutions and the provision of financial services*”. However, this “catch-all” definition does not address the wide spectrum of market maturity of the inherent financial technology, the corporate and financial structures that fintech entities developing or operating such technologies might take, the nature or form of a credit union investment in such entities nor any assessment of graduated risk of such investment.
- The term “*local community investment*” is defined in Section 1(1) (xiv) as “*investment of capital, credit or other funds to an organization that provides essential community products or services such as safe and affordable housing, job opportunities, education, healthcare, financial counselling, and child-care in the communities where members reside*”. We appreciate that FSRA is attempting to facilitate credit union investments in such enterprises that provide such goods and services on terms that *might* not be available to selected populations in the open, private or commercial market and of great benefit to the wider community generally. However, this definition does not distinguish between community investment projects or entities that could be funded on normal commercial terms (qualifying for the applicable lower risk weighting as per Table 2) and those that could be difficult to categorize but still present relatively low risk.
- Row (zz) of Table 2 assigns a 1250% risk weighting to all other investments not otherwise defined (regardless of the inherent risk in such an enterprise or project) simply because it is unique and not foreseen by the drafters of the Proposed Rule. This is inconsistent with FSRA’s overriding objective to adopt a principles-based, appropriate, and proportionate approach to regulating credit unions.
- Notionally, the Proposed Rule appears to suggest a “sandbox” approach to fintech and community investments by providing a 100% risk weighting to a small portfolio of very broadly defined investments (credit unions can “freely” operate within a sandbox the size of 1% of capital) but only invest outside the sandbox at punitive capital requirement levels to offset undefined risks.

We agree with the “sandbox” approach if it is significantly expanded and more clearly defined. We suggest the parameters and definitions as contained in the following table. Adopting this would increase the capacity of Ontario credit unions to make investments in financial technology



(fintech), local community (social benefit, public good) and other strategic opportunities while mitigating risk with appropriate levels of capital.

Table 2 (vv) Sandbox	Box A	Box B	Box C
Relative Risk	Low	Moderate	Higher
Risk Weight	100%	250%	1250%
Box Size Limit	2.5% of Capital	2.5% of Capital	Board Discretion
FinTech Investment Attributes	<ul style="list-style-type: none"> • FinTech firm with strong track record • Mature technology / operational • Data only (no CU\$ at risk past investment) 	<ul style="list-style-type: none"> • FinTech firm has additional backing • Tech developed (eg. in beta trials, etc.) • Minimal CU\$ at risk past investment 	
Local Community Investment Attributes	<ul style="list-style-type: none"> • High/critical/strategic community need(s) • Multiple or established community partners • Short/medium term: outcomes in 1-3 years 	<ul style="list-style-type: none"> • Emerging community need or opportunity • Few or newly developed project partners • Longer term: outcomes in 4+ years 	
Other Strategic Investments (eg. land development, diversification opportunities, etc if not covered elsewhere in Table 2)		<ul style="list-style-type: none"> • Formal business plan (projections, appraisals, approvals) • Multiple &/or established partners • Fit with strategic business plan 	
Documentation	<ul style="list-style-type: none"> • Overall Investment/Project description, plan, budget • Board Approval (minuted): resolution, policy reference(s), due diligence, rationale, etc • Specific reference to assumptions/justification for Box A & Box B amounts and assignments • Supporting/required legal documents (contracts, promissory notes, certificates, regulatory approvals, etc.) • Included in templates/schedules/spreadsheets/appendices used to calculate and report capital adequacy 		
<p>Note: As per Section 7(3), FSRA’s CEO retains the regulatory discretion* to re-assign risk weights to investments and asset categories not otherwise included in Table 2 that differs from the risk weighting specified in paragraph (zz) of Table 2. This serves as a secondary</p>			



regulatory provision, available to FSRA only as needed should there be significant disagreement with the assumptions and assignments as documented by the credit union.

