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Delivered Electronically

RE: Libro Credit Union Response to the Capital Adequacy Requirements for Credit Unions and Caisses Populaires Rule (ID: 2021-006).

To the Reader,

Libro Credit Union (Libro) is pleased to provide a response to the public consultation on the proposed Capital Adequacy Requirements Rule for Credit Unions and Caisses Populaires (Rule 2021-002). We recognize the significant effort underlying this proposal and appreciate FSRA's collaborative approach with the sector.

We are supportive of FSRA's intent to better align credit union capital standards to Basel III requirements and other jurisdictions. Specifically, within Section 3 of the rule where FSRA aims to "promote and otherwise contribute to the stability of the sector in Ontario with due regard to the need to allow credit unions to compete effectively, while taking reasonable risks." The success of our sector hinges on the ability for credit unions to grow and innovate sustainably while protecting member deposits.

Executive Summary and Key Points

Our calculations show that Libro's capital ratio under the proposed rules will not meet the minimum total supervisory capital ratio of 10.5% if the proposed risk weightings were in place today. Libro's risk-weighted capital ratio would decrease approximately 3.0%, pushing Libro dangerously close to the 8% minimum threshold. FSRA's comment that "the requirements outlined in the Proposed Rule will not result in any additional material costs for Ontario's credit unions. Almost all of Ontario's credit unions currently either meet or exceed the requirements specified in the Proposed Rule" indicates this significant decrease is not the intent of the proposed rule. The result highlights the importance of reconsidering the material changes proposed and ensuring a long- term transition period for Ontario credit unions to allow for capital raises and product pricing adjustments. We outline our feedback in detail in the "Section Review and Commentary" section below, but here highlight the four most significant items where we request reconsideration:

1. We request an increase to the proposed 1% cap on Financial Technology ("FinTech") Investments and Community Investments

2. We request changes to risk weightings for several assets including the following:
    A. Other financial and non-financial assets (property, plant, and equipment, prepaids, etc.) – request to remain at 100%
    B. Residential mortgage loans with 4 or less units – request to move from 100% to 35%
    C. Corporate bonds – request specific mention and use of credit rating to determine rating
    D. Cash at Central 1 – request to remain at 0%
    E. Shares in Central 1 – request that shares remain at 100%
3. We request an increase of the small business threshold, currently set at $1.25 million, to reflect the current market
4. We request a transition period of ten years to implement changes, consistent with historical practice of OSFI for regulatory changes of this nature

Response to FSRA Questions

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

The structure and overall content of the Proposed Rule provides regulatory capital adequacy requirements for Ontario credit unions that is consistent with Basel III. However, we have some significant concerns with respect to the detail of the requirements, including areas where there are inconsistencies with OSFI regulations. A list of those items that require clarification, confirmation and/or adjustment are included in the "Section Review and Commentary" section below.

It is 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. Below we highlight language that could benefit from additional clarity to enhance the overall rule.

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 (zz), we strongly suggest that the approach and limits applicable to FinTech and local community investments need to be amended to "allow credit unions to compete effectively while taking reasonable risks".

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, including those issued as dividends and the applicable calculation of Investment Shares qualifying as Tier 1.

In the "Section Review and Commentary" Section below we suggest several individual Rule elements where text and language can be clarified and/or our understanding and interpretation requires confirmation. Notably, numerous definitions within the Interpretation section of the rule refer to the Ontario regulations. In addition, some of the accounting-related terminology related to fair values and allowance for credit losses are outdated and inconsistent with the language used in IFRS 9.

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.

We anticipate minimal direct costs in calculating and reporting capital adequacy under the Proposed Rule as compared to current capital Guidance and related regulatory provisions. However, we note there is a high likelihood of indirect and/or intangible costs of compliance that may arise from the Rule. Such costs may include:

- Lower member-owner loyalty or share of wallet should loan costs (fees and interest rates) 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 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 be excessively restricted by punitive risk weightings

Section Review and Commentary

Section 1: Interpretation

There are still definitions within this section that refer to the Ontario regulation definitions. The definitions chosen will be critical to properly assess this section and subsequent impacts throughout the rule. We have continued to advocate to the Ministry of Finance for a level playing field with federal competitors related to specific definitions and interpretations of assets and their requirements.

