

Capital Modernization Project Consultation

Information Session 2: Capital Overview

September 7, 2023

BCFSA BC Financial
Services Authority

Classification: Protected A



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Agenda

1. Approach and Considerations
 - Consultation
 - Review & Assessment Objectives
2. Proposal Overview
 - Minimum Capital Levels
 - Tier Classification
 - Shares and Subordinated Debt
 - Accumulated Other Comprehensive Income (“AOCI”)
 - Contributed Surplus from B.C. Credit Union Amalgamations
3. Regulatory Adjustments
 - Intangible Assets: Software
4. Question and Answer
5. Next Steps

Approach and Considerations

CONSULTATION

CONSULTATION (PHASE 2)

JULY 25 to NOVEMBER 6*

Capital Modernization:
Consultation Paper for B.C. Credit
Unions

INFORMATION SESSION SERIES

AUGUST/SEPTEMBER

Session 1: Consultation Launch
Session 2: Capital Overview
Session 3: Capital Buffers, Operational Risk,
Leverage Ratio and Market Risk Overview
Session 4: Credit Risk Overview

RULE DEVELOPMENT PROCESS (PHASE 3)

SPRING 2024

*Consultation has been extended for two weeks. The consultation will now formally close on November 6, 2023.

REVIEW & ASSESSMENT OBJECTIVES

- Develop prudent capital requirements that are B.C. tailored, considering:
 - Basel criteria;
 - The cooperative culture that is unique to the B.C. credit union (“CU”) system;
 - Current B.C. legislative requirements and constraints;
 - Known terms of CU shares, possible variations between CUs;
 - Office of the Superintendent of Financial Institutions/Federal Credit Union (“OSFI/FCU”) specific criteria;
 - Approaches by other Canadian regulators; and
 - Viable options for CUs to raise core capital.
- Develop capital instrument eligibility criteria for CUs to apply to issued instruments.

Proposal Overview

MINIMUM CAPITAL LEVELS

MINIMUM RISK-BASED CAPITAL LEVELS PLUS BUFFER (AS A % OF RISK-WEIGHTED ASSETS)

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

TIER CLASSIFICATION

Tier 1 Capital

- Represents the core capital of a credit union from a regulator's point of view; must be able to absorb losses on a going-concern basis.
- Tier 1 capital will be subject to a single minimum requirement.
- Adopt Basel *Additional Tier 1 Capital* definition tailored to the B.C. system; Basel standard of Common Equity Tier 1 not adopted.

Tier 2 Capital

- Must be able to absorb losses on a gone-concern basis; and
- Adopt Basel *Tier 2 Capital Criteria*, tailored to the B.C. system.

Both Tier 1 and Tier 2 instruments must meet Criteria in Appendix B; Membership shares and patronage shares receive Tier 1 treatment

COMPOSITION OF TIER 1

Tier 1 Capital (minimum 6%)

- 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 the criteria for inclusion in Tier 1 capital; and
 - are not required to be redeemed within the following 12-month period.



COMPOSITION OF TIER 1

Tier 1 Capital (minimum 6%) - Continued

- 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;
 - credit unions wishing to include contributed surplus from other sources must obtain approval from BCFSA;
- 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; and
 - are not redeemable within the following 12-month period.
- Accumulated other comprehensive income (“AOCI”); and
- Regulatory adjustments applied in the calculation of Tier 1 capital.



COMPOSITION OF TIER 2

Tier 2 Capital

- 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);
- 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 – defined as "Stage 1" and "Stage 2" allowances under IFRS. Subject to a limit of 1.25% of credit risk-weighted assets.

Refer to [Appendix B](#) for share criteria details



SHARES AND SUBORDINATED DEBT

Membership Shares

BCFSA Proposal (B.C. tailored):

Recognize in Tier 1.

Other Equity Shares and Subordinated Debt

BCFSA Proposal (B.C. tailored):

Tier 1:

- 10% annual retraction cap on all other equity shares (90% inclusion);
- Subordinated to depositors, sub-debt holders;
- Dividends must not be cumulative; and
- Classified as equity for accounting purposes.

