NOVEMBER 2021

CUDIC Fund Size Review

Consultation Paper

BCFSA

Contents

Introduction

The BC Financial Services Authority (“BCFSA”) is undertaking a comprehensive review (“Review”) of the size of the Credit Union Deposit Insurance Corporation of BC (“CUDIC”) deposit protection fund (“Fund”). A periodic Review ensures the Fund is appropriate for the financial conditions and operating environment of the BC credit union sector[1] (“Sector”). This Review informs the setting of the Fund Size[2] Target, and the time horizon to achieve Target goals.

The primary purpose of the Fund is to protect credit union depositors from incurring a loss should a credit union fail. In addition to repaying credit union members’ insured deposits, the Fund can be used to provide financial assistance to credit unions prior to a failure, as permitted by the *Financial Institutions Act* (“FIA”). The Fund is composed of the:

- Stabilization Central Credit Union Committed Fund[3] (“Committed Fund”) and
- CUDIC deposit insurance fund (“Deposit Insurance Fund”).

The Fund Size Targets are determined by including both the Committed Fund and Deposit Insurance Fund values.

To better inform the Review, BCFSA is seeking feedback on key inputs discussed in this consultation paper related to the financial and operating conditions of the Sector. BCFSA welcomes additional suggestions and will communicate the results of the consultation once the information has been compiled.

BCFSA will accept written feedback until December 17, 2021. Send all comments to: depositinsurance@bcfsa.ca.

Background

Section 266 of the FIA prescribes that CUDIC guarantee the insured deposits of the Sector in the event of a credit union’s failure. The guarantee provided by CUDIC contributes to depositor confidence and to the overall stability of the financial system in British Columbia. The guarantee offers protection from losses for credit union depositors and protection from a run-on deposits.

CUDIC is continued under section 261 of the FIA to administer the Deposit Insurance Fund. Periodic assessments received from credit unions and income generated from investments support the Deposit Insurance Fund to make payments and cover expenses as described in the FIA section 267. BCFSA determines the assessments charged to credit unions, while an external asset manager manages the investments of the Deposit Insurance Fund in accordance with the CUDIC Board of Directors approved Investment Policy.

[1] BCFSA authorized credit unions.
[2] Fund Size is the ratio of the Fund value to the total value of insured deposits.
[3] Credit Union Financial Assistance Agreement ($30 Million)

On November 27, 2008, the Provincial legislature passed amendments to the FIA to change the deposit insurance protection from a limited guarantee of $100,000 to an unlimited guarantee on all insured deposits of the Sector. CUDIC guarantees 100 per cent of money on deposit (regardless of the length of the maturity and currency) and money invested in non-equity shares issued prior to January 1, 2020. These funds shall be repaid to all depositors (or deposit holders) of a failed credit union, inclusive of any interest which may have accrued. Personal and business accounts that are guaranteed include:

- Savings Accounts
- Chequing Accounts
- Joint Accounts
- Trust Accounts
- Term Deposits
- Guaranteed Investment Certificates (GICs)
- Foreign Currency Deposits
- Registered and Tax-free Savings Accounts (TFSA)

Not covered by the deposit insurance guarantee are credit union equity shares, debt instruments, investments such as mutual funds or RRSP equity plans, and non-equity shares issued after December 31, 2019.

Unlimited deposit insurance is not unique to the Sector. Other Canadian jurisdictions that provide unlimited deposit insurance protection are Alberta, Saskatchewan, Manitoba, PEI, and New Brunswick. Quebec, Nova Scotia, and Newfoundland offer their members a $250,000 guarantee, while Ontario provides $100,000 per registered account. A summary of the Ranges and Fund Sizes for BCFSA's regional peers is provided in Table 1. These peers face common factors in setting an appropriate Fund Size. This includes the growth in deposits, consolidation of credit unions, concentration of deposits, and credit union exits through federal continuance.

