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Section Notes for Proposed Credit Union Capital Requirements Rules

BCFSA

Contents

Introduction

Overall, the proposed Credit Union Capital Requirements Rules (the Rule) are intended to raise both the quality and quantity of regulatory capital for credit unions and enhance the risk coverage and risk sensitivity of the capital framework by including elements of the Basel III[1] framework, developments in national and international standards, and best practices for deposit-taking institutions' capital. 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.

Please read the Rule carefully and in its entirety. Note that the sections should be read together for a full understanding of how the Rule applies. For example, section 7 of the Rule lists items to be included in Tier 1 capital, but sections 8, 9, 10 and 11 qualify, or provide additional criteria applicable to, included items listed in section 7.

This document is intended to provide a short summary and, where appropriate, some context, for each section of the Rule but is not a substitute for reading the Rule itself. BCFSA suggests reviewing the Section Notes in conjunction with reading the Rule.

Part 1 - Interpretation and General Rule

Section 1: Definitions

This section includes the definitions of certain terms in the Rule. The words defined in this section apply to the Rule in its entirety, whereas certain definitions provided in other parts, divisions or sections of the Rule will only be applicable to the use of that term within that section or will only be relevant to that section. These definitions will standardize some of the terms introduced by the Rule.

Section 2: Consolidated assets and liabilities

This section clarifies that the Rule applies to each credit union on a consolidated basis. Consolidated supervision is the best means to provide supervisors with a comprehensive view of financial and non-financial risks faced by a credit union and to reduce opportunities for regulatory arbitrage. This is a significant change from the current capital regulation which requires the capital adequacy of a credit union to be measured on a stand-alone (unconsolidated) basis.

The consolidated entity includes all subsidiaries, with some exceptions. Where a credit union owns an insurance company subsidiary (i.e., an insurance company that underwrites insurance and is regulated for solvency, and is

[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.

not an insurance brokerage or agency), consolidation does not apply. Instead, that insurance subsidiary would be reported as a significant investment using the equity method of accounting and subject to regulatory adjustment, in accordance with Part 3 of the Rule.

Where a B.C. credit union has a bank subsidiary regulated by the federal Office of the Superintendent of Financial Institutions (OSFI) with balance sheet assets amounting to less than 10 per cent of the credit union's total consolidated assets, credit unions may choose to consolidate the assets and liabilities of the bank or, apply the OSFI's Capital Adequacy Requirements to the commercial and personal loans and leases of the bank. The remaining assets and liabilities of the bank would be consolidated for the purposes of the Rule.

In situations where a bank subsidiary's assets amount to greater than 10 per cent of the parent credit union's total consolidated assets, the credit union must apply BCFSA's framework on a consolidated basis, including the bank subsidiary.

Part 2 – Risk-Based Capital Ratio Requirements

Section 3: Risk-based capital ratio requirements

Capital is a measure of a credit union's capacity to absorb losses. Tier 1 capital contributes to financial strength through periods when a credit union is under stress (going concern) and both Tier 1 and Tier 2 capital contribute to depositor and creditor protection during wind-up (gone concern).

This section sets out the Tier 1 and Total Capital ratios (Tier 1 plus Tier 2) that credit unions are required to maintain during the 2-year transitional period in 2027 and 2028 and on full implementation of the Rule in 2029. The transitional period is intended to allow credit unions sufficient time to achieve the capital levels required at full implementation in 2029 and make any necessary adjustments to data and reporting systems.

This provision is consistent with BCFSA's efforts to raise the quality and consistency of regulatory capital for credit unions and is based on international standards and sound practices developed under Basel III, adjusted for the B.C. credit union system.

Section 4: Calculation of risk-based capital ratio

This section sets out the formula for the calculation of the risk-based capital ratio.

Section 5: Capital conservation buffer and total ratio requirements

This section sets out the Tier 1 and total capital ratios that credit unions are required to hold, including the capital conservation buffers. It includes definitions for various terms that are directly relevant to this section.