We would like more clarification about how FSRA will take these future definitions into consideration as it finalizes the rule. Additionally, we believe further discussion is needed regarding the definitions of commercial, residential, and agricultural loan/property, once determined by the Ministry. We trust that FSRA would incorporate any changes into this rule in an expedient manner.

Section 2: Scope

Libro is satisfied with the scope presented.

Section 3: Minimum Capital Ratios, Capital Conservation Buffer Ratio and Leverage Ratio

We generally agree with the proposed rule changes within this section. We would like to better understand the intent of the supervisory capital ratio introduced in Sections 3(9) and 3(10) as a separate and distinct regulatory limit. Section 3(9) defines the supervisory capital ratio as Tier 1 including the capital conservation buffer plus Tier 2 capital, while section 3(10) sets the minimum at 10.5%. The confusion arises because the capital conversion buffer is included in the definition but already has specific requirements defined outside of the supervisory limit. Section 10, Capital Conservation Buffer, clearly states an action plan is required immediately if the credit union falls below the minimum buffer

of 2.5%. Further, Section 10(3) table 5 clearly states our ability to pay distributions if the credit union does not maintain the 2.5% buffer. This effectively allows credit unions to operate below the 10.5% supervisory capital ratio, if only temporary.

Is the 10.5% supervisory viewed by FSRA as a simplifying definition or will it be an actionable limit? It appears redundant to the requirements of the capital conservation buffer. A related question to this issue is how this ratio and the other regulatory ratio are intended to interact with the credit unions self assessed capital requirement under ICAAP? What are the implications of calculating an ICAAP minimum that is less than 10.50%? Would it justify a credit union operating with a capital conservation buffer of less than 2.5%? We kindly request that FSRA provide direction of how the internal ICAAP limit is incorporated into the Capital Rule more generally and the intended practical use of the supervisory capital ratio.

As a consideration for implementation of the new regulatory ratio, we also believe the sector would benefit significantly from a template to calculate and summarize the ratios and risk weighted assets calculations, ideally prior to the passing of the Capital Rule into force.

Section 4: Tier 1 Capital

Section 4(2) and 4(3) - Investment Shares Clarifications

We request additional clarity around the grandfathering provisions for investment shares. We appreciate that FSRA has indicated that investment shares will continue to qualify as Tier 1 capital under Section 4(4). We also accept that new classes of shares will need to adhere to Section 4(3) of the proposed rule to qualify as Tier 1. Our concern is regarding O. Reg 237/09 17(4) 3 which states "Shares issued after this paragraph comes into force cannot be redeemed or purchased for cancellation in the first 5 years after their issue, except upon the death or expulsion from the credit union of the holder."

At Libro, dividends on investment shares are generally issued as shares and the referenced wording in the rule implies that each annual dividend, on all series, require a holding period of 5 years. Applying the five-year holding requirement to share dividends would add onerous administration to track separately from original share issuances. This would be difficult to manage in practice and confusing for members. In the spirit of simplicity and sustainability, we request that the investment share dividends be treated based on the share series original issuance date and not the date share dividends are issued. This would allow redemption of the investments share issued as dividends one the series' initial 5 year holding period is complete.

Investment shares are critical for the sector to maintain adequate capital, innovate, grow, and remain competitive in the market and serve our members. Since credit unions cannot raise capital on open markets investment shares remain the only capital option available. We seek assurance from FSRA that continuing this practice is within the spirit and intention of the grandfathering provision and continued qualification as Tier 1 capital, with appropriate safeguards as noted within CCUA's rule response.

Section 4(2) (vi) - Available for Sale References

We note that Section 4 uses the term "available for sale" which is no longer applicable under International Financial Reporting Standards (IFRS 9) and is outdated terminology based on those standards. "Available-for-sale" also appears in O. Reg 237/09 17(2)6 which is likely the source of the

term. Since credit unions no longer have securities classified as "available for sale", it is difficult to interpret new holdings under these rules. We recommend Section 4(2) (vi) be updated to "accumulated net after tax unrealized loss on equity securities reported in other comprehensive income" to be consistent with IFRS.

