JULY 2023

Capital Modernization

Consultation Paper for B.C. Credit Unions

BCFSA

Contents

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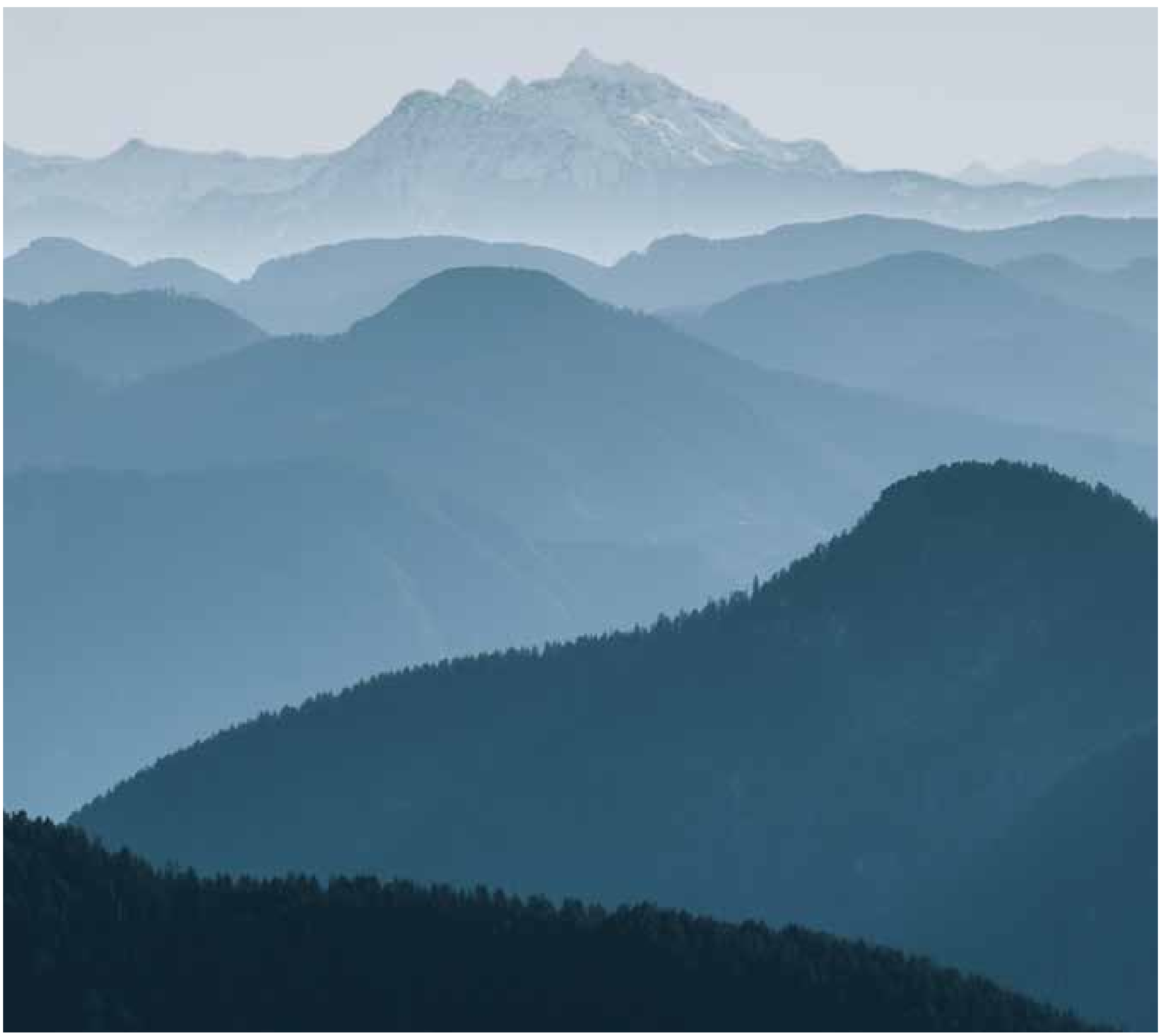
Introduction

The credit union segment in B.C. has grown significantly in both size and complexity since the current capital requirements were introduced in 1990. Growth, consolidation, and increased interconnectivity in the segment have resulted in greater complexity of operations and a greater concentration of assets into fewer and larger credit unions. While credit unions in B.C. delivered strong financial results and remained stable during and since the 2008 financial crisis, credit unions are operating in a changing environment with increased risks relating to the globalization of the financial market, such as economic risk, cyber risk, the effects of climate change, and credit risk.



To fulfill our mandate to be a modern, effective, and efficient regulator, BC Financial Services Authority ("BCFSA") is recommending changes to the current Capital Requirements Regulation to ensure that capital adequacy requirements continue to reflect the underlying risks. As a result of this initiative, a new Capital Rule will replace portions of the existing Capital Requirements Regulation respecting credit unions (the "Capital Rule"). The changes are intended to raise both the quality and quantity of regulatory capital and enhance the risk coverage of the capital framework with some elements of the Basel III[1] framework, international standards, and best practices. Furthermore, the changes introduced have also factored in the significant differences in the nature, structure, size, scope, and complexity between banks and the B.C. credit union segment.

Through this consultation paper, BCFSA aims to enhance transparency by improving stakeholder understanding of the objectives and seeking input at an early stage of the rule-making process. As such, BCFSA is seeking comments on proposed changes in the following areas set out in this paper:

- Consolidated reporting;
- Components of regulatory capital:
  - Definition of capital;
  - Regulatory adjustments to capital;
  - Capital conservation buffer;
  - Minimum capital requirements;
  - Credit risk;
  - Operational risk; and
  - Market risk;
- Leverage ratio requirements; and
- Transitional and implementation arrangements.

Under the current proposal, these changes will take effect January 1, 2026, followed by a two-year transitional period to allow credit unions to make any necessary changes to their policies and banking systems to meet the new requirements.

1 Basel III is an internationally agreed set of measures developed by the Basel Committee on Banking Supervision in response to the financial crisis of 2007-09. The measures aim to strengthen the regulation, supervision, and risk management of banks. Like all Basel Committee standards, Basel III standards are minimum requirements which apply to international active banks.

Background

The Financial Institutions Act (“*FIA*”) and related enactments, including the Capital Requirements Regulation, provide the legislative framework for the regulation of credit union capital in B.C. It is supplemented by BCFSA’s regulatory information.

As part of the B.C. government’s most recent mandated 10-year review of the FIA, the Ministry of Finance issued preliminary recommendations in March of 2018 on the FIA and the *Credit Union Incorporation Act* (“*CUIA*”).

Preliminary recommendation Number 24 of the B.C. government’s 2018 review proposed that BCFSA, which was then known as the Financial Institutions Commission, “adopt a Basel III-like capital framework and guidance/rules-based approach for capital standards, applicable to all provincial credit unions, with modifications to recognize the cooperative nature of credit unions and size differences among credit unions.” All new rules are subject to ministerial approval and to the Financial Services Authority Rule-Making Procedure Regulation.

While developing the proposals described in this consultation paper, BCFSA has taken into consideration the capital standards implemented by other Canadian regulators both nationally and provincially, while recognizing the unique characteristics of the B.C. credit union segment. In addition to incorporating elements of Basel III, BCFSA is also looking to ensure the resilience, relevance, and sustainability of the credit union segment.

How to Approach this Consultation Paper

This consultation paper consists of six sections discussing various aspects of, and proposed changes to modernize, the capital framework. Sections 1-4 describe proposed measures within the anticipated Capital Rule, Section 5 describes the proposed transitional arrangements, and Section 6 provides a list of questions for stakeholders. You may wish to review this list of questions before reading the consultation paper so that you can consider your responses as you read about the proposed changes. Where a section or subsection contains multiple sections, all subsections are meant to be taken together as parts of a whole. In some sections, information is contained in call-out boxes which are intended to provide additional context, definitions, or clarity.

BCFSA is seeking stakeholder responses to the questions contained in Section 6. To facilitate responses, BCFSA has included several appendices to aid in understanding how the proposed changes relate to the Capital Rule Proposal as a whole. BCFSA encourages you to consult Appendix A: Summary of Capital Rule Proposals as you review this consultation paper to see how each proposed change contributes to the full Capital Rule Proposal.

Please send us your feedback and responses to the questions outlined in this consultation paper by completing our online Consultation Feedback Form.

The consultation is open until October 23, 2023. BCFSA values all input received and all comments will be considered as we move forward with this important initiative.

Guiding Principles

The proposed capital framework is based on Basel III and tailored to the B.C. credit union segment. This made-for-B.C. approach to the framework also takes into consideration the approaches taken by other provincial regulators and the Office of the Superintendent of Financial Institutions ("OSFI"). Where appropriate, the framework recognizes the cooperative nature and size differences among B.C. credit unions ("credit unions"). As such, this consultation paper only discusses the standards in Basel III that are considered relevant and appropriate to the B.C. credit union segment.

BCFSA will balance the requirements that extend beyond the Basel III standards against:

- The materiality of the requirement and the related risk exposure;
- The unique attributes of the credit union business model;
- Application of standards to credit unions in other jurisdictions; and
- Risk mitigation through other regulatory requirements (e.g., Internal Capital Adequacy Assessment Process ("ICAAP"), lending exposure limits, etc.).

For transitional arrangements, BCFSA will take the following factors into consideration:

- The feasibility of credit unions meeting new standards by January 1, 2026, including a thorough understanding of the burden placed on the industry, the measures and actions required on the part of credit unions, and the benefits derived from early adoption versus any additional value of a phased approach;
- Operational implications for BCFSA and for credit unions, including the potential for increases in human and financial resources in management information systems, banking systems, reporting systems, and additional policy, procedures, and monitoring effort; and
- Risk mitigation through other existing processes (e.g., a robust supervisory process that results in early identification, regulatory attention, and preventive intervention as required).

Scope of Basel III and Key Recommendations

CONSOLIDATED APPROACH

This Capital Rule proposal applies to each credit union on a consolidated basis. This approach brings BCFSA in line with Basel III and other provincial regulators. Consolidated supervision is the best means to provide supervisors with a comprehensive view of risks and to reduce opportunities for regulatory arbitrage. The consolidated entity includes all subsidiaries except solvency-regulated insurance subsidiaries of the credit union that underwrite insurance. Insurance brokerage and wealth management subsidiaries are included within the scope of consolidation.

Consolidated regulatory reporting, which is adopted internationally and by all Canadian federal and provincial regulators, reflects the financial position and the risk exposures of the consolidated entity. This involves scoping in all material entities including holding companies, subsidiaries, and joint ventures. Unless otherwise specified, regulatory reporting on a consolidated basis will be prepared in accordance with International Financial Reporting Standards ("IFRS").

An implementation period of eight to 10 months is planned to help credit unions prepare for this change in regulatory reporting before the Capital Rule takes effect on January 1, 2026. Refer to Section 5 for the proposed transition timeline.

SCOPE OF BASEL III

The Basel Committee, which sets the global standard for the prudential regulation of banks, made five key commitments which make up the scope of Basel III:

1. Raise the quality and consistency of capital (Section 1);
2. Strengthen risk coverage of the capital framework (Section 2);
3. Promote the build-up of capital buffers that can be drawn upon in periods of stress (Section 3);
4. Adopt an internationally harmonized leverage ratio (Section 4); and
5. Introduce a global minimum liquidity standard for internationally active banks.

This paper addresses the above commitments one to four while considering their applicability to credit unions. BCFSA aims to ensure that the proposals contribute to financial stability while ensuring the resilience, relevance, and sustainability of the credit union segment.

Regarding commitment five, the project to modernize the liquidity standards for credit unions will be carried out in line with the timing set out in the BCFSA Regulatory Roadmap.

1. Raise the Quality and Consistency of Capital

BCFSA's proposed capital framework includes raising Tier 1 capital standards, simplifying Tier 2 capital, and expanding regulatory adjustments from capital. In developing a prudent definition of capital for credit unions, consideration was given to the Basel III definition of capital standards, current legislative constraints, and the characteristics of the B.C. credit union segment.

Basel III seeks to bolster the resilience of financial institutions by proactively addressing risks and enhancing financial institutions' capacity to withstand potential shocks arising from financial stress. This global regulatory framework accomplishes this through improvements in the quantity, quality, and consistency of capital held by banks. Regulatory authorities worldwide share the commitment to strengthen their capital framework.

The objectives of BCFSA's proposed framework are to fortify the credit union segment in a similar manner as Basel III, by mitigating future risks, promoting stability in the financial system, and enhancing the capacity of credit unions to withstand the potential impacts of financial stress.

Under the proposed capital framework, Tier 1 capital will allow the institution to continue operations in a stress scenario by absorbing losses on a going-concern basis. Tier 2 capital will absorb losses on a gone-concern basis. When an institution fails, Tier 2 instruments must absorb losses before depositors and general creditors do. The total capital is the sum of Tier 1 and Tier 2 capital.

Components of Regulatory Capital

BCFSA's efforts to raise the quality and consistency of regulatory capital are based primarily on international standards and sound practices developed by the Basel Committee. BCFSA has tailored these components to address the cooperative culture that is unique to the B.C. credit union segment.

TIER 1 CAPITAL

The underlying principle for Tier 1 capital is that it must be able to fully absorb losses on a going-concern basis. It is intended to absorb unexpected losses and allow the institution to continue operating as a going concern in a stress scenario. Additionally, it must meet several criteria (Appendix B) that build on the principles of permanence, subordination, and freedom from mandatory charges.

Proposal 1(a): Adopt Tier 1 capital definition consisting of the sum of the following elements:

- Retained earnings;
- Membership shares;
- Patronage shares, other than patronage shares redeemable within the following 12-month period;
- Instruments other than membership shares or patronage shares issued by the credit union directly that:
  - Meet or exceed all the criteria for inclusion in Tier 1 capital (Appendix B), and
  - Are not required to be redeemed within the following 12-month period;
- Share premium resulting from the issue of instruments included in Tier 1 capital, including contributed surplus resulting from the issue of membership shares in a merger or amalgamation;
- Instruments other than membership shares or patronage shares issued by consolidated subsidiaries of the credit union and held by third parties that:
  - Meet the criteria for inclusion in Tier 1 capital (Appendix B), and
  - Are not redeemable within the following 12-month period;

- Accumulated other comprehensive income:
  - The amount of the cash flow hedge reserve that relates to the hedging of items that are not fair valued on the balance sheet (including projected cash flows) should be derecognized in the calculation of Tier 1 capital. This means that positive amounts should be deducted, and negative amount should be added back; and
  - This treatment identifies the element of the cash flow hedge reserve to be derecognized for prudential purposes. It removes the element that gives rise to artificial volatility in Tier 1, as in this case the reserve only reflects one half of the picture (the fair value of the derivative, but not the changes in fair value of the hedged future cash flow); and
- Regulatory adjustments in the calculation of Tier 1 capital. Refer to Proposal 1(d) for information.

