FirstOntario
CREDIT UNION

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Delivered Electronically to Bradley Hodgins

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To the Readers,

The purpose of this memo is to provide a summary of FirstOntario's perspective regarding proposed Rule 2021 – 002, "*Capital Adequacy Requirements for Credit Unions and Caisses Populaires*" (herein referred to as the "Draft Capital Rule").

FirstOntario appreciates and support FSRA's intention to (1) transition to principles-based regulation and (2) support modernize the credit union capital governance framework applied at Ontario Credit Unions. FirstOntario also supports the transition of credit unions towards federal and international capital management guidance. Among many benefits, FirstOntario believes financial institutions operating under a consistent international regulatory regime, proportionally applied, advances the assessment, measurement and management of risks, mitigates counterparty risks and improves capital markets capability.

FirstOntario also believes it is important for credit unions to operate under a level playing field. In many segments of the lending and deposit-taking markets, Ontario credit unions compete against federally regulated financial institutions. Many of the smaller institutions operating under the federal framework are largely similar from an overall risk management perspective. It is important that our methodologies for determining appropriate capital levels, the risk-weighted capital and leverage ratios are relatively consistent with the federal and international frameworks. This approach has numerous benefits, including supporting a competitive environment[1], ensuring continued public confidence in Ontario Credit Unions, and enhancing risk assessment comparability among Canadian financial institutions.

The following provides a summary of key, important issues affecting FirstOntario which is followed by a detailed listing of comments on specific areas of the capital draft rule. These comments are intended to be helpful to FSRA in achieving its regulatory objectives, as well as contributing to an improved capital management governance framework for the Ontario credit union co-operative sector.

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[1] As per Section 3 of the *Financial Services Regulatory Authority of Ontario Act* ("FSRA Act")

Transition Period

The effect of transitioning capital standards to the Basel III framework will be material to FirstOntario's calculation of risk-weighted capital ratio, leverage ratio, and internal capital adequacy assessment ("iCAAP"). If the rules were implemented as is, we will need time to adjust our business practices and comply.

The Ministry of Finance has provided comment on this issue, recommending a 10 year transition plan to comply for credit union. We believe this is a reflection of the limited capital availability in the Ontario credit union system (relative to the federal environment) and the significant impact the draft rule will have on required regulatory capital. Please refer to the following publicly available document, recommending this approach: Ontario Finance Ministry Perspective on Transition[2]

As a result of the above, and consistent with the Ontario Finance Ministry, we recommend allowing credit unions up to 10 years to comply with the capital requirements outlined in the draft capital rule.

Securitization Accounting Transactions/Gains

The draft capital rules provide a deduction under section 4(5) for "any increase in equity capital resulting from securitization transactions". There is lack of clarity what qualifies as a "securitization transaction" and it appears transactions initiated under the NHA MBS program are excluded in the current rule.

This is inconsistent with the guidance issued by the Office of the Superintendent of Financial Institutions ("OSFI"), which permits increases in equity capital from NHA MBS transactions. We confirmed this perspective with federally regulated industry participants. Capital Adequacy Chapter 7, paragraph 3, specifically excludes NHA MBS as a securitization exposure for risk-based capital purposes[3]:

> "*3. 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 purposes under the securitization framework.*** *Such exposures are to be treated for risk-based capital purposes according to the applicable sections of Chapter 3 or Chapter 6 of this guideline.*"

FirstOntario is the second largest NHA MBS issuer in the Ontario credit union system, with $3.3 billion NHA MBS issued as of Q2 2021. Approximately $2.8 billion of these NHA MBS are in the form of off-balance sheet transactions, with interest spread receivables in the amount of $18.7 mm. We calculate the deduction could reduce FirstOntario's risk-weighted capital ratio by 0.79% and leverage ratio by 0.37% (pre-tax), even though our federally regulated competitors would not experience this capital treatment.

[2] Link: https://fin.gov.on.ca/en/consultations/cu-cp/moclf.html#toc_9
[3] Link: https://www.osfi-bsif.gc.ca/Eng/Docs/CAR19_chpt7.pdf

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Excluding accounting gains related to NHA MBS from regulatory capital would materially affect the competitiveness of credit unions in certain sectors of the marketplace. As of July 31, 2021, total NHA MBS issued by federal and provincial regulators amounted to $456 billion[4]. Off-balance sheet NHA MBS securitization transactions in the mortgage industry recently amounted to $51.5 billion[5]. Attracting a significantly higher capital cost (12.5x) relative to other competitors would preclude FirstOntario and other competitors from particular segments of the mortgage market, such as funding CMHC insured multi-unit residential mortgages.

We recommend the wording be clarified to specifically exclude securitization transactions that do not involve tranching with associated subordination of credit risk (such as under NHA MBS), as these carry manageable risk to the institution[6], and are not considered securitization exposures under the federally regulated (OSFI) capital framework.