Section 4(3) vii and section 4(3) xi – Investment Share Redemption

While the clause (vii) specifically does not provide the rights for shareholders to redeem more than 10% of a given series, clause (xi) does indicate that investment shares can be converted into another class of investment shares. For clarity and simplicity can FSRA comment on the intention of the rule in situations where outstanding investment share series amounts have become less material in size.

As an example, for Libro Series 1 and Series 2 they are at approximately $3.5 million or about 1% of total capital. The allowable redemption amount is $350 thousand and could become more challenging over time. The rule as written does not seem to prohibit a credit union from converting shares of 1 series to another, but they may be subject to a new five-year holding period.

We recommend an adjustment be made to the rule to allow for effective wind up of previous share series. Potential options include removing the 10% minimum for series of shares that fall below a threshold of capital (e.g. 1%). Alternatively, the 10% minimum could be applied to all investment shares in aggregate that are past the five-year threshold to allow more flexibility in redemption and ease administrative burden while retaining limits on redemptions.

Section 5: Tier 2 Capital

We noted language in Section 5(2) that used the term "general allowance" which is no longer applicable under IFRS 9 and is outdated terminology. This causes some confusion in practice; we recommend it is updated to refer to Stage 1 and Stage 2 Expected Credit Losses to ensure consistent interpretation across the sector.

Section 6: Risk Weighted Assets

No material comments on this section of the risk weighted asset formula. Comments are provided in the subsections of the general formula in the following three sections.

Section 7: Credit Risk – Standardized Approach

Section 7(2) - Central 1 Deposits and Shares

Central 1 provides many fundamental services to Ontario credit unions, which allows credit unions of all sizes to service members banking needs. The system is founded on a shared service model and a co-operative ownership structure. This Cooperative ownership structure allows credit unions control and insight on Central 1 services. As a result, we believe the risk of deposits held at Central 1 is more closely aligned with cash and should carry the same 0% risk weighting. This will also continue to drive credit union use of Central 1 services, which reduces risk, increases stability, and enhances operational services for the entire credit union system. On a similar note, we also request credit union investment in Central 1 shares continue to receive a 100% risk weighting. Under the proposed rules the weighting would increase to 1250% which is punitive and detrimental to the credit union system.

Section 7(2) bb - Residential Mortgage Loans with One to Four Units

The Ministry has indicated that the Credit Union Act will be updated to include non-owner-occupied units with 4 or less units in the definition of a residential mortgage loan. Under current capital rules, these loans are risk weighted at 75-100% as they are included with commercial loans. However, we believe the risk of these loans is more aligned with residential mortgages than commercial loans and therefore request the risk-weighting align with the residential mortgage loan risk weighting of 35%. This treatment would also be consistent with OSFI and would level the playing field within the financial industry.

Section 7(2) mm - Small Commercial Loans

The $1.25 million threshold for identifying small commercial loans at 75% risk weighting needs to be updated to reflect the current market. This threshold is also inconsistent with the similar small business definition in the Liquidity Rule (1(1) xiii which defines the size as $1.5 million. With increasing housing prices many residential mortgages are approaching the $1 million threshold and continue to increase rapidly. We ask that FSRA consider increasing the dollar limit to between three to five million, or consider removing the dollar threshold altogether, to allow for inflationary increases. We also ask that as OSFI considers increasing their definition of small business thresholds and amounts that FSRA takes an approach that is fair in its treatment for credit unions.

Section 7(2) vv - Fintech and Community Investments

Respectfully, we request an increase in the proposed limit of 1% of capital on Financial Technology and Local Community Investment thresholds to allow for larger investments at 100% risk weighting. This area is critical to our future engagement and community plans in terms of innovation, local investments, and social financing. As our market continues to shift rapidly to services in a digital world, investments in technology and innovation are table stakes for our members. Libro continues to invest in this space to meet changing consumer needs. In addition to innovation, investments in our communities are fundamental to our values and provide necessary and significant contributions to our local communities. Both investment types are subjected to the same prudent risk assessment as all Libro investments, and treatment of investments of this type is punitive under the proposed rules.

