

Capital Modernization Project Consultation

Information Session 4:

Credit Risk Overview

September 21, 2023

BCFSA BC Financial
Services Authority

Classification: Protected A



x^wməθk^wəy'əm (Musqueam Nation)
Sk_wx_wú7mesh Úxwumixw (Squamish Nation)
səl'ílwətaʔt (Tsleil-Waututh Nation)

Speakers

**DERRICK
LAU**

Vice President,
Supervision

**REBECCA
LOWREY**

Director, Reporting
and Standards

**FRANZISKA
NIEGEMANN**

Director, Risk
Surveillance and
Analytics

Agenda

1. Credit Risk Overview
2. Credit Risk Key Changes
3. Lending:
 - Residential Exposures
 - Commercial Exposures
4. Question and Answer

Credit Risk Overview

Credit Risk

CONTEXT

- Credit risk accounts for most of credit unions' risk-taking activities and regulatory capital requirements
- Regulatory capital requirements cover credit unions for Unexpected Losses
- Need for regulators to translate international standards into domestic standards
- Basel Standardized Approach lacks granularity and risk sensitivity and fails to differentiate risks across exposures



Develop a risk-sensitive framework tailored to B.C.

Credit Risk Key Changes

Credit Risk Key Changes

BASEL BASED / B.C. TAILORED

- Risk weighting based on external credit rating assessment wherever applicable, examples:
 - Claims on deposit-taking institutions and banks - *Proposal 2(b) and 2(c)*
 - Claims on direct sovereigns - *Proposal 2(b) and 2(h)*
 - Claims on other public sector entities - *Proposal 2(b) and 2(i)*
- Cheques and other items in transit - *Proposal 2(a)*
- Central 1 deposit - *Proposal 2(c)*
- Regulatory retail portfolio - *Proposal 2(k)*

Concentration risk adjustments requirement eliminated.



Credit Risk Key Changes

B.C. TAILORED

Lending - *Proposal 2(d)*:

- Residential exposures - *Proposal 2(d)(i)*
- Commercial exposures - *Proposal 2(d)(ii) and 2(d)(iii)*



Lending

Residential Exposures
Commercial Exposures

Background information

- Focus refinement on material exposures:
 - Uninsured residential mortgages
 - Real estate secured commercial mortgages (“CRE”)
- Refined lending categories to better reflect risk characteristics of lending products
 - Example: Multi-residential commercial loans obtained low risk weights considering low vacancy rates in B.C.
- More fulsome capture of risk drivers and potential risk of losses in various economic scenarios by objective and consistent credit risk measurements
 - Classify exposures based on more than one risk factor



Residential Exposures

Proposal 2(d)(i)

Uninsured Residential Exposures

Classification of exposures based on **three risk factors**:

Proposed

- LTV
- TDS
- Amortization

Loan to Value

$LTV = \text{Loan Balance} / \text{Property Value}$

- Determines loss given default

Total Debt Service Ratio

$TDS = \text{Expenses} / \text{Income}$

- Relates to probability of default
- Proxy of the borrower's ability to service the mortgage debt
- Considered a meaningful predictor of loan performance

Amortization

- Long-term credit is riskier than short-term credit
- Loan is paid down slower with longer amortization

Residential Lending Categorization

Two residential lending categories

- General Residential Real Estate (“RRE”)
- Income Producing Residential Real Estate (“IPRRE”)

IPRRE

Loan repayment materially depends on the cash flows generated by the property securing the loan, rather than the underlying capacity of the borrower to service the debt from other sources.

More than 50% 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 securing the loan.

Capital Requirement for Residential Mortgage

Two residential lending categories

- General Residential Real Estate (“RRE”)
- Income Producing Residential Real Estate (“IPRRE”)

Table 2-1: Mortgages	Risk Weights by Lending Category	
	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%



Capital Requirement for Home Equity Lines of Credit (“HELOC”)

Two residential lending categories

- General Residential Real Estate (“RRE”)
- Income Producing Residential Real Estate (“IPRRE”)

Table 2-2: Home Equity Lines of Credit Risk Factors	Risk Weights by Lending Category	
	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%



Commercial Exposures

Proposals 2(d)(ii) and 2(d)(iii)

**Commercial Real Estate (“CRE”)
General Commercial Lending**

Capital Requirement for Commercial Exposures

Classification of Commercial Exposures by risk factors

Proposed
Commercial Real Estate (“CRE”) <ul style="list-style-type: none"> •LTV •DSCR
Construction <ul style="list-style-type: none"> •LTC
General Commercial <ul style="list-style-type: none"> •DSCR

Loan to Value

$LTV = \text{Loan Balance} / \text{Property Value}$

- Determines loss given default

Debt Service Coverage Ratio

$DSCR = \text{EBITDA}^* / (\text{Interest Expenses} + \text{Scheduled Principal Payments})$

- Relates to probability of default
- Proxy of the borrower’s ability to service the mortgage debt
- Considered a meaningful predictor of loan performance

Loan to Cost

$LTC = \text{Loan Balance} / \text{Construction Costs}$

- Absence of a reliable LTV for construction projects
- LTC determines loss given default