Tier 2:

- 10% annual retraction cap (90% inclusion);
- For sub-debt instruments or shares with a fixed redemption (maturity) date - subject to 20% annual straight-line amortization over last 5 years; and
- Subordinated to depositors; dividends may be cumulative.



SHARES AND SUBORDINATED DEBT

BCFSA Considerations/Constraints

- **BC Legislative/Cooperative Framework**

- Under CUIA, a credit union must redeem membership shares when a member withdraws from membership; and
- Investment shares subject to a 10% annual retraction cap.

- **Basel Key Criteria**

- Ranking in liquidation;
- Liquidation entitlement;
- Retraction; and
- Redemption.

- **Other regulators including OSFI/FCU**

BCFSA Expectations

- Credit unions are responsible to ensure "Other Equity Shares" and "Subordinated Debt" are classified appropriately in accordance with the criteria in Appendix B; criteria not applicable to membership and patronage shares.

ACCUMULATED OTHER COMPREHENSIVE INCOME (“AOCI”)

Three Main Sources

- Unrealized fair market value changes on Available-for-Sale securities;
- Actuarial gains and losses on pension plan liabilities and assets resulting from changes in actuarial assumptions; and
- Unrealized fair market value gains/losses in derivatives, including interest rate swaps.

BCFSA: Tier 1 Treatment

Rationale:

- Helps to strengthen the resilience of credit unions and their ability to withstand adverse economic conditions.
- Focus AOCI impact on capital in a stressed scenario.

ACCUMULATED OTHER COMPREHENSIVE INCOME ("AOCI") Cont'd

EXCLUSION from Tier 1

- Unrealized fair value changes in derivatives, including interest rate swaps, *classified as cash flow hedges*.
 - Cash flow hedges are used to hedge future cash flows (e.g., from variable-rate mortgages) that are not fair valued on the Balance Sheet; and
 - The change in the fair value of the derivative (e.g., interest rate swap) used in the hedge only reflects one half of the picture (the fair value of the derivative but not the changes in the fair value of the hedged future cash flow), hence it would introduce artificial volatility to capital if it were to be included.

BCFSA: Tier 1 Treatment

Expectation:

- Both total AOCI and the amount qualified for derecognition are required for regulatory filing purposes.

CONTRIBUTED SURPLUS FROM B.C. CREDIT UNION AMALGAMATIONS

- Reviewed B.C. credit union amalgamation related documentations.
- Discussed with Working Group members.
- Assessment:
 - Represent permanent equity and have the characteristics of equity instruments; and
 - Represent funds that are contributed by members and are available to absorb losses.

BCFSA: Tier 1 Treatment

Expectation:

- Such contributed surplus is not subject to any obligation to be repaid.

Regulatory Adjustments

REGULATORY ADJUSTMENTS [section 1(d)]

Applied in the calculation of Tier 1 Capital:

- Deferred income tax assets;
- Fair value gains on own-use property;
- Gain on sale related to securitization transactions;
- Goodwill and other intangible assets;
- Investments (significant and insignificant) in capital and/or other total loss-absorbing capacity (“TLAC”) instruments of unconsolidated banking, financial institutions, and insurance entities; and
- Reverse mortgages.



INTANGIBLE ASSETS: SOFTWARE

- Research and Review:
 - Basel Standards; and
 - Other Regulators including European Union.
- Continue monitoring development.
- 2-Year Transitional Period.
- Full deduction of software intangibles from capital under the capital rule applies effective fiscal year end 2028. No deduction required until that time.



Questions?

Contact: CUCapital@bcfsa.ca



NEXT STEPS

INFORMATION SESSIONS

- ✓ **Session 1 – Capital Modernization Consultation Launch**
August 3
- ✓ **Session 2 – Capital Overview**
September 7
- **Session 3 – Capital Buffers, Operational Risk, Leverage Ratio, and Market Overview**
Thursday, September 14, 1 – 3 p.m.
- **Session 4 – Credit Risk Overview**
Thursday, September 21, 1 – 3 p.m.

Please submit your questions in advance using the AskUs Form

Consultation Period ends on November 6, 2023

Thank you.