Consistent with our response in the pre consultation, Libro strongly believe that these two items require a separate limit. We recommend a limit of 5% of capital for both community investments and FinTech investments separately. This will allow continued engagement in our communities and support transition of services to a digital world. Both are paramount to our future success as a vibrant credit union and preferred financial institution.

We also believe that the "sandbox" approach recommend by the CCUA is another viable alternative. The benefit of the "sandbox" is more clearly defined investments characteristics and provides increasing risk weighting for investments that have a higher risk profile. Adopting this method would continue to allow us make investments in financial technology, local community, and other strategic opportunities. We are certainly open to more discussion on both options and the critical need for increased limits.

Section 7(2) zz - Other Assets not included in Table 2

Several common and relatively low-risk types of assets have been omitted from Table 2 and will therefore be risk weighted at 1250%. This category is too broad as currently proposed and includes assets such as the following:

- Investments in Central 1 (as noted previously)
- Equity investments held as part of our liquidity and investment portfolios
- Short-term commercial paper
- Corporate bonds
- Real estate and other alternative investments
- Other non-financial operating assets (e.g. land, buildings, leasehold improvements, right-of-use assets, equipment, software not classified as intangibles)
- Other financial assets (e.g. prepaid expenses such as property taxes and utilities, accrued interest, and other receivables)

We believe many of the assets that are included in this category carry different risk profiles and it is important for this to be reflected in their treatment. On that basis, we recommend the following specific risk weightings:

- Other financial and non-financial assets: 100%
- Corporate bonds and short-term commercial papers: 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 weight, and publicly listed equity exposures at a 250% risk weight.
- 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 item 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 8: Operational Risk – Basic Indicator Approach

Section 8(4)I)c) references the accounting classifications of "held to maturity" and "available for sale" which are no longer applicable under IFRS 9 and is outdated terminology based on the standards. We recommend simplifying this clause to "(c) realized profits or losses from the sale of equities". We believe using the term equities rather than securities reduces confusion around the new HQLA securities which are not consistent with the old designations for held to maturity or available for sale.

Section 9: General Market – Interest Rate Risk

No comments on this Section.

Section 10: Capital Conservation Buffer

Section 10(3)
We seek clarity behind the rationale for the use of a quarterly limit on distributions. Credit union dividends are generally paid on an annual basis and this should be reflected in the rule pertaining to annual financial results unless dividends are distributed on more frequent basis (i.e. quarterly).

Section 10(4)
The term "discretionary bonus payments to employees, directors, officers and contractors" is unclear and difficult to interpret. We request more specific guidance on what constitutes discretionary in this context. We also require clarification of the treatment of non-cash dividends on investment shares and patronage shares.

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

Section 11(1)
Libro requests a 10-year incremental phased in approach to transition all credit unions to the proposed rule and capital requirements. As a result of the new regulations, our 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 Libro's business plans and strategy that requires significant lead time to plan and execute, necessitating a much longer transition period.

Section 12: Leverage Ratio

No comments on this Section.

Section 13: Internal Capital Adequacy Assessment Process

No comments on this Section.

Section 14: Failure to Comply with Capital Requirements

Non-compliance could pose unintended consequences and increase risk for credit unions, FSRA, and the sector. We agree that a credit union should meet and discuss with FSRA the challenges it faces and work on a plan to return to a compliant capital position. We do not believe mandatory ceasing of loan and refinancing should be a part of this plan, as it could have a detrimental impact on reputation and brand, which in turn could create a worse situation for depositors and the sector. We agree an action plan to remedy is critical and the plan should require each credit union to act in the best interest of their members based on specific facts and circumstances.

Section 15: Coming into Force

The sector requires a longer transition period with an incremental tiered approach over 10 years. We believe this is a fair and effective solution to allow credit unions time to adjust to major changes proposed in risk weightings and ratio requirements, while minimizing impacts and unintended consequences to each credit union, its balance sheet, strategy, plans and general operations. This transition period is consistent with the implementation through other regulators such as OFSI. For example, Ministry of Finance proposed a 10- year transition period. See link.

Sincerely,

Stephen Bolton
Head Coach, CEO, President
Libro Credit Union

CC: Nick Best – Ontario Regional Director Canadian Credit Union Association