*Note: notwithstanding the above, the proposed Rule should make as many specific risk weighting assignments as possible in the various rows of Table 2 so as to keep the number and type of asset category risk weights subject to CEO discretion to a minimum. Credit unions need to develop strategies and budgets and implement related tactics and plans with as much regulatory certainty as possible, not subject to the notional judgement (however well founded) of one individual/team at a moment in time. Also, individual investment opportunities may appear with a very short availability window and should not be automatically excluded from credit union consideration because a regulatory interpretation or ruling cannot be obtained in short order.

Asset Risk Weightings as per Table 2

- Loans of all types (as noted in the following table)
- Investments in Central 1 shares
- Investments in corporate bonds and similar instruments
- Operational assets.

Loans of All Types: Before we can definitively comment on the risk weightings to be applied to varying types and classes of loans, Ontario credit unions await clarification and/or language and text that the Ministry of Finance may use in the new Regulations pursuant to the recently renewed Credit Unions and Caisses Populaire Act. This applies to all the following loan types.

Section Reference	Loan Type/Description	Table 2 Reference(s)	Current Suggested Table 2 Risk Weight
• 1(1) ii	• Agricultural loan	• ll), nn)	• 75%
• 1 (1) vi	• Commercial loan	• mm), nn) • oo)	• 75% • 100%
• 1 (1) xxi	• Personal loan	• kk), nn)	• 75%
• 1 (1) xxiv	• Residential mortgage loan <i>and</i>	• f), g), h) • bb), cc), dd)	• 0% • 35%
• 1 (1) xxv	• Residential property	• pp), qq)	• 100%

More specifically, we seek clarity regarding residential properties with up to 4 units where the owner does not directly occupy one of the units. The Ontario Regulation subject to the new Act should reflect a definition for such properties such that credit unions can extend loans and mortgages secured by such properties with the same regulatory requirements and asset risk weighting as applicable to chartered banks and other lenders operating in Canada.



Regarding Table 2 mm) for “small/medium enterprise” or SME loans at the 75% risk weighting, 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 0.035% of the credit union’s total assets (35 basis points) and \$1.25 million), we suggest the following:

- “person” is not defined separately in Section 1(1) and this term should be clarified as to include both natural persons and incorporated entities if that is the intent, and
- The \$1.25 million criteria for small business should be changed for three reasons. First, it was originally set many years ago and this absolute dollar limit has not kept pace with inflation and economic growth. Second, it is not aligned with the similar criteria for small business as set in FSRA’s proposed Liquidity Adequacy Rule 1(1)(xlili) where the figure is \$1.5 million. We recommend that this provision be adjusted as follows:
“... does not exceed the lesser of 0.035% of the credit union’s total assets (35 basis points) and \$3 million” or, failing which “does not exceed the lesser of 0.035% of the credit union’s total assets (35 basis points) and the small business size limit as applicable to OSFI regulated financial institutions”

Note: FSRA’s Liquidity Adequacy Rule should be similarly adjusted and aligned.

Residential Mortgage Loans with Loan to Value ratio greater than 80%: Row (bb) refers to such loans with an LTV ratio less than 80% and applying a 35% risk weight as long as they are current (less than 90 days overdue). What is the risk weight for such loans if LTV is greater than 80%? As these loans are not specifically identified elsewhere in Table 2, we fear FSRA’s intention is to apply a 1250% risk weight which would be inappropriately punitive. We suggest such loans be specifically identified in Table 2 and assigned an appropriate risk weight of 100% (similar to (qq)).

Additionally, and depending on how various types of loans are defined in the Regulations, we seek clarity regarding the risk weighting to be applied to past due loans, their secured and unsecured portions.

Investments in Central 1: We recommend FSRA insert a separate row to apply an appropriate and specific risk weighting for Ontario credit union investment holdings of shares in Central 1 Credit Union. Further, we suggest that, based on Central 1’s current credit ratings from DBRS and Fitch, the applicable risk weighting should be 50% (as per Table 4).