Table 1: Western Canada Jurisdiction Deposit Insurance Survey Summary (March 30, 2021)

Target	Jurisdiction			
	British Columbia	Alberta	Saskatchewan	Manitoba
Deposit Insurance Fund Target Range	105 bps -135 bps	140 bps - 160 bps	140 bps - 160 bps	105 bps -130 bps
Fund Size	131 bps	174 bps	152 bps	118 bps

Source: BCFSA, Annual Reports of relevant Deposit Insurers

The current Fund Size Target is set as a Fund Target Range ("Range") of 105 basis points[4] ("bps") to 135 bps with a Target Point of 110 bps of the Sector's insured deposits. The Fund Size Target Point and Range are based on an ex-ante funding approach following industry best practices[5] and was established through financial modelling conducted by an external actuarial firm using a proprietary model and professional judgement. The current Fund Size Target Range was established in 2014 and achieved in 2019, two years ahead of the scheduled 2021 goal. The federal continuance[6] of a credit union in the Sector impacted the timeline for achieving the Target. At the time of continuance, it was determined to maintain the existing Fund Size Targets until the next Review. The Fund Size is 131 bps as of March 31, 2021.

[4] A basis point is 1/100th of 1 per cent.
[5] Best practices developed by the International Association of Deposit Insurers ("IADI") and published as the Core Principles for Effective Deposit Insurance Systems.
[6] The Federal government introduced legislation in 2012 to allow provincial credit unions to continue federally.

Since the establishment of the 2014 Fund Size Targets, the Sector has witnessed significant changes, moving from 43 credit unions in 2014 to a current total of 38 credit unions. Historically, the Sector has resolved credit unions through the early intervention methods of acquisitions or amalgamations (refer to Table 2) as set out in the Credit Union Incorporations Act ("CUIA"). Through 1982 to 2021 many smaller and mid-sized credit unions were acquired by larger credit unions, increasing the concentration of deposits among a fewer number of credit unions. These methods of resolution led to few historical instances of loss experience or failures in the Sector.

Table 2: BC Credit Union Sector Events (1982 – 2021)

Type of Event	Number of Credit Unions
Acquired	88
Amalgamated	18
Liquidated	11
Incorporated	7
Federal Continuance	1

Source: BCFSA/CUDIC

The composition of the Sector plays an important role in determining the appropriate Fund Size Targets as the concentration of insured deposit (value based) among credit unions is considered in assessing the risks to the Fund associated with supporting a deposit payout.

Fund Size Consultation

The Range is determined by analyzing the appropriate Fund Size required to meet future obligations and to cover operational costs of CUDIC. These future obligations are measured by modelling the financial conditions and operating environment scenarios of the Sector.

The financial and scenario modelling will estimate the potential losses incurred by the Sector with the expectation that the Fund Size Range be appropriate to cover those losses at a 99% confidence interval. The potential losses are projected over a twenty-year period, including a review of the likelihood and impact to the Fund of potential credit union failures. These modelled expected losses are a sum of asset losses given default, multiplied by the probabilities of default, for each credit union under an idiosyncratic crisis; however, it is not expected to be large enough to cover a systemic crisis[7]. Additionally, an appropriate Range that provides depositors with confidence in the Sector should be balanced by not unduly impacting the Sector participants. In other words, the price paid by a credit union for depositor protection should be affordable for the credit union.

In the event of a deposit payout, CUDIC would pay depositors promptly and the appointed liquidator would proceed to sell the credit union assets (e.g., loans, mortgages, investments) in a timely manner. The proceeds recovered from the sale of assets would support deposit payout and then be used to replenish the withdrawals from the Deposit Insurance Fund. Any shortfalls from the proceeds recovered and the repayment of the Deposit

[7] In a systemic crisis requiring resolution, a collaborative effort involving safety net participants (e.g., BCFSA, Central 1 Credit Union, Stabilization Central Credit Union of British Columbia, BC Ministry of Finance) is required.

Insurance Fund would be incurred by the Deposit Insurance Fund itself. To further replenish the Deposit Insurance Fund, the FIA provides CUDIC with the ability to recover losses incurred from the deposit payout from the Sector through tools such as assessments and issuance of debentures.