Shares

Shares, other than membership shares and patronage shares (e.g., investment shares), that are not redeemable in the following 12-month period may be included in Tier 1 capital provided they meet all the criteria for Tier 1 (Appendix B). Credit unions are responsible for ensuring that shares included in Tier 1 meet these criteria.

Contributed Surplus

Contributed surplus arising from mergers or acquisitions may be included in Tier 1. Credit unions wishing to include any contributed surplus arising from other sources in Tier 1 must obtain approval from BCFSA.

TIER 2 CAPITAL

The objective of Tier 2 capital is to provide loss absorption on a gone-concern basis. When an institution fails, Tier 2 instruments must absorb losses before depositors and general creditors do. Instruments qualifying for Tier 2 must meet specific classification criteria (Appendix B). The criteria for Tier 2 inclusion are less strict than for Tier 1. That is, instruments with a maturity date and cumulative distributions are eligible for Tier 2, while only perpetual instruments with distributions that are non-cumulative are eligible for Tier 1.

Proposal 1(b): Adopt Tier 2 capital definition consisting of the following elements:

- Instruments issued by the credit union directly that meet the criteria for inclusion in Tier 2 capital (Appendix B) and are not included in Tier 1 capital;
- Instruments issued by consolidated subsidiaries of the credit union and held by third parties that meet the criteria for inclusion in Tier 2 capital and are not included in Tier 1 capital; and
- General loan-loss allowances.

BCFSA will adopt the provisions introduced by the Basel Committee on general and specific allowances.

General allowances held against future, presently unidentified losses are available to meet losses which later materialize and qualify for inclusion within Tier 2. They are defined as Stage 1 and Stage 2 allowances under IFRS 9. However, allowances held against identified losses or known liabilities, whether individual or grouped, should be excluded. These allowances are termed “specific allowances” and are defined as Stage 3 allowances plus partial write-offs under IFRS 9.

General allowances that qualify for inclusion in Tier 2 under the terms described above are subject to a limit of 1.25 percentage points of credit risk-weighted assets and should exclude allowances held against underlying assets treated as a securitization for capital purposes.

Proposal 1(c): Adopt minimum capital ratios plus buffer

Credit unions are expected to meet the following minimum risk-based capital requirements for exposure to credit risk and operational risk:

- Minimum Tier 1 Capital: Six per cent of risk-weighted assets;
- Minimum Tier 1 Capital plus Capital Conservation Buffer: 8.5 per cent of risk-weighted assets.
- Minimum Total Capital: Eight per cent of risk-weighted assets; and
- Minimum Total Capital plus Capital Conservation buffer: 10.5 per cent of risk-weighted assets

Refer to Section 3. Promote the Build-Up of Capital Buffers for discussions on capital buffers.

Table 1-1: Minimum Risk-Based Capital plus Buffer (As a per cent of risk-weighted assets)

	Tier 1	Total Eligible Capital (Tier 1 plus Tier 2)
Minimum	6.0%	8.0%
Capital Conservation buffer	2.5%	2.5%
Minimum plus buffer	8.5%	10.5%

Proposal 1(d): Regulatory adjustments in the calculation of Tier 1 Capital

The Capital Rule provides for a comprehensive list of regulatory adjustments from regulatory capital. The number of required adjustments has been expanded from the current requirements to address the high degree of uncertainty that these items will have a positive realizable value in periods of stress.

The adjustments are applied in the calculation of Tier 1 capital. The adjustments are applied to Tier 1, rather than Tier 2, as Tier 1 capital represents strength and cushion from a going-concern perspective and absorbs losses when they occur. Deducting items from Tier 1 provides a better measure of a credit union's resilience.

The following adjustments from Tier 1 capital are required:

- Deferred tax assets may be netted with associated deferred tax liabilities only if the deferred tax assets and deferred tax liabilities relate to taxes levied by the same taxation authority. The net amount cannot be negative;
- Fair value gains on own-use property (e.g., premises occupied by the credit union itself) as such gains are a paper gain, and the added value is unreliable in the event of the asset liquidation;
- Securitization gains are increases in equity resulting from securitization transactions (e.g., capitalized future margin income, gains on sale), and should be derecognized in the calculation of Tier 1 capital;
- Goodwill and other intangibles should be deducted in the calculation of Tier 1 capital. This includes goodwill in the valuation of investments in the capital instruments of banking, financial institutions, and insurance entities that are outside the scope of consolidation. The full amount is to be deducted net of any associated deferred tax liability, which would be extinguished if the goodwill becomes impaired or derecognized under relevant accounting standards;
- Investments in the capital and/or other Total Loss Absorbing Capacity instruments of unconsolidated banking, financial institutions, and insurance entities; and
- Reverse mortgages with a current loan-to-value ("LTV") ratio greater than 85 per cent, the exposure amount that exceeds an 85 per cent LTV ratio is deducted from Tier 1 capital. The remaining amount is risk-weighted at 100 per cent. Refer to Proposal 2(g) for the proposed treatment of reverse mortgages.

Additional Information

Deferred Tax Balances

Deferred tax balances represent the future tax impacts of recovering or otherwise consuming assets and settling liabilities at the respective book values. Depending on the nature of the assets and liabilities involved, timing differences may reverse within a year or may take several years to reverse. Moreover, other differences may not reverse until the related asset is disposed of or otherwise impaired for book purposes.

Securitization Gains

Securitization gain on sale deduction applies to a gain on sale that is recorded as an asset on the balance sheet following a securitization transaction. This asset represents a highly concentrated credit risk position.

Investments in Unconsolidated Banking, Financial Institutions, and Insurance Entities

For the purposes of this deduction, insurance entities are solvency-regulated insurance companies that underwrite insurance. For greater certainty, insurance entities do not include insurance brokerages. Accordingly, investments in unconsolidated insurance brokerages do not need to be deducted but must be risk weighted in accordance with the applicable risk weights in Section 2.

Investments in the capital of Central 1 Credit Union are excluded from this deduction requirement. While Central 1 Credit Union is considered as a financial institution, BCFSA recognizes its unique role within B.C.'s cooperative credit union system.

Excluded Provision

System capital

Under the new Capital Rule, BCFSA will remove system capital from the calculation of a credit union's regulatory capital.

System capital[2] as one of the permitted secondary capital elements under the current Capital Requirements Regulation has played a unique supporting role in the capital regime of the B.C. credit union segment since its introduction in the 1990s. As credit unions move forward to a Basel III-like capital framework focusing on raising the loss absorbance qualities of its own capital, applying system capital is no longer appropriate.

2 System capital is defined under the Capital Requirements Regulation as one half of the proportion of retained earnings or deficit in a central credit union or in the deposit insurance corporation, as the case may be, that is attributed to the credit union on the basis of the credit union's relative share of the total assets of all credit unions.

2. Strengthen Risk Coverage of the Capital Framework: Credit Risk, Operational Risk, Market Risk

This section will address three major risk categories facing the credit union segment: credit risk, operational risk, and market risk. A summary of each risk category including the approach and the associated proposals are provided below.

2.1 CREDIT RISK

To strengthen risk coverage of the capital framework within the context of the cooperative culture in credit unions, existing categories and related risk weights have been reviewed and assessed for relevancy and appropriateness to address risk exposures. As a result, new categories were added while some other categories were either expanded or removed. The goal is to arrive at more sound, risk-sensitive capital requirements that address the features of the financial market infrastructure for B.C.'s credit unions.

The proposed risk weighting categories are mostly drawn from Basel II and Basel III frameworks[3] and OSFI[4] guidelines. As indicated in Section 1, these credit risk requirements would apply to credit unions on a consolidated basis, which would include the assets of most types of subsidiaries.

All exposures are subject to the standardized approach and should be risk-weighted net of specific allowances. Furthermore, the risk weight categories apply to on-balance and off-balance sheet credit equivalent amounts except for items that are deducted from capital as regulatory adjustments.

The term "claims" used in this section refers to assets on a credit union's financial statements that represent an investment in, or loan to a third party. Please refer to Appendix A for the list of proposed risk-weighted assets.

3 International Convergence of Capital Measurement and Capital Standards – June 2006, and Basel III: A global regulatory framework for more resilient banks and banking systems – December 2010 (rev June 2011).
4 Office of the Superintendent of Financial Institutions ("OSFI") supervises federally regulated financial institutions and pension plans.

2.1.1 On-Balance Sheet Exposures

Proposal 2(a): Treatment of cheque and items in transit

- Cheque and items in transit are risk-weighted at 20 per cent.

Proposal 2(b): Expanded credit rating assessment categories

- Credit rating assessment that are below BB+ are risk-weighted at 150 per cent.
- Claims on unrated sovereigns are risk-weighted at 150 per cent.

Proposal 2(c): Treatment of claims on deposit-taking institutions and banks

- Canadian deposit-taking institutions include federally and provincially regulated institutions that take deposits and lend money. These include banks, trust or loan companies, and co-operative credit societies. Based on this definition, deposits with Central 1 are risk-weighted at 20 per cent.

Proposal 2(d): Introduce B.C. specific measures for residential and commercial lending

Please refer to Appendix C: Residential and Commercial Lending – Guidance and Definitions in conjunction with Proposal 2(d).

2(d)(i) Residential Lending

In this section, residential lending denotes residential exposures that are not insured against mortgage impairment by either Canada Mortgage and Housing Corporation ("CMHC"), Sagen (formerly Genworth Financial), Canada Guaranty, or a similar insurer.

BCFSA is proposing to split residential real estate exposures into the two categories that Basel III distinguishes. These categories are General Residential Real Estate ("RRE[5]") and Income Producing Residential Real Estate ("IPRRE[6]") exposures, with a higher risk weight allocated to IPRRE. This proposal is also based on discussions in a joint working group between OSFI, Bank of Canada, AMF[7], FSRAO[8], and BCFSA:

- IPRRE exposures are exposures where repayments materially depend on the cash flows generated by the property securing the loan, rather than on the underlying capacity of the borrower to service the debt from other sources; and
- RRE exposures are exposures that do not meet the criteria for IPRRE.

5 RRE or Residential Real Estate is defined as a residential real estate property that has 1 to 4 adjoining units and do not meet the criteria for IPRRE.
6 IPRRE or Income-Producing Residential Real Estate is defined as residential real estate property that has 1 to 4 adjoining units and where the repayment of the loan materially depends on the cashflow generated by the property.
7 AMF or Autorité des marchés financiers is the organization responsible for financial regulation in the Canadian province of Quebec.
8 FSRAO or Financial Services Regulatory Authority of Ontario is the organization responsible for financial regulation in the Canadian province of Ontario.

In the proposed approach to determine risk weights for RRE and IPRRE exposures, BCFSA is mindful of the risks credit unions are exposed to as well as their size and complexity compared to banks. BCFSA closely examined the Basel III framework and OSFI's updated Basel III capital requirements that came into force in 2023 while devising this approach. One important aspect that distinguishes credit unions from banks is that they lend within B.C. and exposures are not diversified across Canada. Credit union borrowers are employed in the local economy and real estate collateral is located within B.C.

To reflect the lending constraints credit unions face, BCFSA's approach relies on more than just the Loan-to-Value ("LTV") ratio to segregate credit risk for retail loans that are secured by real estate.

B.C. currently has among the highest property prices in Canada. This leads to residential mortgage holders taking on high levels of debt to be able to afford a house. As a proxy for the borrower's ability to repay the loan, BCFSA uses the borrower's overall total debt servicing capability, which is expressed by the Total Debt Service ("TDS") ratio.

At mortgage origination, credit unions determine a borrower's TDS ratio as a proxy for the borrower's ability to repay the loan over its amortization period. Usually, if a borrower has issues meeting the regular payment obligations and if the amortization still allows for extension, credit unions have room to work with their members to extend the amortization to lower monthly payments. Conversely, if amortization is high but TDS ratio is low, there is the possibility for borrowers to increase regular payments if required. Delinquency risk is perceived to be higher with higher TDS ratio and longer amortization.

Once a loan becomes delinquent and subsequently defaults, the LTV ratio matters as this metric ties closely to the potential losses a credit union may incur given loan default.

Table 2-1 (below) provides the proposed approach to allocate risk weights to residential mortgages based on three risk factors, namely the TDS ratio, amortization, and the LTV ratio. BCFSA treats all three factors equally and assigns the risk weights as outlined below. Refer to Appendix C: Residential and Commercial Lending – Guidance and Definitions.

Table 2-1: Mortgages	**Lending Category**	
Risk Factors	**RRE**	**IPRRE**
TDS > 42% AND Amortization > 30 years AND LTV > 75%	70%	105%
(TDS > 42% AND Amortization > 30 years AND LTV ≤ 75%) OR (TDS > 42% AND Amortization ≤ 30 years AND LTV > 75%) OR (TDS ≤ 42% AND Amortization > 30 years AND LTV > 75%)	50%	75%
(TDS > 42% AND Amortization ≤ 30 years AND LTV ≤ 75%) OR (TDS ≤ 42% AND Amortization ≤ 30 years AND LTV > 75%) OR (TDS ≤ 42% AND Amortization > 30 years AND LTV ≤ 75%)	30%	45%
TDS ≤ 42% AND Amortization ≤ 30 years AND 50% < LTV ≤ 75%	20%	30%
TDS ≤ 42% AND Amortization ≤ 30 years AND LTV ≤ 50%	15%	22%

Table 2-2 (below) shows BCFSA's proposed approach to classify Home Equity Lines of Credit ("HELOC") secured by residential real estate. In general, HELOCs are associated with higher risk than mortgages since they do not amortize and are a non-reducing credit facility. Refer to Appendix C: Residential and Commercial Lending – Guidance and Definitions for more information.

Table 2-2: Home Equity Lines of Credit	**Lending Category**	
Risk Factors	**RRE**	**IPRRE**
TDS > 42 AND LTV > 65%	70%	105%
(TDS > 42% AND LTV ≤ 65%) OR (TDS ≤ 42% AND LTV > 65%)	50%	75%
TDS ≤ 42% AND 50% < LTV ≤ 65%	30%	45%
TDS ≤ 42% AND LTV ≤ 50%	25%	37%

Insured Residential Lending

The category refers to residential loans insured under the *National Housing Act* or equivalent provincial mortgage insurance programs. These loans may be assigned the risk weight of the guarantor. Loans that are insured by CMHC and hence fully guaranteed by the Government of Canada are assigned a risk weight of zero per cent.