While Central 1 no longer holds Ontario credit union deposits in a Mandatory Liquidity Pool, it does “contribute to the stability of the credit union sector in Ontario” (and other provinces) via its:

- Management of High Quality Liquid Assets (HQLA) held in trust arrangements
- Clearing of cheques and electronic transactions



- Treasury
- Lending to support liquidity and clearing
- Channel facilitation for securitization and syndication

Investments in Corporate Bonds and Similar Instruments: We suggest that such investments be specifically included in Table 2 in a separate row that applies a risk weighting using Table 4 for the bond or credit rating applied to the issuing entity by a recognized agency at the time of making the investment.

Operational Assets: We also recommend that Table 2 include an additional asset category for the net value of non-financial “operational assets” that the credit union uses to carry on business. These would include fixed or capital assets such as:

- Land and buildings representing credit union offices (branch and administrative)
- Furniture and equipment located within credit union premises
- Software that has been capitalized and is being depreciated

This “operational assets” category should be capped at 200 basis points and be assigned a nominal risk weighting of 35%.

Transition

FSRA has expressed an assurance that, according to their own analysis, almost every Ontario credit union can already comply with the capital adequacy requirements per the proposed Rule 002. FSRA assumes that, thus, no formal transition formula is required in the Rule other than the requirement for individual credit unions to apply the FSRA CEO for approval of an individual transition plan.

Without knowing how FSRA will address each of the three major foregoing concerns (especially, in the near term, the precise definitions to be applied to various types of loans and the associated risk weights), credit unions cannot accurately gauge their short, medium and long term capital positions nor blindly accept the assurance that no change will be required.

While an individual credit union and the Ontario credit unions system might appear to be well above the proposed capital requirements based on December 2020 data, FSRA’s proposed approach (“no transition period necessary”) fails to take into account many factors, not limited to the following:

- A single time data point (2020) does not reflect longer term trends (positive or negative with respect to capital ratios);
- Recovery from the covid-19 impact on global and national financial markets, regional and local community economies, individual credit union operations is nowhere near complete nor the strength, duration and other characteristics of that recovery at all predictable.
- Credit unions evolve their business models on an ongoing basis, adopting new strategies and adjusting tactics, products, services and operations accordingly to achieve new visions and



missions and adapting to fast changing environments. Capital plans must also evolve in tandem and are best founded with greater certainty when regulatory minimum requirements provide for moderate and phased increments.

- In the interests of efficiency, fairness and consistency, FSRA should seek to avoid, as much as possible, the necessity for appeals and applications for individual exemptions, variations and unique transition plans. Credit unions should be able to prepare their capital plans with regulatory certainty.

Accordingly, we recommend that the following transition schedule be incorporated into the Proposed Rule 2021-002.

Table ##	Column	B	C	D	E	F	G
A							
Capital as % of RW Assets		Current	Step 1	Step 2	Step 3	Step 4	Final
Retained Earnings (RE)			2.60%	2.70%	2.80%	2.90%	3.00%
Total Tier 1 (including RE)		6.00%	6.10%	6.20%	6.30%	6.40%	6.50%
Capital Conservation Buffer			0.70%	1.30%	1.70%	2.10%	2.50%
Total Tier 1 Quality Capital		6.00%	6.80%	7.50%	8.00%	8.50%	9.00%
Total Risk Weighted Capital		8.00%	8.75%	9.50%	10.00%	10.25%	10.50%

Credit unions start at the Step representing their current capital levels as of Rule 002 coming into force and progress building capital to meet minimum requirements for next Steps, taking a maximum of 12 months for each subsequent step until reaching minimum requirements for the Final Step and thereafter (with no interim reduction or regression to lower, prior Step levels).

We thank you for the opportunity to comment on this proposed Rule. We look forward to continued engagement.

Kind regards,

Nick Best
 Director – Government Relations
 Canadian Credit Union Association

