

**CAPITAL ADEQUACY GUIDELINE FOR ONTARIO'S
CREDIT UNIONS AND CAISSES POPULAIRES**

February 1, 2007

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1. INTRODUCTION

During the past two years the Ministry of Finance, in collaboration with the Financial Services Commission of Ontario and the Deposit Insurance Corporation of Ontario, has been working with the representatives of the credit unions and caisses populaires to modernize the Credit Unions and Caisses Populaires Act, 1994. This review has resulted in new capital and lending rules, effective February 1, 2007. This document provides guidance to Ontario credit unions and caisses populaires on the new capital adequacy rules that were introduced by the Ontario Regulation 560/06, which amended Regulation 76/95. The guideline provides the framework for the credit unions and caisses populaires to maintain adequate capital pursuant to the act and regulation.

This document replaces the Capital Adequacy Guideline for Ontario's Credit Unions and Caisses Populaires that was first published on March 1, 1995. The term "institutions" in this document refers to credit unions and caisses populaires.

1.1 Overview of Major Changes

Class 1 and Class 2

Effective February 1, 2007, all institutions will be designated Class 1 or Class 2 based on the following criteria:

Class 1 – These institutions are smaller, less complex credit unions that have less than \$50 million in total assets and do not make commercial loans. These institutions are subject to quantitative limits prescribed by the regulation for each class of loan they make. These limits have been updated in two revised tables for individual and aggregate limits. These institutions are subject only to the simple capital test known as the leverage test. The updated, simplified rules maintain the same high level of system soundness and consumer protection, without imposing complex regulatory requirements that require sophisticated compliance mechanisms.

Class 2 – These institutions have more than \$50 million in total assets or make commercial loans. These institutions are required to establish prudent lending limits for each class of loans they make (e.g. commercial, personal etc.) These institutions are subject to two capital adequacy tests: the capital to asset (leverage) test and the risk-weighted test based on international standards known as "Basel II" capital test.

Graduating From Class 1 to Class 2

An institution may graduate from Class 1 to Class 2 when the total asset size on its most recent audited financial statements exceed \$50 million. In accordance with the regulation on lending policy and procedure manuals, preparation should be made when total assets approach \$50 million and the institution will have to comply with the lending regulations for Class 2 institutions. An institution may also become a Class 2 institution upon application to the Superintendent to make commercial loans, subject to meeting the conditions described in the regulation. A change will also occur if the combined assets of amalgamating institutions exceed \$50 million. Once an institution becomes a Class 2 institution it cannot revert back to Class 1 either as a result of a change in its total assets to below \$50 million or as a result of ceasing to make commercial loans.

Changes in the Calculation of the Regulatory Capital

- In addition to goodwill, all intangible assets are to be deducted from tier 1 capital. Previously, only goodwill was deducted.
- Certain portions of loan loss provision are to be included in regulatory capital

Capital to Risk Weighted Asset Ratio.

This ratio for Class 2 institutions now includes, lower risk weighting for smaller commercial loans, increased risk weighting for certain delinquent loans, different risk weighting for commercial loans with a credit rating from an specified credit rating agency, a percentage charge for operational risk on average financial margin and non-interest income over the last three fiscal years of the institution and a percentage charge for the institution's exposure to interest rate risk.

2. Capital Adequacy

Institutions are required to meet capital adequacy standards prescribed by the regulations as well as these guidelines. For this purpose, the Superintendent has established minimum standards. The **first** requires a minimum level of capital in relation to a unit's total assets applicable to all institutions. The **second** focuses on the credit risk of specific on-and off-balance sheet asset categories, applicable to only Class 2 institutions.

Similarly, leagues are required to meet capital adequacy standards prescribed by the regulations as well as these guidelines. For this purpose, the Superintendent has established for leagues **one** minimum standard at 5%: a capital-to-assets test. This provides an overall measure of the adequacy of league's capital in relation to its assets.

Institutions must meet capital adequacy requirements on both an unconsolidated basis (i.e. the legal entity) and a consolidated basis unless the Superintendent permits otherwise. The consolidated basis includes all of the institution's subsidiaries as defined by *The Credit Unions and Caisses Populaires Act 1994*, S.O.1994, except insurance subsidiaries or other regulated financial institutions whose leverage is inappropriate for a deposit-taking institution and who, because of their size, would have a material impact on the consolidated entity.

2.1 Capital-to-Assets (Leverage Test)

The Leverage Test is applicable to both Class 1 & 2 institutions. The capital-to-assets ratio is calculated by dividing the institution's total capital by its total assets. The required levels of capital are outlined in Part V of the Regulations made under the Act.

Leverage Test

Regulatory capital expressed as a percentage of total assets. The minimum ratio for Class 1 institutions will be 5%. The minimum leverage ratio for Class 2 institutions will decrease from 5% to 4% over the next three years.