To reflect the effect of the Government of Canada backstop guarantee on a privately insured mortgage exposure (for example, a guarantee made pursuant to section 22 of the *Protection of Residential Mortgage or Hypothecary Insurance Act*), the proposed approach is for credit unions to separate the full amount of the privately insured mortgage exposure into a deductible portion and a backstop portion:

- The deductible portion is calculated as 10 per cent of the original loan amount (i.e., the deductible portion grows as a percentage of the outstanding exposure as the mortgage amortizes), and risk-weighted as an uninsured residential mortgage; and
- The backstop portion is the amount covered by the government guarantee (i.e., the total outstanding amount less the deductible portion), and risk-weighted at zero per cent.

Uninsured Residential Real Estate Construction Exposures

Residential real estate construction projects are subject to additional risk in the form of completion risk. To recognize the completion risk, BCFSA proposes to allocate a risk weight of 65 per cent to all uninsured RRE construction loans.

2(d)(ii) Commercial Real Estate ("CRE") Lending

The proposed approach relies on more than just the LTV ratio to segregate credit risk for commercial loans that are secured by real estate.

Risk factors that can be considered as proxies for default and recovery are given by Debt Service Coverage Ratio ("DSCR") and the LTV ratio for non-construction CRE exposures and the Loan-to-Cost ("LTC") ratio for CRE construction loans. The two tables below outline the risk factors, lending categories, and associated risk weights under the new approach.

Table 2-3: CRE Lending	**Risk Weights by Lending Categories**		
Risk Factors	**CRE – Residential (multi-residential)**	**CRE – Owner-Occupied**	**CRE – Income-Producing (non-residential)**
DSCR < 120% AND LTV > 70%	55%	85%	105%
DSCR < 120% AND LTV ≤ 70% OR DSCR ≥ 120% AND LTV > 70%	45%	70%	85%
DSCR ≥120% AND LTV ≤ 70%	35%	50%	65%

Note: Refer to Appendix C: Residential and Commercial Lending – Guidance and Definitions for more information.

As there is no reliable LTV ratio for construction loans, BCFSA assesses LTC ratios as risk factors to determine associated risk classifications and weights.

Table 2-4	**Construction Lending**			
Risk Factors	**CRE – Construction (multi-residential)**	**CRE – Construction (general)**	**CRE – Construction (speculative)**	**Land-only (speculative)**
LTC > 70%	75%	120%	130%	150%
LTC ≤ 70%	55%	105%	110%	

2(d)(iii) General Commercial Lending

Commercial loans that are not secured by real estate are captured under general commercial lending.

Table 2-5 General Commercial Lending

Risk Factors	Commercial (Otherwise secured) – fixed assets	Commercial (Otherwise secured) – current assets	Insured, Secured by Govt Guarantee	CU deposits secured loans	Unsecured/ non-recourse
DSCR < 110%	100%	120%	20%	10%	150%
110%≤ DSCR < 140%	90%	110%			
DSCR ≥ 140%	80%	100%			

Proposal 2(e): Update treatment of securities secured by residential mortgages

- Investment in securities that are secured by mortgages and not guaranteed by CMHC are currently risk-weighted at 100 per cent. To align with Basel standards, securities that are fully and specifically secured against qualifying residential mortgages will be risk-weighted at 35 per cent.
- Investment in securities that are not fully and specifically secured against qualifying residential mortgages will be risk-weighted at 100 per cent.

Qualifying residential mortgages are defined as:

- Loans secured by first mortgages on individual condominium residences and one-to-four-unit residence made to a person(s) or guaranteed by a person(s), provided that such loans are not 90 days or more past due and do not exceed a LTV (the property value at origination of the loan) ratio of 80 per cent.
- Collateral mortgages (first and junior) on individual condominium residences or one-to four-unit residential dwellings, provided that such loans are made to a person(s) or guaranteed by a person(s), where no other party holds a senior or intervening lien on the property to which the collateral mortgage applies and such loans are not more than 90 days past due and do not, collectively, exceed a LTV ratio of 80 per cent. The LTV for purposes of HELOCs is the authorized amount of the HELOC.
- Investments in hotel properties and time-shares are excluded from the definition of qualifying residential property.

Proposal 2(f): Continue current treatment of 100 per cent risk-weighting Central 1 equity shares

- This proposal deviates from Basel requirements to recognize and accommodate for the unique structure of B.C.'s credit union and co-operative system.
- The underlying principle of the requirement is to address systematic risk and interconnectedness of internationally active financial institutions. Central 1 has a different context playing unique roles that contributes to the stability of the B.C. credit union segment. As a member-owned institution, and subject to regulation by BCFSA, Central 1 is required to maintain strong and prudent business practices and financial standards, including capital adequacy. The capital held by Central 1 represents capital provided by credit unions.
- Given the reasons above, BCFSA does not see any incremental value in having credit unions hold additional capital against Central 1.

Proposal 2(g): Treatment of reverse mortgages

Reverse mortgages are non-recourse loans secured by property that have no defined term and no monthly repayment of principal and interest. The amount owing on a reverse mortgage grows with time as interest is accrued and deferred. The loan is generally repaid from the net proceeds of the sale (i.e., net of disposition costs) after the borrower has vacated the property. Reverse mortgage lenders are repaid the lesser of the fair market value of the home (less disposition costs) at the time it is sold and the amount of the loan. Assuming there is no event of default (for example, failure to pay property taxes and insurance, or failure to keep the home in a good state of repair), reverse mortgage lenders have no recourse to the borrower if the amount realized on the sale of the home is less than the amount owing on the reverse mortgage.

- For a reverse mortgage to qualify for a 35 per cent risk weight, the underwriting institution must have at mortgage inception and at the time such risk weight is being considered, each of the following:
    - Documented and prudent underwriting standards, including systematic methods for estimating expected occupancy term (which should at minimum refer to standard mortality tables), future real estate appreciation/depreciation, future interest rates on the reverse mortgage and determining appropriate levels for maximum initial LTV ratios, and a maximum dollar amount that may be lent;
    - Documented procedures for monitoring LTV ratios on an ongoing basis, based on outstanding loan amounts, including accrued interest, undrawn balances, and up-to-date property values;
    - Documented procedures for obtaining independent reappraisals of the properties at regular intervals, not less than once every five years, with more frequent appraisals as LTV ratios approach 80 per cent;
    - A documented process to ensure timely reappraisal of properties in a major urban center where resale home prices in that urban center decline by more than 10 per cent;
    - Documented procedures for ensuring that borrowers remain in compliance with loan conditions;
    - A rigorous method for stress testing the reverse mortgage portfolio that addresses expected occupancy, property value, and interest rate assumptions; and
    - Ongoing monitoring of reverse mortgage stress testing that is incorporated in the institution's Internal Capital Adequacy Assessment and capital planning processes.
- The following table (Table 2-6) sets out the capital treatment of reverse mortgage exposures:

Table 2-6

Initial LTV		Current LTV	Risk Weight
≤ 40%	and	≤ 60%	35%
> 40%	and	≤ 60%	50%
		> 60% and ≤ 75%	75%
		> 75% and ≤ 85%	100%
		> 85%	Partial deduction

In particular:

- A reverse mortgage exposure that originally qualified for a 35 per cent risk weight but now has a current LTV ratio that is greater than 60 per cent, but less than or equal to 75 per cent, is risk weighted at 75 per cent.
- A reverse mortgage exposure that had an initial LTV ratio greater than 40 per cent (but that otherwise would have qualified for a 35 per cent risk weight) is risk weighted at 50 per cent, provided its current LTV ratio is less than or equal to 60 per cent.
- A reverse mortgage exposure with current LTV ratios greater than 60 per cent and less than or equal to 75 per cent except those that could not (regardless of original LTV ratio) qualify for the 35 per cent or 50 per cent risk weight are risk weighted at 75 per cent.
- All reverse mortgage exposures with current LTV ratios greater than 75 per cent and less than or equal to 85 per cent, and all reverse mortgages that could not (regardless of the original LTV ratio) qualify for a 35 per cent or 50 per cent risk weight and which have a current LTV ratio less than or equal to 85 per cent, are risk weighted at 100 per cent.
- Where a reverse mortgage exposure has a current LTV ratio greater than 85 per cent, the exposure amount that exceeds 85 per cent LTV ratio is deducted from capital. The remaining amount is risk-weighted at 100 per cent.
- For purposes of calculating risk-weighted assets, current LTV ratio is defined as:
    - The reverse mortgage exposures[9] divided by either:
    - Where the most recent appraisal is greater than the original appraisal, the greater of the original appraised value or 80 per cent of the most recent appraised value of the property;

OR

- Where the most recent appraisal is less than the original appraisal, the most recent appraised value of the property.

9 Reverse mortgage exposure means all advances, plus accrued interest and 50% of undrawn amounts, net of specific allowances. Undrawn amounts on reverse mortgages do not include future loan growth due to capitalizing interest. Undrawn amounts are treated as undrawn commitments and are subject to a credit conversion factor of 50% (i.e., commitments with an original maturity exceeding one year).

Proposal 2(h): Treatment of claims on sovereigns

- Claims on sovereigns and their central banks are risk-weighted based on the credit rating of the sovereigns:
  - Adopting this change provides sufficient granularity to address risk associated with such claims while not having a material impact on capital; and
  - The credit assessment refers to the methodology used by S&P Global Ratings (informally known as S&P). Refer to Table 2-7 to determine the applicable risk weight for other rating agency methodologies.

Table 2-7

Standardized Risk Weight Category	DBRS	Moody's	S&P, Fitch & KBRA[10]
AAA to AA-	AAA to AA (low)	Aaa to Aa3	AAA to AA-
A+ to A-	A(high) to A(low)	A1 to A3	A+ to A-
BBB+ to BBB-	BBB (high) to BBB (low)	Baa1 to Baa3	BBB+ to BBB-
BB+ to BB-	BB (high) to BB (low)	Ba1 to Ba3	B+ to BB-

Proposal 2(i): Treatment of claims on other public sector entities ("PSE")

- Claims on the following entities will receive the same risk weight as the Government of Canada:
  - All provincial and territorial governments and agents of the federal, provincial, or territorial governments whose debts are, by virtue of their enabling legislation, obligations of the parent government.
- The PSE risk weight is meant for the financing of the PSE's own municipal and public services. Where PSEs other than Canadian provincial or territorial governments provide guarantees or other support arrangements other than in respect of the financing of their own municipal or public services, the PSE risk weight may not be used.

10 S&P is Standard and Poor's; Fitch is Fitch Rating Services; KBRA is Kroll Bond Rating Agency, Inc. DBRS is DBRS Morningstar.

Public Sector Entities are defined as:

- Entities directly and wholly owned by a government;
- School boards, hospitals, universities, and social service programs that receive regular government financial support; and
- Municipalities.

Proposal 2(j): Risk-weighting for unrated retained securitization exposures

- Unrated retained securitization exposure is risk-weighted at 1,250 per cent except for:
  - The most senior exposure in a securitization;
  - Eligible liquidity facilities; and
  - Exposures that are in a second loss position or better in asset-backed commercial paper programs and meet the following requirements:
    - The exposure is economically in a second loss position or better and the first loss position provides significant credit protection to the second loss position;
    - The associated credit risk is the equivalent of investment grade or better; and
    - The credit union holding the unrated securitization exposure does not retain or provide the first loss position.

Securitization Exposure

Credit unions commonly participate in the NHA, MBS, and CMB programs[11] as a source of funding and not with the objective of transferring the risks associated with the underlying mortgages. Accordingly, credit unions retain such securitized mortgages on their balance sheet and continue to risk weight them for capital purposes. The 1,250 per cent risk weight under this provision does not apply to participation in NHA, MBS, and CMB programs described above.

The 1,250 per cent risk weight for retained securitization exposures may apply when:

- A credit union originates a pool of assets in a "traditional[12] or synthetic[13] securitization" arrangement; and
- The assets securitized are derecognized and no longer risk weighted for capital purposes.

Traditional and synthetic securitizations may give rise to securitization exposures requiring additional capital depending on the risks retained under the securitization structure. They may also give rise to risks requiring consideration in the credit union's ICAAP. Credit unions should consult with their BCFSA contact regarding any plans to enter traditional or synthetic securitization arrangements.

11 These programs refer to the National Housing Act Mortgage-Backed Securities (NHA MBS) program and Canada Mortgage Bond (CMB) program. NHA MBS are investments that are backed by distinct pools of insured mortgages. The timely payment of NHA MBS principal and interest is guaranteed by the Canada Mortgage and Housing Corporation (CMHC), a federal crown corporation fully backed by the Government of Canada. The CMB program is designed to complement CMHC's long-standing NHA MBS program by converting the monthly and amortizing cash flows of the NHA MBS into typical bond-like payments.

12 A traditional securitization is a structure where the cash flow from an underlying pool of exposures is used to service at least two different stratified risk positions or tranches reflecting different degrees of credit risk. Payments to the investors depend upon the performance of the specified underlying exposures, as opposed to being derived from an obligation of the entity originating those exposures.

13 A synthetic securitization is a structure with at least two different stratified risk positions or tranches that reflect different degrees of credit risk where credit risk of an underlying pool of exposures is transferred, in whole or in part, through the use of funded (e.g., credit-linked notes) or unfunded (e.g., credit default swaps) credit derivatives or guarantees that serve to hedge the credit risk of the portfolio. Accordingly, the investors' potential risk is dependent upon the performance of the underlying pool.

Proposal 2(k): Regulatory retail portfolio

- To be included in the regulatory retail portfolio, claims must meet the following four criteria:
    - Orientation criterion – the exposure is to an individual person or persons or to a small business;
    - Product criterion – the exposure takes the form of any of the following: revolving credits and lines of credit (including credit cards and overdrafts), personal term loans and leases (e.g., instalment loans, auto loans and leases, student and education loans, personal finance), and small business facilities and commitments. Securities (such as bonds and equities), whether listed or not, are specifically excluded from this category. Mortgage loans are excluded to the extent that they qualify for treatment as claims secured by residential property;
    - Granularity criterion – BCFSA must be satisfied that the regulatory retail portfolio is sufficiently diversified to a degree that reduces the risks in the portfolio, warranting the 75 per cent risk weight; and
    - Low value individual exposures – the maximum aggregated retail exposure to one counterpart cannot exceed an absolute threshold of CAD $1.50 million. Small business loans extended through or guaranteed by an individual are subject to the same exposure threshold.
    - If meeting the above criteria, the retail portfolio will include revolving credits, line of credits, personal terms loans and leases, small business facilities and commitments excluding securities and mortgage loans;
    - This category may include items reported under "All Other Personal Loans and Lease" in the current Capital Adequacy Return effective April 2022 if meeting the above criteria; and
    - Loans extended to small business and managed as retail exposures are eligible for retail treatment provided the total exposure of the credit union to a small business borrower (on a consolidated basis where applicable) is less than CAD $1.50 million.