Asset Risk Weights

The current version of the draft capital rule attributes a 1,250% risk-weight (or equivalent) to numerous asset types that do not attribute near as much capital risk. This approach is not aligned with the federal framework and is not conducive to a fair and equitable competitive environment against competitors outside of the Ontario credit union system.

We identified numerous assets that appear to inappropriately fall within this asset class:

- Premises, plant and equipment and other fixed assets
- Real estate and other investments
- Prepaid expenses such as property taxes and utilities
- Deferred charges such as mortgage origination costs
- Leasing assets
- Various investment types, including bonds, funds, etc.

We recommend the guidance be clarified to attribute an appropriate risk-weight that aligns with OSFI guidance in this area. For most asset classes, this will result in a 100% risk weight.

FirstOntario, like some financial institutions across Canada, hold equity positions in leveraged real estate ventures and managed funds. FirstOntario's real estate ventures have greatly contributed to our communities,

[4] As per R120 Current Principal Balance report: https://www.cmhc-schl.gc.ca/en/professionals/project-funding-and-mortgage-financing/securitization/nha-mbs/securitization-reports

[5] As per Bank of Canada credit conditions, V122754: https://www.bankofcanada.ca/rates/banking-and-financial-statistics/historical-selected-credit-measures-formerly-e2/

[6] NHA MBS, for example carries little incremental risk to financial institutions as a government sponsored program.

helping to build affordable housing, housing units, and student housing. Strong risk-adjusted returns have been derived from these investments since inception. Our investments in managed funds have contributed greatly to our income and regulatory capital levels. Both of these segments of our business have been great diversifiers of income during the recent recession and has in part contributed to industry-leading profitability in 2020 and 2021.

At the federal level under OSFI, complex rules involving funds and equity positions include the look-through approach, mandate-based approach, and the fall-back approach and various reporting requirements to justify each approach. As a portfolio, our returns in both managed funds and equity positions in leveraged real estate have been consistent over the years and we believe it would be inappropriate to burden credit unions with overly complex requirements in this particular area, given the percentage of assets in these categories are very low in the Ontario credit union system.

We recommend a 400% risk weight for these types of investments, as this would prevent unnecessary regulatory burden and simplify the requirements for credit unions. This will allow for adequate risk-based capital coverage of the assets from a Pillar 1 perspective and roughly align with federal requirements[7], largely preventing regulatory arbitrage and an inequitable competitive environment. Furthermore, operating under current iCAAP requirements for Pillar 2 and Stress Testing, we would expect suitable stress tests on market valuations[8] to be prudent and in line with general market practice, further raising capital requirements in this area.

Detailed Commentary

The following provides a table of specific notes addressing other areas of the draft capital rule. We ask FSRA consider the following comments and proposed changes to the rules.

Reference	FirstOntario Comment / Recommendation
1(1)(ix) 1(1)(xiv) Table 2 (vv)	**Excerpts from Draft Capital Rule:** “financial technology investment” means 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; “local community investment” means an 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; (vv) Financial technology investments and local community investments up to an aggregate maximum of 1 per cent of the credit union’s capital in the credit union’s financial statements.

[7] OSFI Capital Adequacy Requirements, paragraph 148, simply risk weight method for unlisted equity exposures is 400%. Refer to: https://www.osfi-bsif.gc.ca/Eng/fi-if/rg-ro/gdn-ort/gl-ld/Pages/CAR19_chpt6.aspx
[8] Such as a 30% devaluation in the mark-to-market of security positions, currently required by FSRA iCAAP guidance.

	Recommendations: We recommend clarifying both definition of financial technology investment and local community investment, as follows. By including the term "credit", there appears to be overlap between the definition of a commercial loan and a local community investment. Moreover, it is not clear if the percentage of ownership matters when determining a financial technology investment. Capital relief of only 1% of regulatory capital in these investments would not provide any economies of scale to credit unions. For FirstOntario, one of the largest credit unions in Ontario, this would equate to a small, roughly $3 million investment. We recommend increasing the maximum investment to either 10% of capital or 1% of total assets, in order to allow for suitable investment in this area and support a competitive, co-operative credit union system. Adjusting this limit will aid in the development of local communities and support the creation of digital services at local credit unions, mitigating long-term viability risk.
4(3) 4(4)	**Excerpts from Draft Capital Rule:** Investment shares for the purposes of paragraph 4(2)(v) are shares, other than membership shares or patronage shares, that must, … (viii) only be redeemed or purchased for cancellation by the credit union if, (a) 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, and (b) the shares are replaced on conditions that do not use a significant amount of retained earnings given the income capacity of the credit union, or (c) the credit union can demonstrate to the Authority that the capital of the credit union will be substantially above the minimum ratios in section 3 after the shares are redeemed or purchased for cancellation; **Recommendations:** We find part (b) above unfairly and subjectively limits share redemptions of the membership. Part (b) appears to limit the ability of members to redeem shares (and credit unions to approve their redemptions) under two scenarios: 1. if the credit union uses a "significant amount" (not defined) of retained earnings 2. if the income of a credit union is not viewed as high enough For both of these situations, key words are not explicitly defined and could lead to scenarios where credit unions redeem shares in a manner that is not consistent with regulatory expectations. Moreover, regulations are already currently in place that cover minimum capital ratios (part c). We are further not aware of requirements for FSRA to evaluate the "income capacity" of a credit union. We recommend part (b) be deleted, as part (a) and (c) are already sufficient to manage investment share redemption regulatory risk.
4(5) to 4(7)	**Excerpts from Draft Capital Rule:** "B" in the formula in subsection 4(1) is, subject to subsection 4(6), the sum of the following amounts as they would appear in the financial statements of the credit union, if the financial statements were prepared as of the date of the calculation, …. (iv) any increase in equity capital resulting from securitization transactions; (viii) investments in any entity that is not consolidated in the financial statements of the credit union;