2.2 Risk-Based Capital (BIS II Test)

Risk Weighted Test (applicable for only Class 2 institutions)

The BIS II ratio is 8%, calculated by assigning risk weighted values for all the assets of the institutions and applicable operational risk and interest rate risk.

Under the risk-based capital adequacy framework, a financial institution's minimum capital requirement is defined as a ratio of total capital (**the numerator**) divided by risk-weighted assets and risk-weighted off-balance sheet items (**the denominator**). Generally, the risk weighting will be assigned based on an assessment of the counterparty or, if relevant, of the guarantor or of the collateral. The regulation and/or guidelines have been amended to incorporate revised risk-weighting for certain categories and include operational risk and interest rate risk elements. The guidelines may be adjusted in future by the Superintendent so that other risks - position risk, and foreign exchange risk - may be formally considered.

2.3 Payment of Dividends

The Superintendent may, according to the terms of the variance issued to the unit, limit its ability to pay dividends. In general, the Superintendent will exercise his discretion according to the following criterion: if the risk-based capital ratio or the capital-to-assets ratio is below the prescribed level, cash dividends will not be permitted, but share dividends may be permitted.

Although the guidelines do not prescribe a minimum level of retained earnings, the Superintendent continues to view retained earnings as a preferred form of equity. Where an institution makes a dividend payment from previous years earnings, the Superintendent may view this practice as a potential impairment of capital and erosion of the unit's financial position and may exercise his discretion under subsection 85(1) to require additional capital. For the purpose of determining capital adequacy for the redemption of shares and payment of dividends including patronage returns, the Accumulated Other Comprehensive Income is not to be included as part of regulatory capital.

2.4 Capital Adequacy Requirements for Leagues

All leagues are required to meet a capital-to-assets test. The capital-to-assets ratio is calculated by dividing the league's total capital by its total assets. The required level of capital is outlined in Part V of the regulations made under the act and regulation 77/95.

Leagues will not be required to meet a risk-weighted test. Any league that does not meet its capital adequacy requirement must obtain a variance from the Superintendent. As part of the variance, the Superintendent may set annual targets. A league that falls below these targets will not be permitted to pay a cash dividend but may be permitted to pay a share dividend.

2.5 Calculation of the Capital-to-Assets Ratio

All institutions and leagues will be required to maintain the prescribed level of capital throughout its fiscal year. However, for the purposes of measuring compliance based on the audited financial statements produced at the fiscal year end, an adjustment may be made to “total assets” on the following condition:

Where an institution or league experiences an unusually large influx of deposits (which would cause it to be in non-compliance with the capital-to-assets test) within the last five business days of its fiscal year end, it may reduce its total assets by these deposits. The amount of these deposits is to be the net amount after deducting withdrawals over the same period.

3. DEFINITION OF CAPITAL

The three primary considerations for determining whether capital of an institution qualifies for capital adequacy are its:

1. relative permanence;
2. freedom from mandatory fixed charges against earnings; and
3. subordination of legal position to the rights of depositors and other creditors of the credit union.

Note: The concepts of “permanence,” “freedom from mandatory fixed charges,” and “subordination” are defined in Appendix I.

Total capital is made up of two tiers. **Tier 1** capital (“core capital”) is the highest quality. **Tier 2** capital (“supplementary capital”) falls short in either permanence or freedom from charges, but contributes to the overall strength of a financial institution as a going concern. Tier 1 or tier 2 shares may contain a feature that permits redemption upon the death or expulsion of the member without changing its classification as either tier 1 or tier 2. The capital elements in tier 1 and 2 capital, as well as the various limits, restrictions and deductions to which they are subject, are specified next.

3.1 Tier 1 Capital

Tier 1 capital is restricted to:

- member equity, defined to include membership shares, contributed surplus, reserves, and retained earnings;
- 90% of the issued and outstanding qualifying non-cumulative, non-membership shares (where these shares have a 10% redeemability);
- 100% of qualifying non-cumulative, non-membership shares (where no redeemability feature exists) (see Appendix I); and
- qualifying minority interests in subsidiaries arising on consolidation of tier 1 capital instruments;
- investments by the Deposit Insurance Corporation of Ontario or a stabilization authority as approved by the Superintendent.

3.2 Tier 2 Capital

A capital instrument will qualify as tier 2 capital if it has an element of permanence, and has certain characteristics of both equity and debt. The maximum amount of these instruments that can be included in tier 2 capital is 100% of tier 1 capital.

Tier 2 will include the following instruments:

Capital instruments that, at a minimum, have these characteristics:

- 10% of tier 1 capital that are redeemable at the holder's initiative and have not been redeemed;
- 90% of the issued and outstanding capital instruments that have a 10% redeemability feature;
- 90% of the unamortized portion of qualifying redeemable shares and subordinated debentures;
- 100% of the capital instruments that are not redeemable at the holder's initiative;
- 100% of the capital instruments that may be redeemable by the credit union after an initial term of five years;
- are available to participate in losses without triggering an end to ongoing operations or the start of insolvency proceedings; and
- allow debt service obligations to be deferred (as with cumulative preferred shares) if the profitability of the credit union/caisse populaire would not support payment;
- are unsecured, subordinated to the rights of depositors and other creditors of the credit union and fully paid up;
- Tier 2 will also include any loan loss allowance in excess of a specific loan loss allowance up to:
 - 0.75% of the total assets of the credit union (leverage ratio/test).
 - 1.25% of the risk weighted assets for the credit union (BIS ratio/test).