Proposal 2(l): Treatment of non-significant investments in the capital of banking, financial and insurance entities to which a credit risk standardized approach applies not deducted from capital

- The term "non-significant investment" refers to investments that are less than 10 per cent of all the outstanding shares of that class of shares of the institution invested.

Proposal 2(m): Treatment of purchased receivables

- Purchased retail receivables that meet the four criteria for regulatory retail exposures, as specified in proposal 2(k), are risk-weighted at 75 per cent. Purchased receivables of corporate entities or exposures that do not meet the retail definition, are risk-weighted as corporate exposures, or claims on corporate.

Procedures for Receivables Program

As part of the institution's risk management processes, it should establish underwriting criteria and monitoring procedures for all purchased assets/receivables, particularly where an institution regularly purchases assets from a seller pursuant to a facility or program. Therefore, an institution is expected to:

- Establish quality criteria both for receivables to be purchased and for the seller/servicer of the receivables;
- Regularly monitor the purchased receivables to ensure they meet the criteria;
- Regularly monitor the financial condition of the seller/servicer of the receivables;
- Have legal certainty that the institution has ownership of the receivables and all associated cash remittances;
- Have confidence that current and future advances or purchases can be repaid from the liquidation or collections from the receivables pool;
- Periodically verify the accuracy of reports related to both the seller/servicer and the receivables/obligors;
- Periodically verify the credit and collection policies of the seller/servicer; and
- Establish procedures for monitoring adherence to all contractual terms by the seller/servicer and regular audits of critical phases of the program.

2.1.2 Off-Balance Sheet Exposures

Proposal 2(n): Categories, risk-weighting, and credit conversion factors

Information about specific off-balance sheet items is provided below. Refer to Appendix A for the credit conversion factor and risk-weighting.

- Forward rate agreements refer to arrangements between two parties where at some predetermined future date a cash settlement will be made for the difference between the contracted rate of interest and the current market rate on a predetermined notional principal amount for a predetermined period.
- Purchased options refers to a purchased right to sell or buy an asset for a specified value at a specified date.
- Credit derivatives refers to contracts that allow for the transfer of the credit risk related to an underlying entity from one party to another transferring the actual underlying entity. Examples include credit default swaps, collateralized debt obligations, total return swaps, credit default swap options, and credit spread forwards. Please refer to Appendix D: Conditions for Credit Derivative Contracts for more information.
- Transaction-related contingencies refers to the ongoing business activities of a counterparty, where the risk of loss to the reporting institution depends on the likelihood of a future event that is independent of the creditworthiness of the counterparty. It includes the performance-related and non-financial guarantees such as:
  - Performance bonds, warranties, and indemnities; and
  - Customs and excise bonds. The amount recorded for such bonds should be the reporting institution’s maximum liability.
- Sale and repurchase agreements refer to an agreement that involves the sale of a security or other asset with the simultaneous commitment by the seller that, after a stated period, the seller will repurchase the asset from the original buyer at a pre-determined price. A reverse repurchase agreement consists of the purchase of a security or other asset with the simultaneous commitment by the buyer that, after a stated period, the buyer will resell the asset to the original seller at a pre-determined price. In any circumstance where they are not reported on-balance sheet, they should be reported as an off-balance sheet exposure with a 100 per cent credit conversion factor.

Excluded Provision

Concentration risk adjustments

BCFSA is strengthening our credit risk section on commercial lending. As concentration risk is addressed in a variety of areas in the proposed requirements under credit risk, specific measures addressing concentration risk as stipulated in Section 15(3) of the Capital Requirements Regulation are not necessary.

2.2 OPERATIONAL RISK

Operational risk, as defined under the Basel Standards, is the risk of loss resulting from inadequate or failed internal processes, people, and systems, or from external events. This definition includes legal risk[14] but excludes strategic and reputational risk.

Managing operational risk is intrinsically difficult for many reasons. Compared with financial risk such as credit or market risk, operational risk is more complex, involving dozens of diverse risk types. Second, operational risk management requires oversight and transparency of all organizational processes and business activities. Third, the distinguishing features of the roles of the operational risk function and other oversight groups especially compliance, financial crime, cyber risk, and IT risk, have been fluid. Further, the number and diversity of operational risk types have enlarged as important specialized risk categories become more defined, including unauthorized trading, third-party risk, fraud, questionable sales practices, misconduct, new product risk, cyber risk, and operational resilience. At the same time, digitization and automation are changing the nature of work, reducing traditional human errors but creating new change management risks. BCFSA has seen that operational risk losses have grown both in frequency and magnitude in the banking sector.

These developments and challenges highlight the importance of a capital framework that incorporates an appropriate capital charge for operational risk. For this purpose, BCFSA is adopting the Basic Indicator Approach ("BIA"), which is explained below. It offers simplicity and is a reasonable starting point for credit unions. BCFSA will continue to monitor operational risk developments/practices with a view to introducing a more risk sensitive approach in future. Further, BCFSA is planning to issue a guideline on Operational Risk Management applicable to credit unions.

14 Legal risk includes, but is not limited to, exposure to fines, penalties, or punitive damages resulting from supervisory actions, as well as private settlements.

BIA

Credit unions are required to use the BIA to determine the amount of capital required for operational risk. The BIA uses a credit union's gross income as a proxy for operational risk because income is a good indicator of the volume and complexity of its business activities, which can increase the potential for operational risk events. While the BIA is a simple rule-based method and lacks risk sensitivity, it is a reasonable starting point for credit unions compared to more complex, risk sensitive measures that may be introduced in the future.

Risk-weighted assets equivalent for operational risk = capital charge for operational risk X 12.5.

Capital charge for operational risk = 15 per cent X 3-year average of net interest income and non-interest income (where positive).

- Figures for any year in which the annual total net interest income and non-interest income is negative or zero must be excluded from both the numerator and denominator when calculating the average.
- The credit union's operational risk capital requirement is calculated in accordance with the following formula:

$$K_{BIA} = \frac{\sum(GI_{1 \ldots n} \times \alpha)}{n}$$

Where:

- K_{BIA} is the capital charge under the Basic Indicator Approach.
- ***GI*** is the credit union's average annual Gross Income (as defined below) for those years (out of the previous three years) for which the credit union's annual gross income is more than zero.
- α is 15 per cent.
- ***n*** is the number of years out of the previous three years for which the credit union's gross income is more than zero.

The risk-weighted assets for operational risk under the BIA are determined by multiplying the capital requirements, calculated in accordance with the above formula, by 12.5. This is a multiplier to translate the operational risk capital requirements into a risk weighting corresponding with an eight per cent minimum total capital requirement ratio.

Gross income, for a year, means net interest income plus net non-interest income[15] for the year. This measure should:

i. be gross of any provisions (e.g., provisions for unpaid interest);

ii. be gross of operating expenses, including fees paid to outsourcing service providers;

iii. exclude realized profits/losses from the sale of securities in the banking book. Realized profits/losses from securities classified as "held to maturity" and "available for sale," which typically constitute items of the banking book, are also excluded from the definition of gross income; and

iv. exclude extraordinary or irregular items.

15 As defined by national accounting standards ("IFRS")

2.3 MARKET RISK

Market risk describes the risk of losses in on- and off-balance sheet positions arising from movements in market prices. In general, the risks that are subject to market risk capital requirements include but are not limited to interest rate risk ("IRR"), credit spread risk, equity risk, foreign exchange ("FX") risk, and commodities risk.

All financial services organizations are exposed to different or all sub-types of market risk in varying degrees depending on the scale, scope, and nature of their businesses. IRR refers to the current or prospective risk to a credit union's capital and earnings arising from movements in interest rates that adversely affect the credit union's balance sheet positions. Equity risk is unrealized or realized losses due to change in value of equity portfolios held in trading books. FX risk is the adverse impact of portfolio revaluation due to movement of FX rates in the market. A credit spread is the yield differential between different securities, caused by differences in their credit quality. Commodity risk is the potential loss from an adverse change in commodity prices.

Scope for BCFSA Market Risk Regulatory Framework

The principal business activity of credit unions is lending to current and future home buyers and businesses and accepting deposits from their members. This exposes the credit unions to significant degrees of IRR. This is because interest rates encode the time-value of money, the funding cost gap, and timing/tenure mismatch between deposits and loans. Thus, due to credit union's business models, the main contribution to market risk arises from IRR. Due to these reasons, BCFSA market risk regulations only address IRR.

Market Risk

The BCFSA Capital Rules for Market Risk, which lay out BCFSA's expectations for credit unions' identification, measurement, monitoring, and control of IRR as well as its supervision, will consist of the following principles:

Interest Rate Risk in the Banking Book ("IRRBB")

For all positions on a credit union's balance sheet, related to deposits, loans and similar products (products with similar structure, cashflows and payoffs), including those held only for hedging risks related to these products, BCFSA will adopt and implement a tailored version of the IRR in the banking book standards as published by Basel Committee on Banking Supervision (BCBS) in 2016 ("BCBS IRRBB"). Going forward, BCFSA will refer to its adopted approach as the "BCFSA IRRBB" standards. The BCBS IRRBB standard has also been adopted by OSFI, with amendments, for management of IRR in the banking book for the institutions under its regulatory scope. BCFSA may make amendments to some or all provisions of these standards, as required, to make them more responsive to rapidly evolving market conditions while simultaneously considering its operational implementation for credit unions.

Credit unions will be expected to report the capital required to mitigate IRR, as measured by BCFSA IRRBB standards, under ICAAP on a quarterly basis. Based on these reports, after a one-year period, BCFSA will decide on whether to continue with BCFSA IRRBB under ICAAP or to move it under Pillar 1 of the Regulatory Capital Requirements.

Interest Rate Risk for non-Banking Book positions

For positions which do not meet the criteria for banking book positions as detailed above, BCFSA proposes to measure the IRR using Basel III Standard Approach for Market Risk and set aside required capital under Pillar 1 of Regulatory Capital Requirements. Positions that will fall under this are trading book positions and instruments held in the Mandatory Liquidity Pool ("MLP"). A trading book consists of positions in financial instruments held either with trading intent, being available for sale, or to hedge trading book positions.

Positions held with trading intent are those held intentionally for short-term resale and/or with the intent of benefiting from actual or expected short-term price movements or to lock in arbitrage profits. They may include positions arising from client servicing (e.g., matched principal brokering).

Next Steps

For credit unions which have internal models in place or utilize the services of third-party vendors or service providers for IRR identification, measurement, and management, BCFSA will perform a comprehensive review of these models and the metrics produced. Based on the findings of the comprehensive review exercise, BCFSA will make its final decision regarding the approach to be used by these credit unions regarding the treatment of IRR under capital adequacy and ICAAP. BCFSA also proposes that the credit unions which, based on the findings of the comprehensive review exercise, qualify for adoption of the Internal Models Approach[16] should also measure their IRR as per BCFSA IRRBB standards and Basel III Standard Approach for Market Risk (as applicable) and report both sets of results.

16 The Internal Models Approach refers to the use of the credit union's own risk management models to measure IRR.

3. Promote the Build-Up of Capital Buffers

The package of reforms commonly known as Basel III is a comprehensive set of measures developed by the Basel Committee on Banking Supervision (“BCBS”) to address the fault lines in the financial system exposed by the 2008 financial crisis. One of these fault lines was the lack of a system-wide approach to financial sector risks, a so-called macroprudential perspective that aims to promote financial stability and mitigate systemic risk.

To address this shortcoming, Basel III introduced two buffers that apply to all banks: the capital conservation buffer and the countercyclical capital buffer. A further element introduced was the specific capital surcharge for global systemically important banks (“G-SIBs”) and domestic systemically important banks (“D-SIBs”). These Basel III buffers and surcharges are described in sections 1, 2, and 3 below, followed by BCFSA’s proposals for their adoption.

1. Capital conservation buffer

Basel III introduced this buffer to ensure that banks build up capital buffers outside periods of stress, which can be drawn down as losses are incurred. If an institution’s capital falls below the conservation buffer amount, regulators will constrain distributions of earnings, such as dividends and staff bonus payouts. This is intended to address market pressure to keep paying out dividends.

Basel III sets the buffer at 2.5 per cent of total risk-weighted assets. It must be met with Common Equity Tier 1 (“CET1”) capital only, and it is established above the regulatory minimum capital requirement. Whenever the buffer falls below 2.5 per cent, automatic constraints on capital distribution (e.g., dividends, share buybacks, and discretionary bonus payments) will be imposed so that the buffer can be replenished. The distribution constraints increase as the bank’s capital ratio approaches the minimum capital requirement. The applicable conservation standards must be recalculated at each capital distribution date. Apart from these constraints, a bank will be able to continue to conduct business as normal when it draws down its capital conservation buffer.

2. Countercyclical capital buffer

This buffer is introduced to protect the financial system against excess credit growth. The notion is that the most severe crises are preceded by credit bubbles. When the bubbles burst, the banking sector is the first casualty. This buffer would be implemented by national jurisdictions only when they determine that credit growth is excessive and leading to the buildup of system-wide risk.

The buffer varies between 0 and 2.5 per cent of total risk-weighted assets and must be met with CET1 capital. Basel III requires banks to calculate and publish their countercyclical capital buffer requirements with at least the same frequency as their minimum capital requirements.

Supervisory authorities are expected to deploy the buffer on an infrequent basis and only when circumstances warrant. An authority is expected to pre-announce its decision to raise the level of the buffer by up to 12 months. The buffer is an extension of the capital conservation buffer. Accordingly, banks that fall below their countercyclical capital buffer requirement are subject to automatic distribution restrictions.

3. Global systemically important bank (G-SIB) surcharge and domestic systemically important bank (D-SIB) surcharge

To reduce the likelihood and severity of their failure, banks that are considered G-SIB are required to hold additional capital. The capital surcharge ranges from one per cent to 3.5 per cent of risk-weighted assets depending on the degree of the G-SIB's systemic importance.

Basel III also introduced complementary guidance for identifying and assigning surcharges to D-SIBs which are not significant from an international perspective, but nevertheless could have an important impact on their domestic financial system and economy compared to non-systemic institutions.