	4(6) A credit union may exclude in the calculation of "B", for the purposes of subsection 4(5), the following assets up to an aggregate amount equal to 1 per cent of the credit union's Tier 1 capital, (i) mortgage servicing rights; (ii) deferred tax assets arising from temporary differences; and (iii) computer software assets included in intangible assets. **Recommendations:** *Securitization Accounting Gains* As mentioned in our introduction, we recommend part (iv) above should be aligned with OSFI to exclude securitizations that do not involve tranching of securities (such as NHA MBS securitizations). *Non-Consolidated Investments* We recommend part (viii) above be eliminated, as it is not required once FSRA clarifies the risk weight on certain equity-based investments. Under accounting rules, non-consolidated investments represent partial ownership and are generally risk-weighted 400% for those under federal regulation. We do not believe it is prudent to deduct each investment. In particular, FirstOntario would be concerned our investments in funds and/or equity investments in real estate joint ventures would be inappropriately caught within the scope of this requirement. *1% of tier capital cap in relation to software intangibles* We believe limiting under 4(6) deductions to capital in relation to software intangibles to be inappropriately low for Ontario credit unions. 1% for FirstOntario is only ~$3 million of investments for an organization that, like others, is investing and transitioning significant portions of operations towards automation and digital experiences. Federally regulated banks have significantly higher economies of scale relative to Ontario credit unions, and increasing this cap to a range of 5% to 10% would be helpful in addressing this competitive inequity.
5(5)	**Excerpts from Draft Capital Rule:** 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. **Recommendation:** Section 5(5) appears to read as if FSRA is seeking to adjust the externally published financial statements of a credit union. We recommend FSRA not attempt to require credit unions to absorb a particular accounting policy. Externally prepared IFRSs-compliant financial statements are audited by independent third parties, and the above proposed regulatory requirements may not meet international accounting requirements, leading to issues related to external audit reports. If it is viewed an adjustment to Tier 2 capital is required, we recommend this be addressed by adjusting the regulatory capital calculation, as opposed to externally published financial statements.
Table 2 - 35%	**Excerpts from Draft Capital Rule:** bb) Residential mortgage loans where the amount of the loan, together with the amount then outstanding of any mortgage having an equal or prior claim against the residential

	property, does not exceed 80 per cent of the value of the property when the loan is made, provided that the residential mortgage loans are not 90 days or more past due. cc) Mortgage-backed securities that are fully and specifically secured by residential mortgage loans, other than mortgage-backed securities described in paragraph h). 35% **Recommendation:** We recommend investment properties, up to a four-plex, be permitted to be accounted for at a 35% risk weight as opposed to a commercial loan (75% - 100% risk weight). Currently, these mortgage assets receive a 35% risk weight treatment and historical losses indicate they do not carry the level of risk of a commercial loan. This change will appropriately align the risk weight with risk level, and also correct a market inequity, whereby credit unions are often required to offer higher rates to offset the impact of the higher risk weight.
Table 2 - 75%	**Excerpts from Draft Capital Rule:** mm) 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 per cent of the credit union's total assets and $1.25 million. **Recommendation:** We recommend the minimum of $1.25 million be raised to a level of between $3 and $5 million, and (approximately) indexed to commercial property valuations. This level has not been raised over time, unfairly increasing substantially the relative risk-weights of commercial lending in the Ontario credit union industry.
Table 2 - 1,250%	**Excerpts from Draft Capital Rule:** zz) Investments in entities, or assets generated by business activities not otherwise included in Table 2. aaa) Unrated retained securitization exposures except for (i) the most senior exposure in a securitization, (ii) exposures that are in a second loss position or better in asset-backed commercial paper programs; and (iii) eligible liquidity facilities. **Recommendations:** As indicated in our introduction, numerous assets are caught within part (zz) and attributed 1,250%. We recommend FSRA review each possible asset that is not mentioned previously, and attribute an appropraite risk weight to each. We believe the following assets require the following risk weights in this table: • Premises, plant and equipment and other fixed assets – 100% • Real estate and other investments – 100% • Prepaid expenses such as property taxes and utilities – 100% • Deferred charges such as mortgage origination costs – 100% • Leasing assets – 100% • Various investment types, including bonds, funds, etc. – 100% to 400% As indicated previously, we believe an appropriate risk weight for managed funds and joint ventures is 400%. This generally approximates OSFI's risk weights in this area. An important area that also needs to be addressed is rated corporate bonds. We recommend rated corporate should attract risk weightings similar to OSFI, with ratings of a similar nature as Table 4 (20% to 150%). However, this needs to be explicitly stated for credit unions.