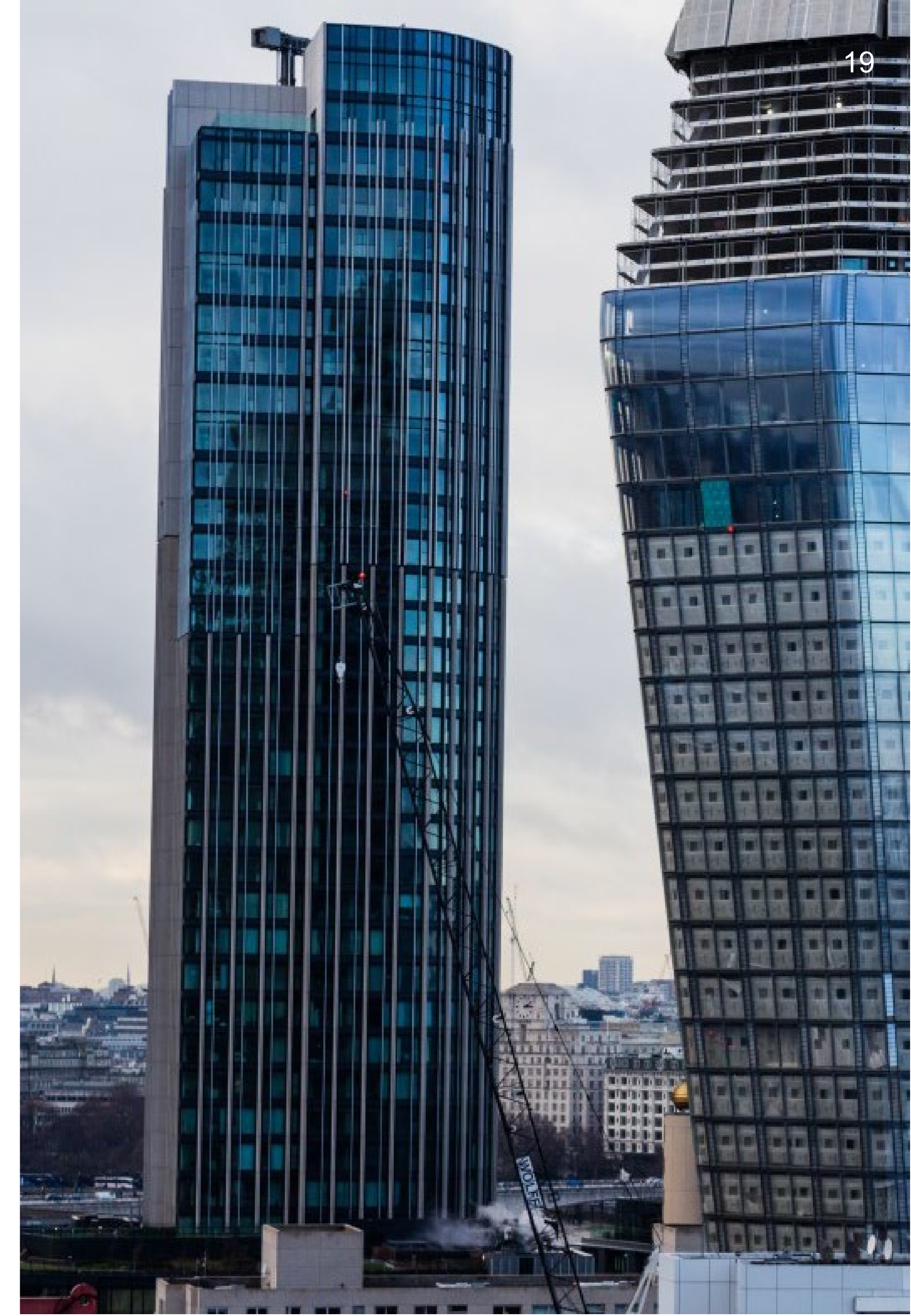
* EBITDA: Earnings before interest, taxes, depreciation and amortization

Capital Requirement for CRE

Commercial Real Estate (“CRE”) lending categories

- **Multi-residential:** Income-producing residential real estate made up of over four adjoining units
- **Owner-occupied:** Owned by business using property for its own operations
- **Income-producing:** Occupied by rent-paying commercial tenants

Table 2-3: CRE Lending		Risk Weights by Lending Category		
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%	



Capital Requirement for CRE

CRE-CONSTRUCTION CATEGORIES

- **Construction (multi-residential):** Residential apartment buildings
- **Construction (general):** Income-producing and owner-occupied
- **Construction (speculative):** No buyer identified
- **Land-only (speculative):** Re-zoning required



Table 2-4: Construction Lending		Risk Weights by Lending Category			
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%		

Capital Requirement for General Commercial Lending

- **Otherwise secured – fixed assets**
Equipment and premise improvement
- **Otherwise secured – current assets**
Account receivables and inventories

Table 2-5: General Commercial Lending	Risk Weights by Lending Category	
Risk Factors	Commercial (otherwise secured) – fixed assets	Commercial (Otherwise secured) – current assets
DSCR < 110%	100%	120%
110% ≤ DSCR < 140%	90%	110%
DSCR ≥ 140%	80%	100%



Questions?

Contact: CUCapital@bcfsa.ca



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
– September 14
- ✓ Session 4 – Credit Risk Overview
– September 21

Consultation Period ends on November 6, 2023.



Reminder: Have your say!

- Complete the consultation feedback form included in the Consultation Paper and on our [website](#).
- The consultation will be open for submissions until **November 6, 2023**.
- Please contact CUCapital@bcfsa.ca if you have any questions or need more information.



**Thank
you.**