Proposal 3(a): Adopt capital conservation buffer comprised of Tier 1 capital in the amount of 2.5 per cent of risk-weighted assets.

The capital conservation buffer is designed to ensure that credit unions have an additional layer of usable capital that can be drawn down when losses are incurred. The buffer is set at 2.5 per cent of total risk-weighted assets. It must be met with Tier 1 only, and it is established above the regulatory minimum capital requirement.

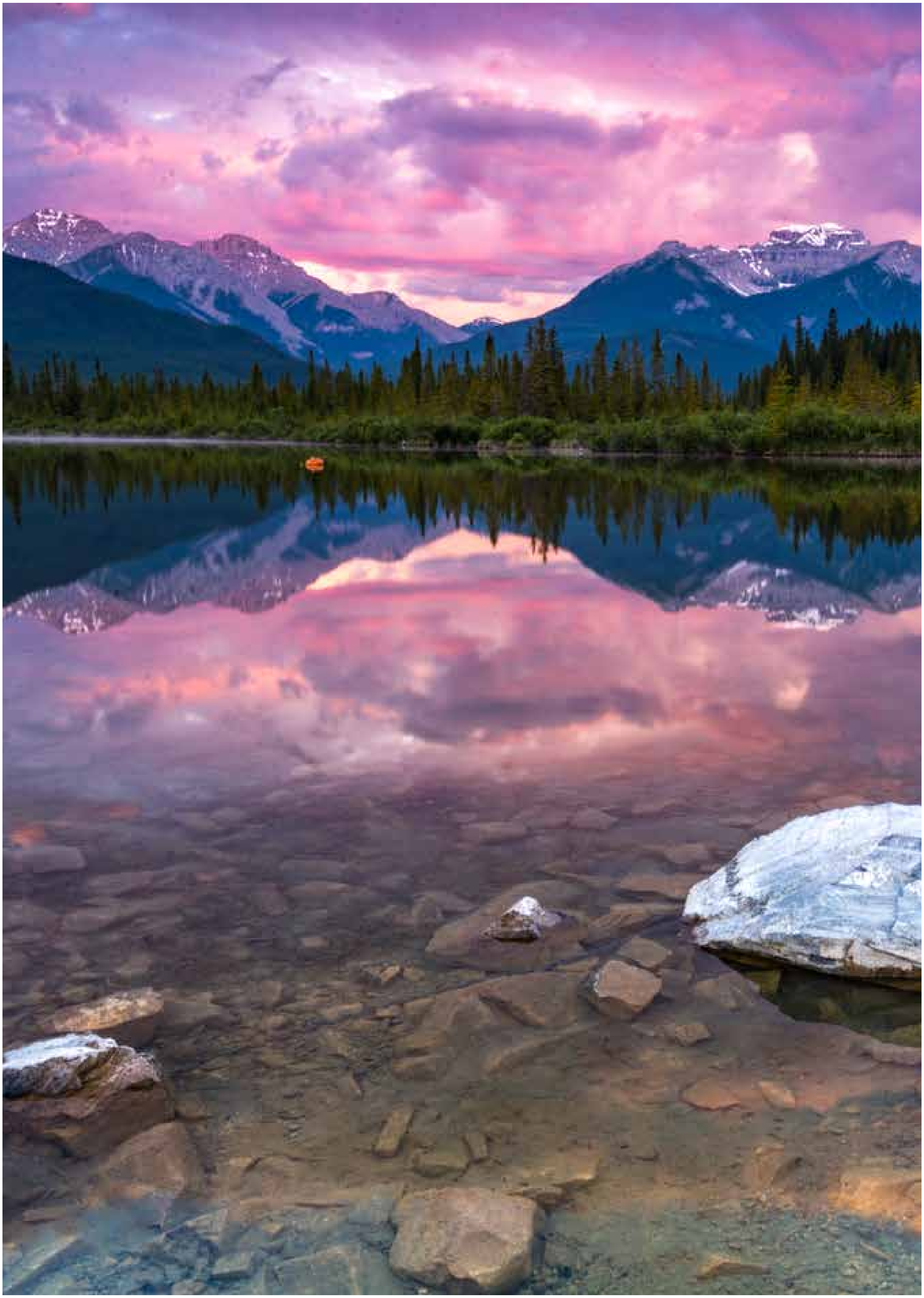
Whenever the buffer falls below 2.5 per cent, the following automatic constraints on capital distribution will be imposed so that the buffer can be replenished:

- Dividends;
- Share buybacks;
- Discretionary bonus payments; and
- The distribution constraints increase as the credit union's capital ratio approaches the minimum capital requirement. BCFSA may also impose other requirements such as the need for capital plans that seek to rebuild buffers over an appropriate timeframe.

Refer to Table 1-1 for a summary of minimum capital ratios plus buffers.

Proposal 3(b): Do not adopt countercyclical capital buffer or domestic systemically important banks surcharge.

The current risk-based supervisory approach is to work with individual credit unions proactively to ensure appropriate levels of capital and plans that support their risk profile. BCFSA is not currently proposing to adopt the countercyclical capital buffer or a D-SIBs surcharge framework. The applicability in B.C. may be reviewed in the next Capital Rule update.



4. Adopt an Internationally Harmonized Leverage Ratio

One of the underlying features of the 2008 financial crisis was the build-up of excessive on- and off-balance sheet leverage in the financial system. In many cases, financial institutions built up excessive leverage while still showing strong risk-based capital ratios. The risk-based capital ratios appeared strong because certain asset classes were believed to be low risk and therefore received a very low or zero risk weighting.

The leverage ratio serves as an additional safeguard by supplementing the risk-based capital measures detailed earlier in this paper with a simple, transparent, and independent measure of risk. It will also constrain leverage in the banking sector. The Basel III leverage ratio is defined as the capital measure (the numerator) divided by the exposure measure (the denominator) with this ratio expressed as a percentage.

Proposal

BCFSA expects all credit unions to maintain a minimum leverage ratio greater or equal to three per cent on a continuous basis, calculated as follows:

$$\textbf{Leverage Ratio} = \frac{\textbf{Eligible Capital}}{\textbf{Exposure Measures}}$$

This will replace the current assets to capital multiple ("ACM") ratio when the Capital Rule takes effect.

Table 4-1

	New Standards
Eligible Capital (Numerator)	Tier 1 Capital
Exposure Measures (Denominator)	Sum of the following exposures: • On-balance sheet exposures; • Derivative exposures; • Securities financing transaction exposures; and • Off-balance sheet exposures.
	The netting of specific provisions or accounting valuation adjustments (e.g., accounting credit valuation adjustments) is allowed.
	Netting of loans and deposits is not allowed; and no credit is given for physical or financial collateral, guarantees, or other credit risk mitigation.

5. Transitional Arrangements

In addition to the proposed transitioning timeline below, another eight to 10 months during 2025 will be provided as part of the implementation phase before the Capital Rule takes effect on January 1, 2026. This will provide additional latitude for credit unions to transition to the Capital Rule.

Proposed Transition Timeline

BCFSA proposes that the risk-based capital ratio requirements be phased in over a two-year period as noted in Table 5-1 (below).

Year 0 refers to the effective date of the Capital Rule (i.e., January 1, 2026). Year 1 refers to the first fiscal year end after the Capital Rule takes effect. This will be January 1/October 1, 2027 for credit unions with a fiscal year ending December 31 or September 30, respectively. Credit unions will be expected to meet or exceed minimum capital requirements by Year 2 or January 1/October 1, 2028, respectively.

Table 5-1: Risk-Based Capital Target Ratio

Components of capital (Capital Rule effective Jan 1, 2026)	Year 0 (Jan 1, 2026)	Year 1 (Jan 1/Oct 1, 2027)	Year 2 (Jan 1/Oct 1, 2028)
Tier 1 capital	4.5%	5.25%	6.0%
Capital conservation buffer	1.0%	1.75%	2.5%
Tier 1 capital with buffer	5.5%	7.00%	8.5%
Total Capital (Tier 1 capital plus Tier 2 capital)	8.0%	9.25%	10.5%
Software intangibles	No deduction	No deduction	Full deduction
Leverage ratio	3%	3%	3%

Proposed Transition Arrangement for Software Intangibles

Full deduction of software intangibles from capital under the Capital Rule applies effective fiscal year end 2028. Until that time, software intangibles are not subject to deduction.

6. Consultation Questions

Please send us your feedback and responses to the questions outlined in this consultation paper by completing our online Consultation Feedback Form.

The consultation is open until October 23, 2023. BCFSA values all the input we receive and all comments will be considered as we move forward with this important initiative.

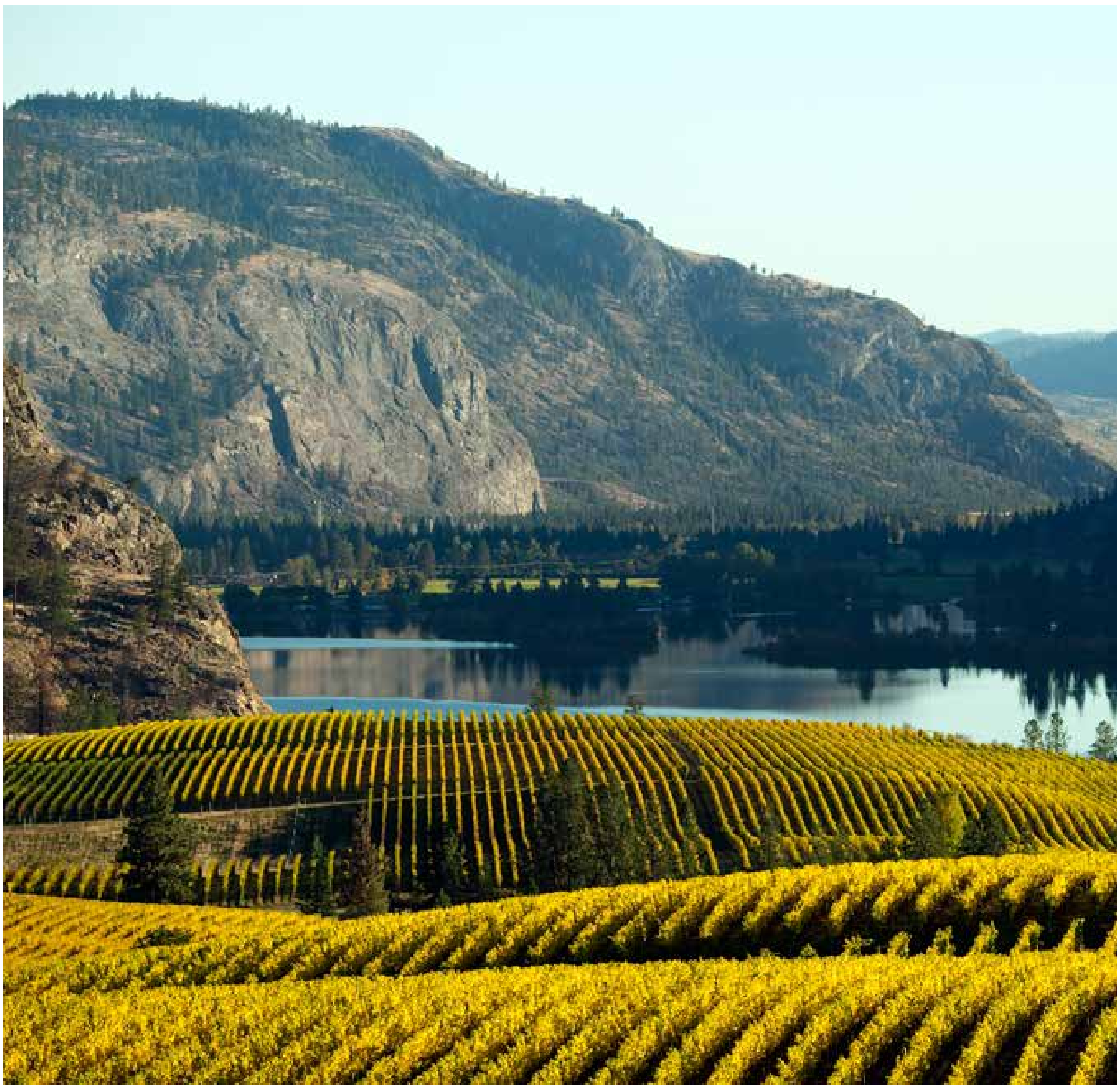
1. Do you have any general feedback concerning the proposals described in this paper?
2. Do you believe that the Capital Rule proposed in this paper would result in a framework that is suitable for credit unions? Are there any positions proposed in this paper that you disagree with? What additional items should be considered to reflect the unique capital structure of credit unions?
3. Do you have any suggestions on areas of the capital regime that could be made more risk-sensitive and/or areas that could be simplified or made less costly to administer?
4. Do you anticipate any barriers or challenges to implementing the changes to the capital framework? If so, are these challenges expected to be short-term or ongoing?
5. What are the challenges for your credit union in adopting the consolidated approach?
6. Does your credit union have capital instruments that do not qualify for recognition under the proposed Tier 1 and Tier 2 capital given the criteria in Appendix B? If yes, please explain what, why they do not qualify, and provide supporting information including terms and conditions of the instruments.
7. New risk-weighting categories:

    a) How will the proposed credit risk impact your capital adequacy ratio?

    b) Are there components of credit risks missing from the proposal? Please provide details.

    c) Are the credit conversion factors in the Appendix A for the off-balance sheet commitments appropriate for both commercial and retail (including HELOC) commitments?

8. For operational risk, what is your view on the risk sensitivity of BIA? Please provide details to support your position.
9. How is your credit union addressing market risk? Please include, as relevant, type of market risk exposures, techniques for measuring exposure types, how the measures are incorporated in a credit union's overall capital adequacy requirements, governance, and risk mitigation measures employed.
10. Will the transition arrangements (section 5) provide enough time for you to adopt the consolidated regulatory reporting methodology? If no, why not?



Appendix A: Summary of Capital Rule Proposals

Appendix A is a comprehensive summary of the components that make up the proposed capital framework, including proposed changes from the existing Capital Requirements Regulation. References to the corresponding sections of the consultation paper are provided where applicable.