Capital conservation buffers were introduced with Basel III and are intended to ensure that banks build up capital buffers outside periods of stress, which can be drawn down as losses are incurred. If a credit union's capital falls below the conservation buffer amount, the distribution of earnings through, for example dividends and staff bonus payouts is constrained. Prescribing constraints at the outset is intended to address market pressure to keep paying out dividends when a credit union is under stress. Similar to section 3, this section also sets out the transitional requirements relating to restrictions on distributions if the capital conservation buffer is breached.

Part 3 – Calculation of Tier 1 Capital

DIVISION 1 – CALCULATION OF TIER 1 CAPITAL

Section 6: Calculation of Tier 1 capital

This section provides that Tier 1 capital is the sum of all the items to be included in Tier 1 capital, minus regulatory adjustments. The underlying principle for Tier 1 capital is that it must be able to absorb losses on a going-concern basis.

DIVISION 2 – ITEMS TO BE INCLUDED IN TIER 1 CAPITAL

Section 7: Items to be included in Tier 1 capital

This section provides a list of the items that may be included in Tier 1 capital and includes items such as retained earnings, membership shares, equity shares, other instruments meeting the Tier 1 criteria in Section 8 and accumulated other comprehensive income (AOCI). For the purposes of this section, AOCI excludes the cash flow hedge reserve that relates to the hedging items that are not fair valued on the balance sheet. This removes the element that gives rise to artificial volatility in equity. Section 7 does not explicitly reference equity shares issued pursuant to a patronage allocation, but equity shares and other instruments may be included in Tier 1 capital where all of the Tier 1 criteria of the Rule are met.

Section 8: Criteria for inclusion of instrument in Tier 1 capital

This section explains the criteria for including an instrument in Tier 1 capital and includes definitions for some words used within this section to ensure a common understanding. The underlying principle for Tier 1 capital is that it must be able to absorb losses on a going-concern basis. Additionally, it must meet several criteria that build on the principles of permanence, subordination, and freedom from mandatory fixed charges.

Section 9: Criteria respecting call of Tier 1 instrument

This section explains the criteria respecting the call of a Tier 1 instrument by the issuer. To maintain a stable and reliable capital base to absorb losses, an instrument should not be callable by the issuer except under certain conditions, including that it is not callable any earlier than 5 years after the date the instrument is issued, and the issuer does not create an expectation that the instrument will be called.

Note that equity shares are exempted from the criterion imposing a 5-year restriction on calling an instrument, as an adaptation for the credit union segment. This is because equity shareholders may vote on a separate resolution respecting asset transfers or amalgamation, so restricting a credit union's ability to call a class of equity shares restricts options where a credit union pursues an asset transfer or amalgamation. The risk of frequent calls on equity shares is mitigated by other factors such as cost, the requirements to maintain an adequate capital base, and an existing restriction on redemption in the *Credit Union Incorporation Act* (CUIA).

Section 10: Criterion respecting redemption and acquisition of instrument

This section provides that, for an instrument other than an equity share to be included in the Tier 1 capital of a credit union, it must not have any rights that allow holders to require the issuer to redeem or buy back the instrument. For equity shares (other than membership shares), the issuer cannot be required to redeem or buy back more than 10% of the shares in the same class within a 12-month period. Where the instrument is an equity share (not a membership share), the credit union may be called upon by the holder to redeem or buy back up to 10% of these shares within any 12-month period. However, only the equity shares that are not required to be redeemed or bought-back in the 12-month period after the reporting date can be included in Tier 1 capital for that reporting period. This exception is carried forward from the existing Capital Requirements Regulation.

Section 11: Criteria respecting dividends or coupons

To qualify as Tier 1 capital, the distribution of any dividends or coupons is subject to certain criteria set out in this section, including that the credit union has full discretion to cancel undeclared distributions/payments, the 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.

DIVISION 3 – REGULATORY ADJUSTMENTS

Section 12: Definitions

This section provides the definitions of certain terms in this division (Division 3). These definitions will standardize the terms introduced in this division.