FINANCIAL CONDITIONS

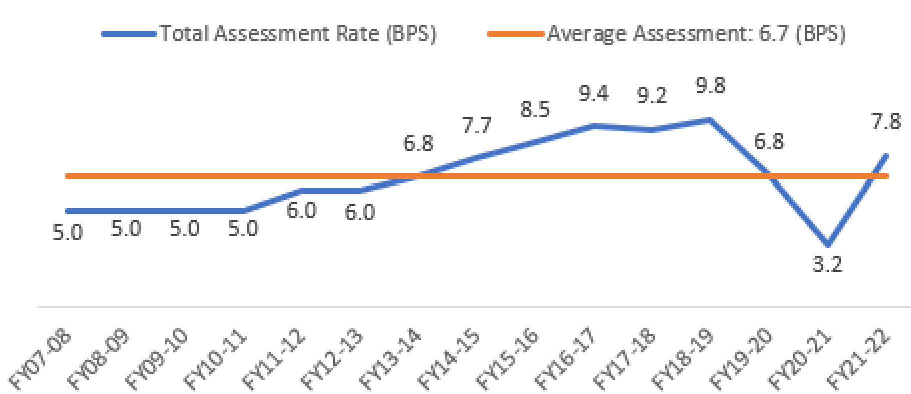
Key factors considered in modelling of the financial conditions include total assessments, potential asset losses, and the expected growth rate of insured deposits. Expenses and investment income are also considered but are of secondary importance to the modelling exercise.

Total Assessments

Total assessments involve a Risk Based Assessment Methodology evaluation of the capital adequacy, earnings, liquidity, and asset quality of each credit union and are calculated on an annual basis. The assessments are communicated through the CUDIC assessment letters issued to each credit union. These assessments also incorporate the Supervision Composite Risk Rating ("CRR") and Intervention Stage Rating ("ISR") of each credit union that reflects their respective probability of default, a measure of likelihood that a credit union will fail in a given year that is used in modelling the financial conditions.

Total assessments (refer to Figure 1) from 2008 to 2022, based on CUDIC's fiscal year, have averaged approximately 6.7 bps. The current variable assessment methodology[8] used to calculate the assessment was introduced in 2015; a flat rate methodology was used in prior years. Implementing a variable assessment rate allows for the total assessment to better differentiate the risk profiles, and associated premiums, of individual credit unions. From 2015 to 2022, the risk premium averaged 0.4 bps and the Base Assessment Rate averaged 7.4 bps.

Figure 1: Total Assessments



Source: CUDIC

The propensity of a credit union's risk rating to change from year to year is modelled through transitional probabilities. The modelling correlates the changes in risk rating with the economic conditions of the operating environment. The assessment of each credit union is used to determine the probability of default in the expected loss calculation, as part of this analysis.

[8] Under the Variable Assessment methodology, the Total Premium Assessment equals Base Assessment Rate plus Risk Premium Rate.

Asset Losses

Potential asset losses, and loss given default, are measured as the size of the loss expected to occur in the event of a credit union failure. That is, the term “loss” refers to the loss resulting from the sale of an asset for less than its value recorded in the credit union’s financial records. Asset haircut rates are applied to the asset composition characteristics of individual credit unions. The proceeds recovered would be used to support deposit payout, as needed, and for repayment of the Deposit Insurance Fund.

Table 3 displays BCFSA analysis for the haircut rates applied to different asset classes in the event of an idiosyncratic credit union failure. The analysis refers to the Assets Eligible as Collateral under the Bank of Canada’s Standing Liquidity Facility[9]. For each asset class, a range of haircuts are provided, where riskier assets warrant higher rates.

Table 3: Haircut Rates

Asset	Asset Class	Haircuts (Idiosyncratic)
Cash & Liquid Investments	Cash and Deposits	0%
Cash & Liquid Investments	Debt Security Instruments	2% –12%
Other Investments	Equity Shares – CU Centrals	0%
Loans & Leases	Personal – Insured, Secured, Unsecured	15% – 85%
Loans & Leases	Commercial – Insured, Secured, Unsecured	15% – 85%
Loans & Leases	Securitizations	15% – 65%
Other Assets	PP&E, Equity Investments, Goodwill, and other assets	20% –100%

Source: BCFSA

Loss experience from other Provincial deposit insurers over the last fifteen years saw total credit union losses range from three per cent to thirty-six per cent.