RISK-BASED CAPITAL RATIO

Credit unions are expected to meet minimum risk-based capital requirements for exposure to credit risk and operational risk. Total risk-weighted assets are determined by multiplying the capital requirements for operational risk by 12.5 (i.e., the reciprocal of the minimum capital ratio of eight per cent) and adding the resulting figures to risk-weighted assets for credit risk. The risk- based capital ratio is calculated by dividing regulatory capital by total risk-weighted assets as stated below.

$$\text{Risk-Based Capital Ratio} = \frac{\text{Regulatory Capital}}{\text{Credit Risk-Weighted Assets} + \text{Capital Charge for Operational Risk} \times 12.5}$$

Where:

Regulatory capital = Total capital as set out in Section 1

Credit Risk-Weighted Assets = Items included in the Appendix A

Operational Risk = The operational risk capital charge calculation as set out in Section 2.2

CALCULATING REGULATORY CAPITAL

Elements of Eligible Capital (consolidated[17])	Proposal
Tier 1 Capital	1(a)
Retained earnings	1(a)
Membership shares	1(a)
Patronage shares, other than patronage shares redeemable within the following 12-month period	1(a)
Instruments other than membership shares or patronage shares issued by the credit union directly that: 1) meet or exceed the criteria for inclusion in Tier 1 capital; and 2) are not required to be redeemed within the following 12-month period. (Refer to Appendix B for criteria)	1(a) and Appendix B
Share premium resulting from the issue of instruments included in Tier 1 capital, including contributed surplus resulting from the issue of membership shares in a merger/amalgamation	1(a)
Instruments other than membership shares or patronage shares issued by consolidated subsidiaries of the credit union and held by third parties that: 1) meet the criteria for inclusion in Tier 1 capital; and 2) are not redeemable within the following 12-month period. (Refer to Appendix B for criteria)	1(a) and Appendix B
Accumulated other comprehensive income	1(a)

17 The consolidated entity includes all subsidiaries but excludes solvency-regulated insurance subsidiaries that underwrite insurance.

Elements of Eligible Capital (consolidated[17])	Proposal
Accumulated other comprehensive income: adjust for the derecognition of cash flow hedge reserve (refer to proposal 1(a) for conditions)	1(a)
Regulatory adjustments applied in the calculation of Tier 1 capital:	1(d)
Deferred income tax assets	1(d)
Fair value gains on own-use property	1(d)
Gain on sale related to securitization transactions	1(d)
Goodwill & other intangible assets	1(d)
Investments in capital and/or other Total Loss Absorbing Capacity ("TLAC") instruments of unconsolidated banking, financial institutions, and insurance entities	1(d)
Reverse mortgages	1(d) and 2(g)
Tier 2 Capital	1(b)
Instruments issued by the credit union directly that meet the criteria for inclusion in Tier 2 capital (and are not included in Tier 1 capital) (Refer to Appendix B for criteria)	1(b) and Appendix B
Instruments issued by consolidated subsidiaries of the credit union and held by third parties that meet the criteria for inclusion in Tier 2 capital and are not included in Tier 1 capital. (Refer to Appendix B for criteria)	1(b) and Appendix B
General loan loss allowance	1(b)

17 The consolidated entity includes all subsidiaries but excludes solvency-regulated insurance subsidiaries that underwrite insurance.

CAPITAL CONSERVATION BUFFER

The capital conservation buffer is set at 2.5 per cent of total risk-weighted assets and it must be met with Tier 1 capital only. Please refer to Proposal 3(a) for more information.

OPERATIONAL RISK – THE BASIC INDICATOR APPROACH

The credit union's operational risk capital requirement is calculated in accordance with the following formula. Please refer to Section 2.2 for more information.

$$K_{BIA} = \frac{\Sigma(GI_{1...n} \times \alpha)}{n}$$

Where:

- K_{BIA} is the capital charge under the Basic Indicator Approach;
- GI is the credit union's average annual Gross Income for those years (out of the previous three years) for which the credit union's annual gross income is more than zero;
- α is 15 per cent; and
- n is the number of years out of the previous three years for which the credit union's gross income is more than zero.

LEVERAGE RATIO

Each credit union must maintain on a continuous basis a minimum leverage ratio greater or equal to three per cent calculated using the following formula. Please refer to Section 4 for more information.

$$\textbf{Leverage Ratio} = \frac{\textbf{Eligible Capital}}{\textbf{Exposure Measures}}$$

	New Standards
Eligible Capital (Numerator)	Tier 1 Capital
Exposure Measures (Denominator)	Sum of the following exposures: • On-balance sheet exposures; • Derivative exposures; • Securities financing transaction exposures; and • Off-balance sheet exposures.
	Net of specific provisions or accounting valuation adjustments (e.g., accounting credit valuation adjustments); and Netting of loans and deposits is not allowed; and no credit is given for physical or financial collateral, guarantees, or other credit risk mitigation.

RISK-WEIGHTED ASSETS FOR CREDIT EXPOSURES

On-Balance Sheet Exposures

Asset Class	Risk Weighting	Proposal
Cash	0%	N/A
Cheques and other items in transit	20%	2(a)
Central 1 deposit	20%	2(c)
Federal or provincial government guaranteed liquidity deposits	0%	N/A
Claims on deposit-taking institutions and banks		2(b) and 2(c)
Credit rating of the sovereign:		
AAA to AA-	20%	
A+ to A-	50%	
BBB+ to BBB-	100%[18]	
Below BB+ and unrated	150%	
Claims on corporate		N/A
AAA to AA-	20%	
A+ to A-	50%	
BBB+ to BBB-	100%	
Below BB+ and unrated	150%	
For commercial and retail lending activities, please refer to “On-Balance Sheet Exposures: Residential and Commercial Lending” section below		2(d)
Securities secured by residential mortgages guaranteed by CMHC	0%	N/A
Securities secured by qualifying residential mortgages	35%	2(e)
Securities secured by non-qualifying residential mortgages	100%	2(e)
Other investments[19]	100%	N/A

18 BBB is risk weighted at 100% under Basel III standards. This risk weight is updated to 75% under Basel IV.
19 Property held for investments are included.

Asset Class	Risk Weighting	Proposal
Credit union central equity shares	100%	2(f)
CUDIC debentures	100%	N/A
Claims secured by residential property: insured portion	0%	N/A
Reverse mortgages:		2(g) and 1(d)
Initial LTV ≤ 40% and current LTV ≤ 60%	35%	
Initial LTV > 40% and current LTV ≤ 60%	50%	
60% < current LTV ≤ 75%	75%	
75% < current LTV ≤ 85%	100%	
Current LTV > 85%	Partial deduction	
Claims on direct sovereigns – credit assessment of sovereigns:		2(b) & 2(h)
AAA to AA-	0%	
A+ to A-	20%	
BBB+ to BBB-	50%	
Below BB+ and unrated	150%	
Claims fully secured by deposits and government securities	-	2(d)(iii)
Loans to local government	-	2(b) & 2(i)
Claim on other public sector entities ("PSE"):		
Credit Assessment of Sovereign	PSE Risk Weight	
AAA to AA-	20%	
A+ to A-	50%	
BBB+ to BBB-	100%	
Below BB+ and Unrated	150%	
Securitized personal and commercial insured mortgages originated by the credit union that do not meet IFRS de-recognition criteria	0%	N/A

Asset Class	Risk Weighting	Proposal
Securitizations: unrated retained securitization exposures	1250%	2(j)
Claims secured by commercial real estate: insured portion	0%	N/A
Claims secured by commercial real estate: other	-	2(d)(ii)
Unsecured portion of personal loan, past due > 90 days, net of specific provision greater or equal to 20% and less than 100%	100%	N/A
Unsecured portion of personal loan, past due > 90 days, net of specific provision < 20%	150%	N/A
Regulatory retail portfolio (excluding mortgages)	75%	2(k)
Fixed assets	100%	N/A
Foreclosed property	100%	N/A
Non-significant investments in the capital of banking, financial & insurance entities to which a credit risk standardized approach applies not deducted from capital (exclude Central 1)	100%	2(l)
Non-significant investments in the equity of non-financial entities	100%	N/A
Adjustments from capital	0%	N/A
Derivatives assets related amounts	0%	N/A
Accounts receivable from sale of mortgages under NHA mortgage-backed programs	100%	N/A
Purchased receivables	75%	2(m)
Other assets	100%	N/A
Commercial leases otherwise secured	100%	N/A

On-Balance Sheet Exposures: Residential and Commercial Lending

Proposal 2(d)

Proposal 2(d)(i) Residential Lending

Risk Factors	Lending Category	
	RRE	IPRRE
Mortgages	**RRE**	**IPRRE**
TDS > 42% AND Amortization > 30 years AND LTV > 75%	70%	105%
(TDS > 42% AND Amortization > 30 years AND LTV ≤75%) OR (TDS > 42% AND Amortization ≤ 30 years AND LTV > 75%) OR (TDS ≤ 42% AND Amortization > 30 years AND LTV > 75%)	50%	75%
(TDS > 42% AND Amortization ≤ 30 years AND LTV ≤ 75%) OR (TDS ≤ 42% AND Amortization ≤ 30 years AND LTV >75%) OR (TDS ≤ 42% AND Amortization > 30 years AND LTV ≤ 75%)	30%	45%
TDS ≤ 42% AND Amortization ≤ 30 years AND 50% < LTV ≤ 75%	20%	30%
TDS ≤ 42% AND Amortization ≤ 30 years AND LTV ≤ 50%	15%	22%
HELOC	**RRE**	**IPRRE**
TDS > 42% AND LTV > 65%	70%	105%
(TDS > 42% AND LTV ≤ 65%) OR (TDS ≤ 42% AND LTV > 65%)	50%	75%
TDS ≤ 42% AND 50% < LTV ≤ 65%	30%	45%
TDS ≤ 42% AND LTV ≤ 50%	25%	37%
Uninsured Residential Construction Exposures	65%	-

Proposal 2(d)(ii) Commercial Real Estate (“CRE”) Lending

CRE Lending	Risk Weights by Lending Categories		
Risk Factors	**CRE – Residential (multi-residential)**	**CRE – Owner-Occupied**	**CRE – Income-Producing (non-residential)**
DSCR < 120% AND LTV > 70%	55%	85%	105%
DSCR < 120% AND LTV ≤ 70% OR DSCR ≥ 120% AND LTV > 70%	45%	70%	85%
DSCR ≥ 120% AND LTV ≤ 70%	35%	50%	65%

<table>
<tr><th colspan="5">Construction Lending</th></tr>
<tr><th>Risk Factors</th><th>CRE – Construction (multi-residential)</th><th>CRE – Construction (general)</th><th>CRE – Construction (speculative)</th><th>Land-only (speculative)</th></tr>
<tr><td>LTC > 70%</td><td>75%</td><td>120%</td><td>130%</td><td rowspan="2">150%</td></tr>
<tr><td>LTC ≤ 70%</td><td>55%</td><td>105%</td><td>110%</td></tr>
</table>

Proposal 2(d)(iii) General Commercial Lending

<table>
<tr><th colspan="6">General Commercial Lending</th></tr>
<tr><th>Risk Factors</th><th>Commercial (Otherwise secured) – fixed assets</th><th>Commercial (Otherwise secured) – current assets</th><th>Insured, Secured by Govt Guarantee</th><th>CU deposits secured loans</th><th>Unsecured/ non-recourse</th></tr>
<tr><td>DSCR < 110%</td><td>100%</td><td>120%</td><td rowspan="3">20%</td><td rowspan="3">10%</td><td rowspan="3">150%</td></tr>
<tr><td>110% ≤ DSCR < 140%</td><td>90%</td><td>110%</td></tr>
<tr><td>DSCR ≥ 140%</td><td>80%</td><td>100%</td></tr>
</table>

Off-Balance Sheet Exposures

Proposal 2(n)

Notional Amount × credit conversion factor × risk weighting

	Credit Conversion Factor ("CCF")	Risk Weighting
Derivatives		
Interest rate contracts	0.5%	20%
Forward rate agreements	0.5%	20%
Purchased options	8%	20%
Credit derivatives	100%	100%
Other (specify)		100%
Guarantees of Indebtedness	100%	On-balance sheet risk weighting
Transaction-related contingencies	50%	On-balance sheet risk weighting
Letter of Credit (Short-Term)	20%	On-balance sheet risk weighting
Letter of Credit (Transaction)	50%	On-balance sheet risk weighting
Letter of Credit (Standby)	100%	On-balance sheet risk weighting
Commitments		
Unconditionally cancellable any time	0%	0%
Original maturity ≤ 1 year	20%	On-balance sheet risk weighting
Original maturity > 1 year	50%	On-balance sheet risk weighting
HELOC (refer to Appendix C)	10%	On-balance sheet risk weighting
Sales and Repurchase Agreements	100%	On-balance sheet risk weighting
Other (specify)		100%

Appendix B: Capital Standards

1. CRITERIA FOR INCLUSION IN TIER 1 CAPITAL

1.1 Tier 1 instruments other than membership shares or patronage shares issued by the credit union directly.

The following is the minimum set of criteria for an instrument other than a membership share or patronage share issued by the credit union directly to meet or exceed to be included in Tier 1 capital:

1. Issued and paid-in in cash.
2. Subordinated to depositors, general creditors, and subordinated debt holders of the credit union.
3. Is neither secured nor covered by a guarantee of the issuer or related entity or other arrangement that legally or economically enhances the seniority of the claim vis-à-vis the credit union's depositors and/or creditors[20].
4. Is perpetual, i.e., there is no maturity date and there are no step-ups[21] or other incentives to redeem[22].
5. May be callable at the initiative of the issuer only after a minimum of five years except upon the death or expulsion from the credit union of the holder:
   - A credit union's actions and the terms of the instrument must not create an expectation that the call will be exercised[23] and
   - A credit union must not exercise the call unless:

     (i) It replaces the called instrument with capital of the same or better quality, including through an increase in retained earnings, and the replacement of this capital is done at conditions which are sustainable for the income capacity of the credit union[24]; or

     (ii) The credit union can demonstrate to BCFSA that its capital position will be substantially above the minimum capital requirements after the call option is exercised[25].

20 Further, where a credit union uses a Special Purpose Vehicle ("SPV") to issue capital to investors and provides support, including overcollateralization, to the vehicle, such support would constitute enhancement in breach of Criterion # 3 above.
21 A step-up is defined as a call option combined with a pre-set increase in the initial credit spread of the instrument at a future date over the initial dividend (or distribution) rate after taking into account any swap spread between the original reference index and the new reference index. Conversion from a fixed rate to a floating rate (or vice versa) in combination with a call option without any increase in credit spread would not constitute a step-up.
22 Other incentives to redeem include a call option combined with a requirement or an investor option to convert the instrument into common shares if the call is not exercised.
23 An example of an action that would be considered to create an expectation that a call will be exercised is where a credit union calls a capital instrument and replaces it with an instrument that is more costly (e.g., a higher credit spread).
24 Replacement issues can be concurrent with but not after the instrument is called.
25 Minimum refers to the regulator's prescribed minimum requirement.