Section 13: Regulatory Adjustments

This section provides for a comprehensive list of regulatory adjustments from Tier 1 capital. The number of required adjustments is expanded from the current requirements to align with Basel III standards and address the high degree of uncertainty that these items will absorb losses in periods of stress. Regulatory adjustments include deductions related to:

- Significant and non-significant investments in deposit-taking institutions, insurance entities and permitted financial entities; details concerning this adjustment are included in sections 17 and 18.
- Securitization gains;
- Deferred tax assets; details concerning this adjustment are included in section 14.
- Fair value gains on property owned and occupied by the credit union; and
- Goodwill and other intangible assets; details concerning this adjustment are included in sections 15 and 16.

Section 14: Regulatory adjustments – deferred tax assets

This section provides clarity on where deferred tax assets are required to be deducted from Tier 1 capital. Where deferred tax assets are not required to be deducted from Tier 1 capital, this section also sets out the risk weight that applies.

Section 15: Regulatory adjustments – goodwill

This section provides details on where goodwill must be deducted from Tier 1 capital. This provision is separate from intangible assets other than goodwill because, in calculating the goodwill to be deducted, the credit union must also include any goodwill included in the valuation of the significant investments in deposit-taking, insurance entities and permitted financial entities of the credit union.

Section 16: Regulatory adjustments – intangible assets other than goodwill

This section provides details on where intangible assets, other than goodwill, must be deducted from Tier 1 capital. Note that section 21 sets out the transitional provisions for intangible assets that are software assets.

Section 17: Regulatory adjustments – non-significant investments

This section details the regulatory adjustments for non-significant investments in deposit-taking institutions, insurance entities and permitted financial entities that are not a consolidated subsidiary of the credit union. This deduction from capital is intended to ensure that credit unions maintain sufficient capital buffers to absorb potential losses from these investments due to the contagion effect, where a problem at one financial institution could trigger a cascade of losses throughout the financial system. The portion of the investment that is not deducted from Tier 1 capital is risk weighted according to whether the investment is an equity exposure, a capital instrument other than equity exposure including subordinated debt, or other total loss absorbing capacity (TLAC) Instrument. These risk weights appear in Schedule 4, Table 1. Note that section 21 sets out the transitional provisions for non-significant investments in deposit-taking institutions, insurance entities and permitted financial entities.

Section 18: Regulatory adjustments – significant investments

This section details the regulatory adjustments for significant investments in deposit-taking institutions, insurance entities and permitted financial entities that are not consolidated. As with non-significant investments, this deduction relating to significant investments is also intended to ensure that credit unions maintain sufficient capital buffers to absorb potential losses from these investments due to the contagion effect, where a problem at one financial institution could trigger a cascade of losses throughout the financial system. The portion of the investment that is not deducted from Tier 1 capital is risk weighted according to the applicable risk weights appearing in Schedule 4, Table 1.

Section 19: Regulatory adjustments – reverse mortgages

This section details the regulatory adjustments for reverse mortgages. The portion of reverse mortgages not deducted from capital is risk weighted according to the applicable risk weights appearing in Schedule 4, Table 1.

Section 20: Current tax assets

This section sets out how credit unions must treat current tax assets for capital purposes which are distinct from deferred tax assets.

Section 21: Transition – regulatory adjustments for 2027 and 2028

This section sets out the transitional treatment of certain regulatory adjustments. Intangible assets that are software assets and non-significant investments in deposit-taking institutions, insurance entities and permitted financial entities are not required to be deducted from capital in the 2027 and 2028 transition years. However, in those years, software assets will attract a risk weight of 100%, and non-significant investments receive a risk weight of 250%.

Part 4 – Calculation of Tier 2 Capital

Section 22: Calculation of Tier 2 capital

This section sets out the items that are eligible for inclusion in the calculation of Tier 2 capital and includes definitions for terms used in this section. Eligible items include instruments issued by the credit union or a subsidiary meeting the criteria specified in section 23. General allowances up to 1.25% of credit risk-weighted assets may also be included. The objective of Tier 2 capital is to provide loss absorption on a gone-concern basis. When a credit union fails, Tier 2 instruments must absorb losses before depositors and general creditors.

Section 23: Criteria for inclusion of instrument in Tier 2 capital

This section sets out the criteria for an instrument to be included in the calculation of Tier 2 capital. The criteria are aligned with and support the objective of Tier 2 capital.