Question 1:

In modelling an idiosyncratic event, are the asset haircut rates in Table 3 appropriate for the Sector? If not, what asset recovery rates would you recommend and why?

[9] Updated on Jul 26, 2021

Insured Deposit Growth

The total exposure of deposits insured by CUDIC amounts to approximately $64 billion[10]. Deposit growth for the Sector, based on ten-year historical modelling, is approximately six per cent annually. Additional analysis that examines the potential credit union market share of deposits in BC indicates Sector deposit growth potential to be approximately 7.4 per cent per year, based on historical trends. These two estimates provide a range of Sector deposit growth to be used in modeling financial conditions and scenario analysis.

Question 2:

What is the range of expected deposit growth for the next one and/or five-year periods based on your credit union deposit projections?

OPERATING ENVIRONMENT

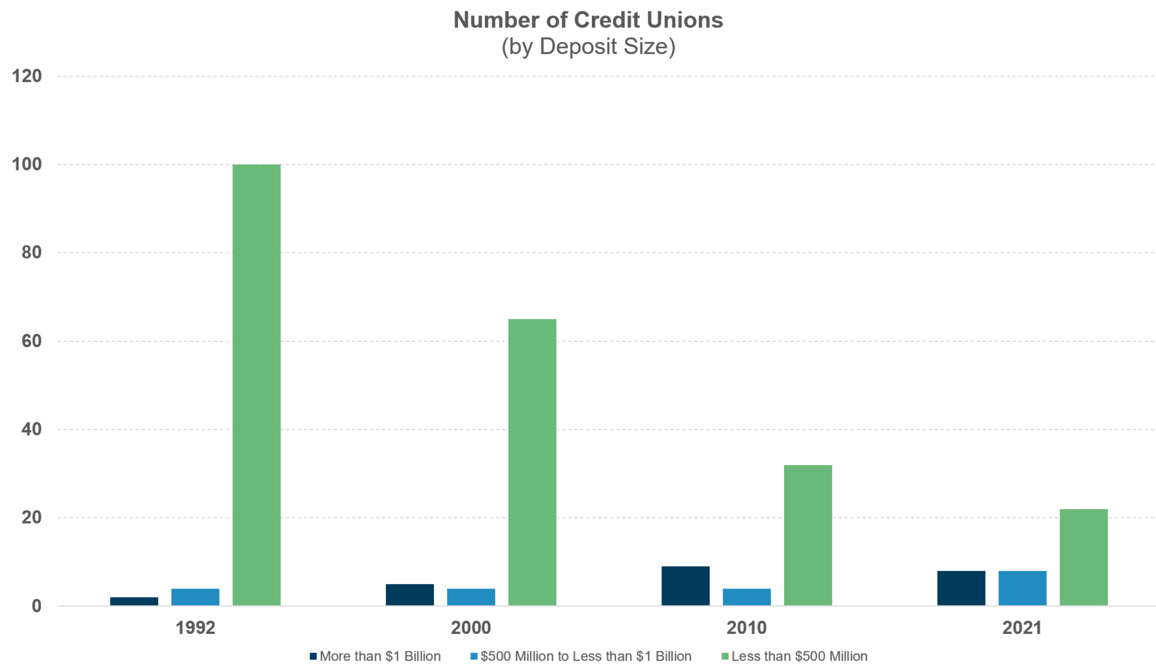
The environment in which the Sector operates in is a factor in assessing if the Fund Size is appropriate to meet its objectives. The operating environment includes macroeconomic conditions, the strength of the financial safety net partners, prudential regulation and supervision, the legal and judicial framework, as well as the Sector's structure. Many elements of the operating environment are outside the scope of this Review; however, consideration is given to the structure of the Sector as well as certain macroeconomic conditions through scenario and simulation exercises.