6. The credit union cannot be required to redeem, purchase, or otherwise acquire the instrument at a rate of more than 10 per cent of the outstanding amount of that class of the instrument during any one-year period. The amount that may be recognized as Tier 1 capital is the amount of the share capital associated with the number of the instruments that are not redeemable or otherwise acquirable during this one-year period.

7. Dividend/coupon discretion:

   - the credit union must always have full discretion to cancel distributions/payments[26];
   - cancellation of discretionary payments must not be an event of default or credit event;
   - cancelled distributions must be non-cumulative; and
   - cancellation of distributions/payments must not impose restrictions on the credit union.

8. Dividends/coupons must be paid out of distributable items including retained earnings.

9. The instrument cannot have a credit-sensitive dividend feature a dividend/ coupon must not reset periodically based in whole or in part on the credit union or organization's credit standing[27].

10. The instrument cannot at the date of issuance, be classified as a liability under the applicable insolvency law for credit unions.

11. The instrument must be classified as equity for accounting purposes[28].

12. Neither the credit union nor a related party over which the credit union exercises control or significant influence can have purchased the instrument, nor can the credit union directly or indirectly have funded the purchase of the instrument[29].

26 A consequence of full discretion at all times to cancel distributions/payments is that "dividend pushers" are prohibited. An instrument with a dividend pusher obliges the issuing bank to make a dividend/coupon payment on the instrument if it has made a payment on another (typically more junior) capital instrument or share. This obligation is inconsistent with the requirement for full discretion at all times. Furthermore, the term "cancel distributions/payments" means extinguish these payments. It does not permit features that require the credit union to make distributions/payments in kind.

27 Credit unions may use a broad index as a reference rate in which the issuing credit union is a reference entity; however, the reference rate should not exhibit significant correlation with the credit union's credit standing. If a credit union plans to issue capital instruments where the margin is linked to a broad index in which the credit union is a reference entity, the credit union should ensure that the dividend/coupon is not credit-sensitive.

28 BCFSA expects Tier 1 instruments to be fully classified as equity at all times.

29 The intention of this criterion is to prohibit the inclusion of instruments in capital in cases where the credit union retains any of the risk of the instruments. The criterion is not contravened if third-party investors bear all of the risks and rewards associated with the instrument.

13. The instruments cannot have any features that hinder recapitalization, such as provisions that require the issuer to compensate investors if a new instrument is issued at a lower price during a specified timeframe.

14. If the instrument is not issued out of an operating entity or the holding company in the consolidated group (i.e., it is issued out of a special purpose vehicle ("SPV")), proceeds must be immediately available without limitation to an operating entity[30] or the holding company in the consolidated group in a form which meets or exceeds all of the other criteria for inclusion in Tier 1 capital. For greater certainty, the only assets the SPV may hold are intercompany instruments issued by the credit union or a related entity with terms and conditions that meet or exceed the Tier 1 criteria. Put differently, instruments issued to the SPV have to fully meet or exceed all of the eligibility criteria for Tier 1 capital as if the SPV itself was an end investor (i.e., the credit union cannot issue a lower quality capital or senior debt instrument to an SPV and have the SPV issue higher quality capital instruments to third-party investors so as to receive recognition as Tier 1 capital).

1.1.1 Tier 1 capital criteria clarifications

Purchase for cancellation of Tier 1 capital instruments is permitted at any time. For further clarity, a purchase for cancellation does not constitute a call option as described in the above Tier 1 criteria.

Dividend stopper arrangements that stop payments on Tier 1 instruments are permissible provided the stopper does not impede the full discretion the credit union must have at all times to cancel distributions or dividends on the Tier 1 instrument, nor must it act in a way that could hinder the recapitalization of the credit union pursuant to criterion 13 above. For example, it would not be permitted for a stopper on a Tier 1 instrument to:

- Attempt to stop payment on another instrument where the payments on the other instrument were not also fully discretionary;
- Prevent distributions to shareholders for a period that extends beyond the point in time that dividends or distributions on the Tier 1 instrument are resumed; and
- Impede the normal operation of the credit union or any restructuring activity, including acquisitions or disposals.

30 An operating entity is an entity set up to conduct business with clients with the intention of earning a profit in its own right.

A dividend stopper may also act to prohibit actions that are equivalent to the payment of a dividend, such as the credit union undertaking discretionary share buybacks.

Credit unions are permitted to "re-open" offerings of Tier 1 capital instruments to increase the principal amount of the original issuance subject to the following:

- Call options will only be exercised on or after the fifth anniversary of the date the shares are issued.

Defeasance or other options that could result in a decrease of the credit union's regulatory capital may only be exercised on or after the fifth anniversary of the closing date.

1.2 Tier 1 qualifying capital instruments issued by a consolidated subsidiary to third parties

Tier 1 capital instruments issued by a fully consolidated subsidiary of the credit union to third-party investors may receive recognition in the consolidated Tier 1 capital of the parent credit union only if the instrument, if issued by the credit union, would meet or exceed all criteria for classification as Tier 1 capital.

1.3 Tier 1 instruments issued to third parties out of SPVs

Capital issued to third parties out of a SPV can be included in consolidated Tier 1 and treated as if the credit union itself had issued the capital directly to the third-parties only if:

- It meets all the relevant eligibility criteria; and
- The only asset of the SPV is its investment in the capital of the credit union in a form that meets or exceeds all the relevant eligibility criteria[31] (as required by criterion 14 of the Tier 1 criteria set out under section 1.1).

In cases where the capital has been issued to third-parties through a SPV via a fully consolidated subsidiary of the credit union, such capital may, subject to the requirements of this paragraph, be treated as if the subsidiary itself had issued it directly to the third-parties and may be included in the credit union's consolidated Tier 1 or Tier 2 in accordance with the treatment outlined in sections 1.2 and 2.2.

31 Assets that relate to the operation of the SPV may be excluded from this assessment if they are de *minimus*.

2. CRITERIA FOR INCLUSION IN TIER 2 CAPITAL

2.1 Tier 2 instruments issued by the credit union directly

The following is the minimum set of criteria for an instrument issued by the credit union directly to meet or exceed to be included in Tier 2 capital:

1. Issued and paid-in in cash.
2. Subordinated to depositors and general creditors of the credit union.
3. Is neither secured nor covered by a guarantee of the issuer or related entity or other arrangement that legally or economically enhances the seniority of the claim vis-à-vis the credit union's depositors and/or general creditors.
4. The credit union cannot be required to redeem, purchase, or otherwise acquire the instrument at a rate of more than 10 per cent of the outstanding amount of that class of the instrument during any one-year period. The amount that may be recognized as Tier 2 capital is the amount of the share capital associated with the number of the instruments that are not redeemable or otherwise acquirable during this one-year period.
5. Maturity:
   a) Minimum original maturity of at least five years;
   b) Recognition in regulatory capital in the remaining five years before maturity will be amortized on a straight-line basis; and
   c) There are no step-ups[32] or other incentives to redeem;
6. May be callable at the initiative of the issuer only after a minimum of five years:
   a) A credit union must not do anything which creates an expectation that the call be exercised[33]; and
   b) A credit union must not exercise the call unless:
      (i) It replaces the called instrument with capital of the same or better quality, including through an increase in retained earnings, and the replacement of this capital is done at conditions which are sustainable for the income capacity of the credit union[34], or
      (ii) The credit union demonstrates that its capital position is well above the minimum capital requirements after the call option is exercised[35].

32 A step-up is defined as a call option combined with a pre-set increase in the initial credit spread of the instrument at a future date over the initial dividend (or distribution) rate after taking into account any swap spread between the original reference index and the new reference index. Conversion from a fixed rate to a floating rate (or vice versa) in combination with a call option without any increase in credit spread.

33 An option to call the instrument after five years but prior to the start of the amortization period will not be viewed as an incentive to redeem as long as the credit union does not do anything that creates an expectation that the call will be exercised at this point.

34 Replacement issues can be concurrent with but not after the instrument is called.

35 Minimum refers to the regulator's prescribed minimum requirement, which may be higher than the Basel III Pillar 1 minimum requirement.

7. The investor must have no rights to accelerate the repayment of future scheduled principal or interest payments, except in bankruptcy, insolvency, wind-up, or liquidation.
8. The instrument cannot have a credit sensitive dividend feature; that is, a dividend or coupon that is reset periodically based in whole or in part on the credit union or organizations' credit standing[36].
9. Neither the credit union nor a related party over which the credit union exercises control or significant influence can have purchased the instrument, nor can the credit union directly or indirectly have funded the purchase of the instrument.
10. If the instrument is not issued out of an operating entity[37] or the holding company in the consolidated group (i.e. it is issued out of a special purpose vehicle ["SPV"]), proceeds must be immediately available without limitation to an operating entity or the holding company in the consolidated group in a form which meets or exceeds all of the other criteria for inclusion in Tier 2 capital. For greater certainty, the only assets the SPV may hold are intercompany instruments issued by the credit union or a related entity with terms and conditions that meet or exceed the above Tier 2 criteria. Put differently, instruments issued to the SPV have to fully meet or exceed all of the eligibility criteria for Tier 2 capital as if the SPV itself was an end investor – i.e., the credit union cannot issue a senior debt instrument to a SPV and have the SPV issue higher quality capital instruments to third party investors so as to receive recognition as Tier 2 capital.

2.1.1 Tier 2 capital criteria clarifications

Tier 2 capital instruments must not contain restrictive covenants or default clauses that would allow the holder to trigger acceleration of repayment in circumstances other than the insolvency, bankruptcy or winding-up of the issuer.

Purchase for cancellation of Tier 2 instruments is permitted at any time. For further clarity, a purchase for cancellation does not constitute a call option as described in the above Tier 2 criteria.

Defeasance or other options that could result in a decrease of the credit union's regulatory capital may only be exercised on or after the fifth anniversary of the closing date.

36 Credit unions may use a broad index as a reference rate in which the issuing credit union is a reference entity; however, the reference rate should not exhibit significant correlation with the credit union's credit standing. If a credit union plans to issue capital instruments where the margin is linked to a broad index in which the credit union is a reference entity, the credit union should ensure that the dividend/coupon is not credit-sensitive.

37 An operating entity is an entity set up to conduct business with clients with the intention of earning a profit in its own right.

Credit unions are permitted to "re-open" offerings of capital instruments to increase the principal amount of the original issuance subject to the following:

- Call options will only be exercised on or after the fifth anniversary of the date the shares are issued.

2.2 Tier 2 qualifying capital instruments issued by a consolidated subsidiary to third parties

Total capital instruments (i.e., Tier 1 and Tier 2 capital instruments) issued by a fully consolidated subsidiary of the credit union to third-party investors may receive recognition in the consolidated total capital of the parent credit union only if the instruments would, if issued by the credit union, meet all of the criteria for classification as Tier 1 or Tier 2 capital.

The amount of this total capital that will be recognized in Tier 2 will exclude amounts recognized in Tier 1 under section 1.2.

2.3 Tier 2 instruments issued to third-parties out of SPVs

Capital can be included in consolidated Tier 2 and treated as if the credit union itself had issued the capital directly to the third-parties only if:

a) It meets all the relevant eligibility criteria; and

b) The only asset of the SPV is its investment in the capital of the credit union in a form that meets or exceeds all the relevant eligibility criteria[38] (as required by criterion 10 of the Tier 2 criteria set out under section 2.1).

In cases where the capital has been issued to third-parties through an SPV via a fully consolidated subsidiary of the credit union, such capital may, subject to the requirements of this paragraph, be treated as if the subsidiary itself had issued it directly to the third-parties and may be included in the credit union's consolidated Tier 1 or Tier 2 in accordance with the treatment outlined in sections 1.2 and 2.2.

38 Assets that relate to the operation of the SPV may be excluded from this assessment if they are de *minimus*.

2.3.1 Amortization

Tier 2 capital instruments are subject to straight-line amortization in the final five years prior to maturity. Hence, as these instruments approach maturity, such outstanding balances are to be amortized based on the following criteria:

Years to Maturity	Included in Capital
5 years or more	100%
4 years and less than 5 years	80%
3 years and less than 4 years	60%
2 years and less than 3 years	40%
1 year and less than 2 years	20%
Less than 1 year	0%

Appendix C: Residential and Commercial Lending – Guidance and Definitions

The following guidance and definitions are provided in conjunction with proposal 2(d) and relate to residential and commercial lending.

Amortization

The amortization is the length of time it takes to pay off a mortgage in full. For capital reporting, amortization will correspond to the remaining amortization of the residential mortgage.

Commercial Commitments

Commitment status refers to the nature of the credit union's obligation to advance additional funds within a credit facility and as such applies to the undrawn portion of a facility only.

Balance of Commercial Commitments = utilization + non-utilized balance * CCF[39]

Commercial Loans – General – Categories

Commercial Loans (Otherwise Secured Loans) – current assets:

- Revolving credit facility for financing current assets such as account receivables and inventory of finished goods or raw materials, and in some cases work-in-progress;
- Secured by a floating charge under general security agreement which allows the borrower to purchase and sell current asset without the need for a discharge; and
- Security collapses at time of bankruptcy when the lender seeks to seize the assets to pay outstanding debts.

Commercial Loans (Otherwise Secured Loans) – fixed assets:

- Reducing credit facility for financing the purchase of fixed assets such as machinery or equipment with features like make, model and serial number;
- Loans secured by Chattel Mortgage which is a specific charge over movable assets; and
- Loans for which the owner (borrower) of the asset cannot sell and transfer ownership without the release/discharge by holder (lender) of the security.

39 CCF is the Credit Conversion Factor.

Credit Union Deposits Secured Loans:

- Hypothecated credit union cash deposits secured loans.

Insured, Secured by Government Guarantee:

- Guarantee from federal government programs such as Canada Small Business Financing Loans, Export Development Canada's Guarantee Program, and Refundable Investment Tax Credit Program.

Unsecured/non-recourse Commercial Loans:

- Any loans to commercial borrowers without the personal guarantee of the beneficial owner and/or controlling shareholder;
- Loans to borrower where the credit union is not in first position or *pari passu* within the *Personal Property Security Act* ("*PPSA*"); and
- Loans for which the credit union's first position in the *PPSA* is superseded by "super priority" charges such as purchase money security interest, trade liens, and government account payable such as tax.

Commercial Real Estate ("CRE") Categories

- **CRE-Residential (multi-residential):** Income-producing multi-residential real estate that is made of over four adjoining units.