Section 24: Criteria respecting call of a Tier 2 instrument

The criteria respecting the call of a Tier 2 instrument is the same as that in Tier 1. Among other qualifications, Tier 2 instruments can be callable, provided that for instruments other than equity shares, it is not any earlier than 5 years after the instrument is issued.

Section 25: Criteria respecting redemption and acquisition of Tier 2 instrument

Similar to Tier 1 capital, this section provides that for an instrument to be included in the Tier 2 capital of a credit union, it must not have any rights that allow holders to require the issuer to redeem or buy it back, subject to the exception that applies to equity shares provided in this section.

Section 26: Criterion respecting dividends or coupons Tier 2 instrument

Unlike a Tier 1 instrument, a Tier 2 instrument does not require that distributions/payments be cancellable at the discretion of the credit union and where such distributions/payments are cancelled, they may be cumulative. To be included in the calculation of Tier 2 capital, the instrument cannot have a credit sensitive dividend/coupon feature.

Section 27: Amortization of Tier 2 instrument

Tier 2 capital instruments are subject to straight-line amortization in the final five years prior to maturity. As these instruments approach maturity, outstanding balances are to be amortized in accordance with Table 1 in Schedule 2. This gradual reduction ensures the capital provided by the instrument aligns with its limited lifespan.

Section 28: Calculation of general allowances

General allowances are the sum of Stage 1 and Stage 2 allowances under International Financial Reporting Standard (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, as noted in section 22 (Calculation of Tier 2 capital).

Part 5 – Calculation of Total Risk Weighted Assets

DIVISION 1 – DEFINITIONS

Section 29: Definitions

This section provides the definitions of certain terms in this part (Part 5), as well as the schedules to the Rule. These definitions will standardize the terms introduced in this part.

DIVISION 2 – CALCULATION OF TOTAL RISK WEIGHTED ASSETS

Section 30: Calculation of total risk weighted assets

This section provides that the total risk weighted assets of a credit union are calculated by adding up the credit risk weighted assets and the operational risk weighted assets of the credit union. The methodologies for calculating those risk weighted assets are set out in subsequent sections of the Rule. The risk weights are aligned with a more risk sensitive approach to capital requirements under the Rule

DIVISION 3 – CALCULATION OF CREDIT RISK WEIGHTED ASSETS

Section 31: Calculation of credit risk weighted assets

Credit risk is one of the three major risk categories facing credit unions. The others are operational risk and market risk. The calculation of operational risk-weighted assets is covered in Division 5 of the rule. Market risk will be addressed in the subsequent phase of the Rule development. This section details how credit risk weighted assets are calculated.

Section 32: External credit ratings

This section provides clarification around how to interpret Table 1 of Schedule 3 and the relationship between external credit ratings and the standardized credit ratings used to assign credit risk weights.

DIVISION 4 - RISK WEIGHTS FOR ON-BALANCE SHEET ASSETS

Section 33: Criteria respecting qualifying residential mortgages

This section sets out the criteria for a mortgage to be treated as a qualifying residential mortgage. This is important because securities that are backed by or secured against qualifying residential mortgages are given a less punitive risk weighting under this Rule.

Section 34: Criteria respecting reverse mortgages

This section provides the criteria that a reverse mortgage must meet in order to qualify for the applicable risk weights appearing in Schedule 4, Table 1.

Section 35: Criteria respecting project financing exposures

This section provides the criteria that a project financing exposure must meet in order to qualify for the applicable risk weights appearing in Schedule 4, Table 1. Project financing exposures are loans where the lender looks primarily to the revenues generated by a single project, both as the source of repayment and as security. Specialized lending for project financing exposures may finance business in communities in which credit unions operate. The Rule is aligned with the Basel III capital requirements for these types of exposures, to ensure consistency of treatment and level playing field.

Section 36: Criteria respecting high-quality project financing exposures

This section sets out the criteria for a project finance exposure to be classified as a high-quality project finance exposure. A high-quality project finance exposure refers to an exposure to a project finance entity that is able to meet its financial commitments in a timely manner and when measured against potential adverse changes in economic cycles and business conditions. A high-quality project finance exposure is eligible for a less punitive risk weight that would otherwise apply, per Schedule 4, Table 1.