10(3)	**Excerpts from Draft Capital Rule:** 10(3) In each of its financial quarters, a credit union must not make any distribution that would cause the credit union to retain less than the percentage of the credit union's earnings for its previous financial quarter specified in Table 5 at the intersection of, 10(4) In section 10 of this Rule, (i) "distributions" includes dividends, share buybacks, discretionary payments on Tier 1 securities, discretionary bonus payments to employees, directors, officers and contractors of the credit union, its subsidiaries and affiliates, and other discretionary payments, but excludes payments that do not result in a reduction of Tier 1 capital such as non-cash dividends paid on membership shares; and (ii) "earnings" means distributable profits calculated prior to the deduction of distributions and after the tax which would have been reported if the credit union had not made distributions. **Recommendations** We recommend 10(3) be reworded to reflect an annual time period, as opposed to quarterly. Credit unions typically make distributions once or twice on an annual basis. Moreover, credit unions do not publish quarterly financial statements like large, federally regulated banks. Thus, we do not believe a quarterly requirement is necessary. Under 10(4), we believe the board is already charged with the fiduciary accountability to manage revenue and expenses appropriately in the case whereby the credit union does not meet the capital conservation buffer. As a result, we believe the limits on discretionary bonus payments are imprudent. Usually, continued recruitment is challenging in an environment whereby the company is not as successful as others, and the issuance of retention bonuses may be required for the benefit of both the company and the regulator. Moreover, the proposed rules can be circumvented through contract negotiation. In some cases, executives and other key persons do not receive bonuses and are instead compensated with salary or contracts. For these reasons, we recommend eliminating limitations on discretionary bonus payments to employees, directors, officers, and contractors of the credit union.
11	**Excerpts from Draft Capital Rule:** 11(1) If, on the date that this Rule comes into force, a credit union cannot meet the minimum Tier 1 capital ratio, the minimum capital conservation buffer ratio or the minimum total supervisory capital ratio, the credit union must apply to the Chief Executive Officer for approval of a transition plan to relieve the credit union from complying with its obligations to maintain the minimum Tier 1 capital ratio, the minimum capital conservation buffer ratio or the minimum total supervisory capital ratio or any combination of the these ratios, as provided in the transition plan and subject to the terms of the transition plan. 11(2) An application under subsection 11(1) must be in a form approved by the Chief Executive Officer and must describe how and when the credit union will meet the requirements to maintain the minimum Tier 1 capital ratio, minimum capital conservation buffer ratio and minimum total supervisory capital ratio. 11(3) The Chief Executive Officer may, pursuant to section 80 of the Act, approve the transition plan referenced in subsection 11(1), subject to any terms the Chief Executive Officer considers appropriate if the Chief Executive Officer considers that approval of the transition plan is in the best interests of the members of the credit union and that the credit union will meet the requirements to maintain the minimum Tier 1 capital ratio, the minimum capital conservation buffer ratio and the minimum total supervisory capital ratio within a reasonable time. **Recommendations**

	As indicated previously, given the magnitude of the changes proposed in the Draft Capital Rule, we believe a prudent transition period of 10 years is necessary. This is in line with the Ontario Finance Ministry recommendations and will allow FirstOntario, among other credit unions, adjust business plans accordingly. Under Section 11, it is evident many credit unions (FirstOntario included) will be below or close to the risk-weighted capital buffer of 10.5%. Requiring such an immediate drop in risk-weighted regulatory capital rules is not equitable, and can create credit union-specific reputational and counterparty risks.
12(5)	**Excerpts from Draft Capital Rule:** 12(5) In subsection 12(3), "L" means the sum of the amounts calculated pursuant to subsection 4(4) as they would appear in the financial statements of the credit union, if the financial statements were prepared as of the date of the calculation. **Recommendation:** We believe the reference of subsection 4(4) should be 4(5).

Best,

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FirstOntario Credit Union