  This category of commercial loans is secured by apartment buildings that generate rental income from residential tenants. The main risk for this category is the loss of the cash flow from the property due to vacancies and rental payments not being honored. In addition, valuation for this segment will be impacted by the cash flow generated by the property. As such, high vacancy rates will also impact market value and loan-to-value ratios. The main factors considered in allocating risk weights are DSCR and LTV ratios.

- **CRE-Owner-Occupied:** Commercial property that is fully or partially occupied by the owner.

  This category of commercial loans is secured by commercial properties (such as retail, office, or industrial) occupied by the business to be utilized for their own operations. For this category, debt-servicing will come from the cash flow of the business' own operations. The main risk for this segment is the lack of cash flow from operations to service the debt, which is normally driven by the industry of the borrower. The main factors considered in allocating risk weights are DSCR and LTV ratios.

- **CRE-Income-Producing:** Commercial real estate properties that are primarily occupied by rent-paying commercial tenants.

  This category of commercial loans is secured by commercial properties (such as retail, office, or industrial) that are not occupied by the owners. The purpose of holding these commercial properties is to generate rental income from other commercial entities. For this category, debt-servicing will come from the rental income generated by the property. Like multi-residential properties, the main risk for this category is also vacancy, though the drivers are different. In addition, the valuation for this segment will be impacted by the cash flow generated by the property and prevailing capitalization rates. As such, high vacancies will impact the market value and loan-to-value ratios. The main factors considered in allocating risk weights are DSCR and LTV ratios.

- **CRE-Construction (multi-residential):** This category of commercial loans finances the construction of residential apartment buildings to be rented out, although the property will not be occupied until completion. The main risk for this category is completion risk (the risk the construction will not complete), driven by factors such as construction cost and prevailing interest rates. For this reason, this category is considered higher risk compared to non-construction CRE – Residential (multi-residential) loans since credit unions may have to take over unfinished projects in the event of a default. Another risk to consider is the cap on the allowable rent increase, which is set by the provincial government of B.C. Lastly, this category will be impacted by vacancies. The main factor considered in allocating risk weights is loan-to-cost ("LTC") ratios. LTC is the ratio of the construction loan balance in relation to construction costs. This is a better measure compared to LTV as it captures the credit union's exposure during the construction period.

- **CRE-Construction (general)** refers to multiple draw interest-only loans to finance the construction of commercial property to be occupied or rented out (income-producing) by the owner upon completion.

  This category of commercial loans finances the construction of commercial non-residential properties that will either be occupied or rented out (income-producing) by the owner upon completion. The main risk for this category is completion risk (the risk the construction will not complete), driven by factors such as construction cost and prevailing interest rates. The main factor considered in allocating risk weights is LTC.

- **CRE-Construction (speculative)** refers to commercial loans to finance the construction of properties for the purpose of selling or commercial properties for the purpose of selling and renting out the completed units (excludes construction projects for residential apartment buildings which is a separate category). This category is speculative since loan repayment will come from the sales proceeds or anticipated rental income of completed commercial units (such as retail or office properties). At the time of underwriting, there is no identified buyer for the development project and no actual pre-sale. As such, there is no guaranteed cash flow upon completion. There are many variables to consider for this segment, such as construction costs, prevailing interest rates, and the ability of the market to absorb the completed units. The main risk for this segment is completion risk and absorption risks. The only factor considered in allocating risk-weight is LTC.
- **CRE-Land-only (speculative)** refers to multiple draw interest-only loans to finance construction of unsold commercial property.

  This typically denotes commercial land loans to finance the purchase of land for the purpose of holding it while waiting for re-zoning without a definitive approval timeframe. This category is highly speculative and deemed to be of high risk due to lack of cash flow for debt servicing (debt-servicing is often via interest/payment reserves). The same risk weight will be assigned to all land-only (speculative) loans.

DSCR (Debt Service Coverage Ratio)

Debt service coverage ratio (DSCR) is defined as:

DSCR = EBITDA[40] / (Interest Expenses + Schedule Principal Payments)

- Where interest expense and schedule principal payments are from funded debts which excludes postponed debts but includes all borrowed money that bears interest or to which interest is imputed.

Determination of DSCR:

- BCFSA will provide high-level guidance to the credit unions to provide consistency in calculating DSCR through a regulatory instrument for capital purpose.

General RRE (General Residential Real Estate)

General RRE is defined as residential real estate property that has one to four adjoining units and do not meet the criteria for IPRRE.

The following types of exposures are subject to the capital treatment of General RRE:

- An exposure secured by a property that is the borrowers primary residence;
- An exposure secured by residential real estate property to associations or cooperatives of individuals that are regulated under national law and exist with the only purpose of granting its members the use of a primary residence in the property securing the loans; and
- An exposure secured by residential real estate property to public housing companies and not-for-profit associations regulated under national law that exist to serve social purposes and to offer tenants long-term housing.

HELOC (Home Equity Lines of Credit)

A HELOC is a form of non-amortizing (revolving) credit that is secured by a residential property. Unlike a traditional residential mortgage, most HELOCs are not constructed to fit a pre-determined amortization, although regular, minimum periodic payments are required by most lenders.

To determine the amount to be risk weighted for lines of credit, BCFSA expects credit unions to derive line of credit authorized available limit for capital purposes. Please note that the balance, utilization, and non-utilized balance are determined as of reporting date.

Balance of HELOC = utilization + non-utilized balance * the credit conversion factor

IPRRE (Income-Producing Residential Real Estate)

Income producing residential real estate is defined as residential real estate property that has one to four adjoining units where the repayment of the mortgage loan materially depends on the cash flow generated by the property. A loan is considered materially dependent if more than 50 per cent of the income used in the credit union's assessment of the borrower's ability to service the loan is from cash flows generated by the residential property.

40 Earnings before interest, taxes, depreciation, and amortization.

LOC (Line of Credit)

Credit facility that is revolving and re-advanceable with interest-only payments and no scheduled principal payments.

LTC Ratio (Loan-to-Cost Ratio)

Loan-to-cost is defined as underwriting value of the real estate asset that is based on the total cost incurred for the completion of the project development.

Determination of LTC:

- LTC is the ratio of the construction loan balance in relation to construction costs.

LTV Ratio (Loan-to-Value Ratio)

Loan-to-value is a measure that applies to real estate secured loans. LTV is defined as the sum of outstanding balance of term mortgages and authorized limits of secured lines of credit on all collateral that supports the loan divided by the value of the property pledged as collateral.

LTV Ratio Determination:

- At origination, the value of the real estate will be determined as the lesser of sales price or appraised value;
- The loan balance corresponds to current outstanding balance of term mortgages and authorized limits of secured lines of credit;
- For residential loans, the property value should be refreshed at loan renewal or refinance; and
- For commercial lending, BCFSA has the expectation for the credit union to update collateral property values annually to reflect the vibrant nature of real estate market in B.C, and dynamic proportion of risk exposure relative to risk mitigation approach in the lending industry.

TDS Ratio (Total Debt Service Ratio)

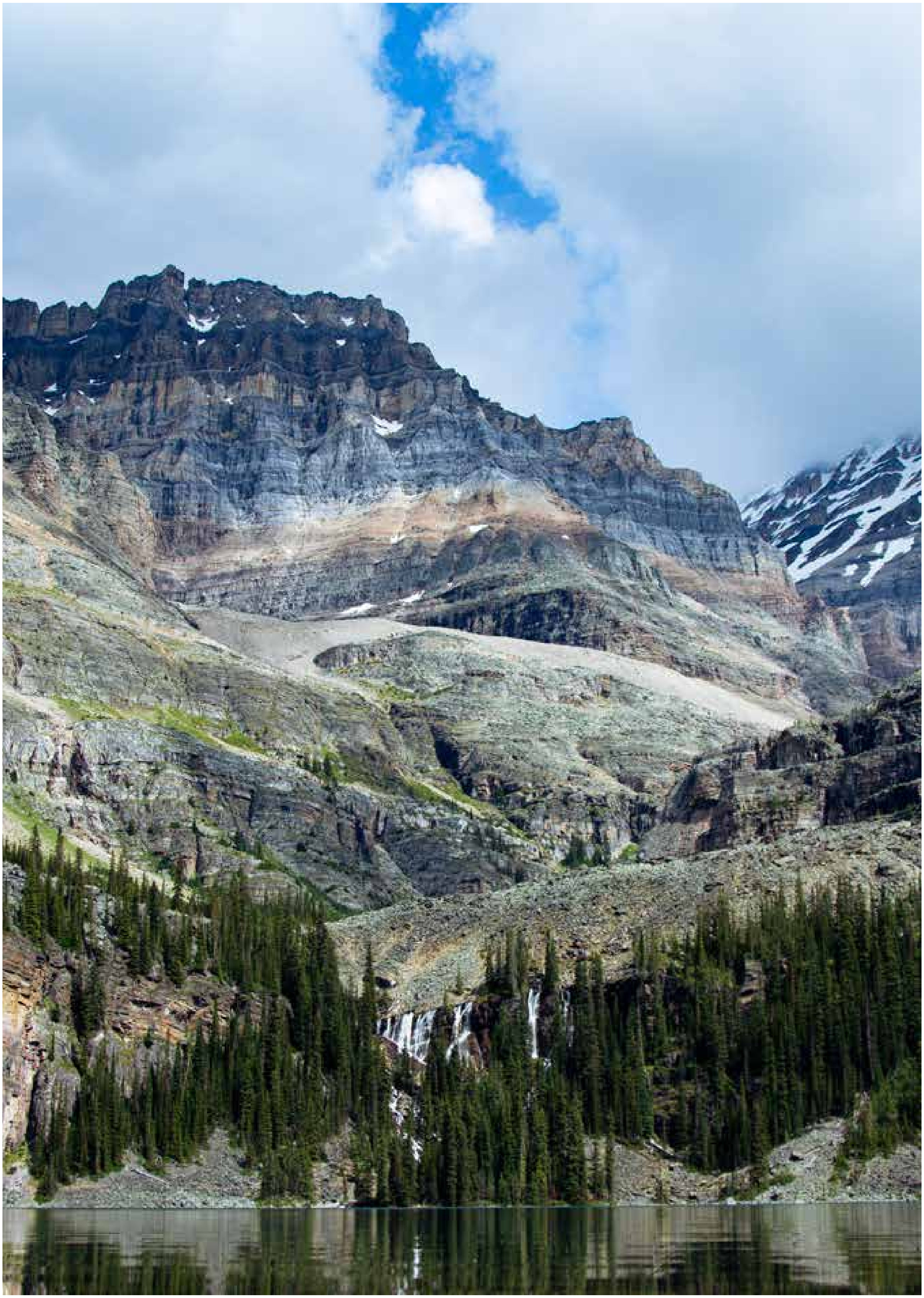
Total debt service ratio is defined as borrower's annual expenses divided by annual income.

Determination of the TDS ratio:

- BCFSA will provide high-level guidance to the credit unions to provide consistency in calculating the TDS ratio through an appropriate regulatory instrument for capital purpose; and
- BCFSA intends to provide a high-level formula for credit unions to determine the TDS ratio for capital purposes.

$$\textbf{TDS} = \frac{\textbf{Principal + Interest + Property related expenses + Other debts and expenses}}{\textbf{Gross Income}}$$

Expectation is that the TDS ratio is determined at mortgage origination and reasonably reflects the risk profile of the borrower throughout the life of the mortgage.



Appendix D: Conditions for Credit Derivative Contracts

The following information is provided in conjunction with proposal 2(n) and relates to credit derivatives.

(I) In order for a credit derivative contract to be recognized in accordance with Basel Standards, the following conditions must be satisfied:

a) The credit events specified by the contracting parties must at a minimum cover:

- Failure to pay the amounts due under terms of the underlying obligation that are in effect at the time of such failure (with a grace period that is closely in line with the grace period in the underlying obligation);
- Bankruptcy, insolvency, or inability of the obligor to pay its debts, or its failure or admission in writing of its inability to pay its debts as they become due, and analogous events;
- Restructuring of the underlying obligation involving forgiveness or postponement of principal, interest or fees that results in a credit loss event (i.e., charge-off, specific provision or other similar debit to the profit and loss account). When restructuring is not specified as a credit event, refer to (II) below;

b) If the credit derivative covers obligations that do not include the underlying obligation, section g) below governs whether the asset mismatch is permissible;

c) The credit derivatives shall not terminate prior to expiration of any grace period required for a default on the underlying obligation to occur due to a failure to pay;

d) Credit derivatives allowing for cash settlement are recognized for capital purposes insofar as a robust valuation process is in place to estimate loss reliably. There must be a clearly specified period for obtaining post-credit-event valuations of the underlying obligation. If the reference to obligation specified in the credit derivative for purposes of cash settlement is different than the underlying obligation, section g) below governs whether the asset mismatch is permissible;

e) If the protection purchaser's right/ability to transfer the underling obligation to the protection provider is required for settlement, the terms of the underlying obligation must provide that any required consent to such transfer may not be unreasonably withheld;

f) The identity of the parties responsible for determining whether a credit event has occurred must be clearly defined. This determination must not be the sole responsibility of the protection seller. The protection buyer must have the right/ability to inform the protection provider of the occurrence of a credit event;

g) A mismatch between the underlying obligation and the reference obligation under the credit derivative (i.e., the obligation used for purposes of determining cash settlement value or the deliverable obligation) is permissible if (1) the reference obligation ranks *pari passu* with or is junior to the underlying obligation, and (2) the underlying obligation and reference obligation share the same obligor (i.e., the same legal entity) and legally enforceable cross-default or cross-acceleration clauses are in place; and

h) A mismatch between the underlying obligation and the obligation used for purposes of determining whether a credit event has occurred is permissible if (1) the latter obligation ranks *pari passu* with or is junior to the underlying obligation, and (2) the underlying obligation and reference obligation share the same obligor (i.e., the same legal entity) and legally enforceable cross-default or cross-acceleration clauses are in place.

(II) When the restructuring of the underlying obligation is not covered by the credit derivative, but the other requirements under (I) above are met, partial recognition of the credit derivative will be allowed. If the amount of the credit derivative is less than or equal to the amount of the underlying obligation, 60 per cent of the amount of the hedge can be recognized as covered. If the amount of the credit derivative is larger than that of the underlying obligation, then the amount of eligible hedge is capped at 60 per cent of the amount of the underlying obligation;

(III) Only credit default swaps and total return swaps that provide credit protection equivalent to guarantees will be eligible for recognition. Except where a credit union buys credit protection through a total return swap and records the net payments received on the swap as net income but does not record offsetting deterioration in the value of the asset that is protected (either through reductions in fair value or by an addition to reserves), the credit protection will not be recognized; and

(IV) Other types of credit derivatives will not be eligible for recognition at this time.

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