Section 37: Criteria respecting regulatory retail exposures

This section sets out the criteria that regulatory retail exposures must meet in order to qualify for the applicable risk weights appearing in Schedule 4, Table 1. Regulatory retail exposures include exposures like revolving credit 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 business facilities and commitments.

Section 38: Criteria respecting equity exposures

This section sets out the criteria to determine whether an instrument is an equity exposure. These criteria are important because whether an instrument is an equity exposure is determined by looking at the underlying economic substance of the instrument, rather than the legal form of the instrument. The criteria established in the Rule are largely based on the criteria included in the OSFI Capital Adequacy Requirements guideline[2].

Section 39: Repurchase agreement exposures

This section sets out the criteria that must be met for repurchase agreement exposures to qualify for the applicable risk weights appearing in Schedule 4, Table 1. A repurchase agreement is a contractual arrangement

[2] Capital Adequacy Requirements (CAR) (2024) - Chapter 4 – Credit Risk – Standardized Approach

between two parties, where one party agrees to sell securities to another party at a specified price with a commitment to buy the securities back at a later date for another (usually higher) specified price. BCFSA understands that credit unions utilize repurchase agreements to manage funding and short-term liquidity requirements.

Section 40: Defaulted exposures

This section sets out the risk weights that apply to defaulted exposures. A defaulted exposure is defined in section 29 as an exposure that is past due for more than 90 days or is an exposure to a defaulted borrower.

Section 41: Exposures associated with securitization transactions

This section sets out the risk weights that apply to traditional and synthetic securitization transactions and clarifies that, for the purposes of section 31 (calculation of credit risk weighted assets), such transactions are to be treated as on balance assets regardless of how the transaction is treated for accounting purposes. Traditional and synthetic securitizations are defined in section 28 and exclude securitizations under the National Housing Act Mortgage-Backed Securities and Canada Mortgage Bond programs.

DIVISION 5 – CALCULATION OF OPERATIONAL RISK WEIGHTED ASSETS

Section 42: Definitions

This section provides the definitions of certain terms in this Division (Division 5). These definitions will standardize the terms introduced in this division.

Section 43: Calculation of operational risk weighted assets

This section sets out the calculation of a credit union's operational risk weighted assets. Operational risk, as defined under the Basel III, is the risk of loss resulting from inadequate or failed internal processes, people, and systems, or from external events. Credit unions are required, under this Rule, to hold a certain amount of capital to address operational risk.

Section 44: Calculation of operational risk capital requirement

This section provides the formula for calculating the operational risk capital requirement. The calculation is based on the Basic Indicator Approach (BIA) but slightly modified to meet the reporting requirements of credit unions.

Section 45: Calculation of gross income

This section explains how to calculate the gross income of a credit union for purposes of calculating the operational risk capital requirement and, importantly, what is excluded from gross income.

Part 6 – Leverage Ratio Requirement

Section 46: Leverage ratio requirement

This section requires all credit unions to maintain a minimum leverage ratio greater than or equal to 3%, at all times. The leverage ratio serves as an additional safeguard by supplementing the risk-based capital measures contained in the Rule with a simple, transparent, and independent measure of risk.

Section 47: Calculation of leverage ratio

This section details how the leverage ratio is to be calculated for the purposes of the Rule. It is the Tier 1 capital of the credit union as calculated under this Rule divided by the credit union's total exposure.

Section 48: Calculation of total exposure

This section provides details on how to calculate a credit union's total exposure for purposes of the leverage ratio. The total exposure takes into account on and off-balance sheet assets. Credit unions must not take account of physical or financial collateral, guarantees or other credit risk mitigation techniques to reduce the total exposure measure.

Schedules

The Rule contains multiple schedules, which contain the tables referred to throughout the Rule. Although the tables contain the risk weights applicable to the rule sections that refer to them, they should be read in conjunction with the relevant section(s) in the Rule. The document: *Proposed Capital Requirements Rules Consultation: Rule References by Selected Topics* included in the consultation package helps to link various parts of the Rule and schedules/tables.

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