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Mark White
Financial Services Regulatory Authority of Ontario
25 Sheppard Ave West, Suite 100
Toronto, ON, M2N 6S6

Response to Proposed Differential Premium Score (DPS) Methodology Consultation

Dear Mr. White,

The Canadian Credit Union Association (CCUA) supports a risk-based method that ensures adequate premium differentiation based on risk profiles and historical data.

Goals of Risk Based Supervisory Framework (RBSF)

It is important to be clear about the goals of the RBSF, where we believe there is strong alignment between FSRA and the sector. Specifically, the sector believes the goals of the overall RBSF should be measured against the following outcomes:

- increasing fairness and incentivising regulatory compliance;
- improving predictability of premiums assessed to credit unions;
- reducing administrative burden for the sector in the long-term; and
- limiting adverse effect on weakened institutions, while mitigating moral hazard.

DPS Methodology Review

Based on previous discussions, it is our understanding that the proposed DPS methodology was developed using imperfect industry data. We believe that this is acceptable given the stage of development and availability of information today. However, once more information becomes available, we hope that FSRA will recalibrate the model to ensure that it aligns with the goals of the RBSF as noted above.

This is especially important since effectiveness of the Overall Risk Rating (ORR) is uncertain. For example, how will the ORR behave over an entire economic cycle? Is it a predictor or a laggard? Is it stable or will we see big swing in credit unions' premiums?

Once nearing completion, we encourage FSRA to utilise back-testing to compare the performance of current and proposed models. For example, using evaluation of the past, FSRA should look at whether the proposed 8% risk-weight capital target for being in default is accurate. If the DPS presumes that governance and not capital are viewed as the more predictive factors for a failure, why has 8% been used as the failure level test?

With this in mind, we would like to challenge the importance of using a 70/30 split as an initial weighting. We hope that this was proposed as a jumping-off point and FSRA is open to considering something that is more aligned to other regimes in Canada. Specifically, the Canada Deposit Insurance Corporation (CDIC) 40/60 split.

The CDIC categorisation is based on quantitative factors, which account for 60 percent of the total weight, and qualitative factors, which account for 40 percent of the total weight (35 percent examiner rating, and 5 percent CDIC-determined considerations). Quantitative metrics fall within the broad areas of capital adequacy, profitability, efficiency, liquidity (applying only to D-SIBs), and asset quality and concentration.[1]

While we recognize that capital considerations are also a component with the ORR (and therefore capital's weight is in practice greater than 30 percent), FSRA has not been sufficiently transparent as to the degree to which capital plays in the establishment of the ORR for a credit union[2].

- ***Given the effects on competitiveness and the ability of sector to absorb the new framework, we ask that FSRA consider aligning with CDIC in setting the initial weighting to 40/60.***

Frequency of data collection

Consistent with our past messaging, we want to ensure that the benefits of more frequent data collection are balanced against the reporting burden on credit unions.

The levying of assessments and data reporting must be frequent enough for the system to capture changes in risk profile, but not so frequent that it imposes an excessive burden on the sector.

In addition, reliance on three year (or more) comprehensive assessments needs to be complimented by a soft-touch supervisory approach that monitors implementation of risk mitigation strategies, as to allow credit unions to quickly implement risk management practices that reduce the risk profile and therefore result in a better ORR.

This is particularly important if FSRA's maintains the proposal to have 70% of the rating be based on a more subjective evaluation by supervisors. FSRA has in the past acknowledged that if issues are addressed FSRA would be open to re-evaluation of the RBSF score.

DPS inherently has more likelihood of dispute than a linear method. Therefore, it is important for FSRA to establish an appeals process that is fair and open and that allows credit unions to challenge their risk classification and assessment.

We note that CDIC has a formal appeal process, whereby institutions can appeal their score and categorization directly to CDIC.

- ***The sector would like to ask FSRA to please provide a formal documentation of process for how a credit union may have its RBSF score adjusted outside of a new examination. In addition, we would like to hear from FSRA regarding appeal process.***

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[1] Differential Premiums By-law Manual https://www.cdic.ca/wp-content/uploads/2021-Differential-Premiums-By-law-Manual.pdf

[2] As per the FSRA RBSF Consultation, we only know that Capital will be used to "determine modifications to the Summary Residual Risk (SRR), if any".

New institutions

With the success of having welcomed a new credit union in 2022, it bears to mention considerations of DPS as it relates to new credit unions. An evaluation of the DPS should consider whether it strikes the right balance between deterring excessive risk-taking by new entrants and discouraging new entrant formation.

To reduce this potential barrier to entry, some jurisdictions create 'grace periods' for new credit unions or take a graduated approach to risk-based pricing, assessing a low premium initially and raising it in small increments until it reflects the institution's risk[3].

- ***Would FSRA be open to incorporating this factor in its DPS regime?***

Transition Period

We support the proposed transition period but ask FSRA to please provide greater clarity around the two-year amnesty period and how it interacts with FSRA's stated objective of reaching a desired DIRF adequacy target. We presume several assumptions were generated to align the two items and the sector would appreciate if FSRA could share this detail, in confidence.

Sincerely,

Andrei Belik
Regional Director, Government Relations
Canadian Credit Union Association

[3] https://www.iadi.org/en/assets/File/Papers/Approved%20Research%20-%20Discussion%20Papers/DPS_Paper_final_16June2020_Final.pdf