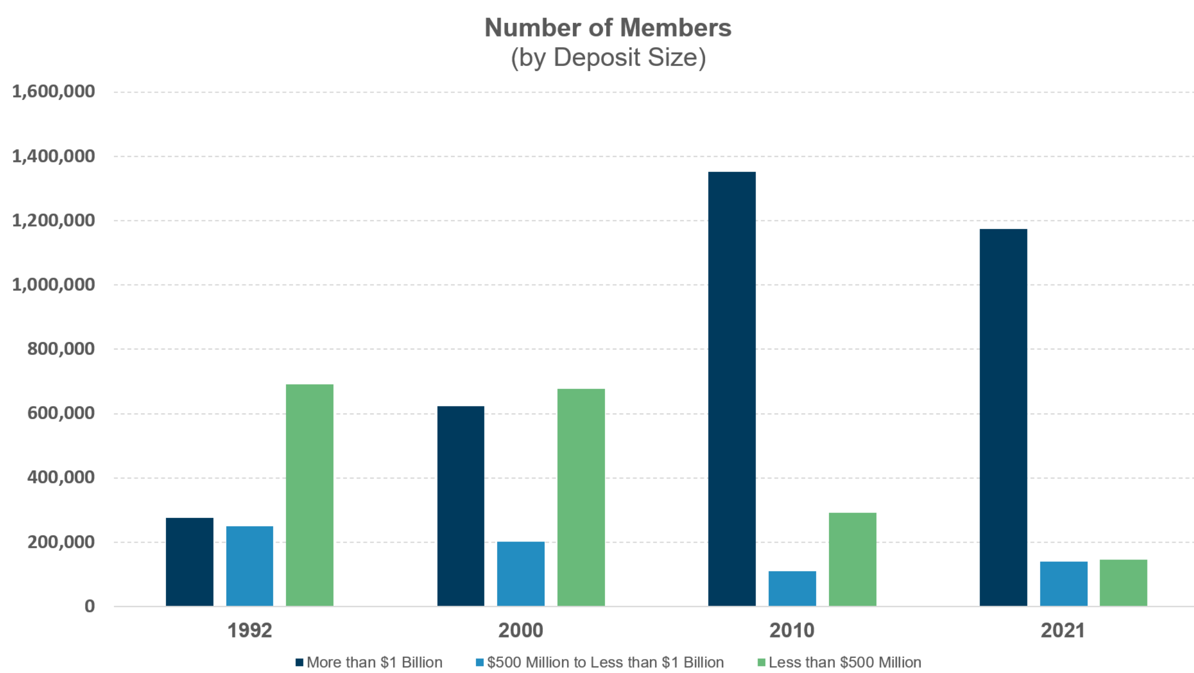
The macroeconomic environment, either deteriorating, improving, or stable, impacts a credit union's assessment rating, as well as its business strategy and operating conditions. Three economic conditions[11] were used to model different operating environment scenarios.

Supervisory monitoring provides an early warning system to identify credit unions that may become problematic. Intervening early, prior to the credit union becoming non-viable, is an action that protects depositors and contributes to financial stability. Through the years, intervention coupled with the business response to competitive pressures and changing economic environments have led to a reduction in the number of credit unions and a concentration of system assets in larger credit unions (refer to Figure 2).

[10] As March 31, 2021
[11] Based on BC GDP and BC Housing Price Index.

Figure 2: Evolving Credit Union Landscape





Source: BCFSA

Consequently, this concentration increases the value of a singular potential draw on the Fund in a payout event, and the disproportionate distribution of Sector size increases the variability should financial assistance be required. These system imbalances may lead to a higher requirement for the Range depending on the risk tolerance accepted for the Sector, and the availability of contingency funding.

Question 3:

What are the most important trends (e.g., economic, sector composition, industry) impacting the Sector that should be considered in the scenario analysis?

Next Steps

BCFSA is seeking feedback on key inputs discussed in this consultation paper related to the financial and operating conditions of the Sector.

BCFSA welcomes additional suggestions to ensure the Fund is suitable to meet its future obligations and contributes to the Sector's financial stability.

Between November 18 to December 17, 2021, BCFSA encourages the Sector to provide written feedback to: depositinsurance@bcfsa.ca.

This feedback will be summarized and used to inform or validate the assumptions used in the modelling framework. Subsequently, BCFSA will schedule meetings with Sector participants with the intent to share summarized feedback along with initial results from the actuarial modelling.

BCFSA will treat submissions of feedback as confidential records and will not publish individual submissions or attribute content. However, please note that all submissions are subject to the *Freedom of Information and Protection of Privacy Act.*

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