3.3 League Guarantee of Capital

Where a league or other body provides a guarantee of capital, which is satisfactory to the Superintendent, the amount of this guarantee will be deducted from the capital of the league.

3.4 Qualifying Minority Interest

Minority interests arising on consolidation of an institution's financial statements with those of its subsidiaries will be included in either tier 1 or tier 2 capital, provided:

- the instruments meet the criteria applicable to that category; and
- are subordinate to the rights of the institution's depositors.

If a subsidiary issues capital instruments for the funding of its parent credit union or substantially in excess of its requirements, the terms and conditions of the issue, as well as inter-company transfers, must ensure that members are placed in the same position as

if the instrument was issued by the regulated credit union in order for it to qualify as capital on consolidation.

3.5 Deductions/Adjustments

Deductions from tier 1 capital include:

- Goodwill, unless unconditionally guaranteed;
- Other identified intangible assets
 - Note: This rule applies to identified intangible assets purchased **directly or acquired** in conjunction with or arising from the acquisition of a business. These include, but are not limited to, trademarks, core deposit intangibles, mortgage servicing rights and purchased credit card relationships. Identified intangible assets include those related to consolidated subsidiaries and subsidiaries deconsolidated for regulatory capital purposes.

Deductions from tier 1 and tier 2 capital include:

- appraisal increases;
- income tax recoverable that cannot be realized through a carry-back to preceding years;
- deferred tax debits that will not be realized in the following fiscal year;
- investments in unconsolidated subsidiaries and in corporations that are accounted for using the equity method of accounting, as well as capital issues between two or more financial institutions that represent, either, directly or indirectly, back-to-back placements.

4. RISK-WEIGHTED ASSETS

4.1 On-balance sheet

In establishing the denominator of the risk-based capital ratio, the assets of an institution and credit equivalent amounts for off-balance sheet items are assigned risk categories. These risk categories are prescribed under the regulation. Generally, classification is according to the nature of the counterparty or, if relevant, of the guarantor or of the collateral.

Amounts included in these categories are multiplied by the risk weight for the category, with the resulting weighted values added together to arrive at total risk-weighted assets.

The amount of assets such as goodwill, intangibles, investments in corporations carried on the equity method of accounting, or back-to-back securities that are deducted from capital are risk weighted at 0%. Where goodwill has been unconditionally guaranteed, it will not be deducted from tier 1 capital.

Certain types of collateral such as cash, government securities and residential mortgages will be recognized for the purpose of reducing the credit risk of claims. That portion of a claim covered by collateral will be assigned the weight given to the collateral. However the collateral must represent more than 25% of the loan and the credit union/caisse populaire must internally account for the calculation separately.

4.2 Off-balance sheet assets (See Appendix II)

The face amount of an off-balance sheet instrument does not always reflect the amount of the credit risk. To approximate the potential credit exposure, the face amount of the instrument must be multiplied by a credit conversion factor to derive a credit equivalent. Broadly, the credit conversion factors are:

- 100% direct credit substitutes;
- 0% unused portions of commitments with an original maturity of one year or less or unconditionally cancelable at any time (e.g. normal line of credit).

The resulting credit equivalent is then treated in the same manner as an on-balance sheet instrument. It is then assigned the weight appropriate to the counterparty or, if relevant, the weight assigned to the guarantor or the collateral security.

A commitment involves an obligation (with or without a material adverse change or similar clause) of an institution to fund its member in the normal course of business should the member seek to draw down the commitment. Normally, commitments involve a written contract or agreement and a commitment fee or some other form of consideration.

4.3 Commercial loans

All commercial loans that do not exceed 0.035% of the institution's total assets and \$1.25 million described under paragraph 15(5)3 are rated 75% for risk weighting. Commercial loans not covered under paragraph 15(5)3 the percentage of risk weighting will be 100% unless a different weighting is applicable based on the credit rating of an approved external credit rating agency. For applicable rates see Appendix III. Risk weighting on loans that qualify under paragraph 15(7)1 are 150%.

4.4 Operational Risk (Regulation 15(9))

The charge for operational risk is calculated based on average financial margin and non-interest income over the last three fiscal years, exclude any year in which financial margin, when added to non-interest income, did not exceed zero. An example for the calculation has been provided on Appendix IV.

4.5 Interest Rate Risk (Regulation 15(12))

The charge for interest rate risk of the institution's exposure to interest rate risk. An example has been provided in Appendix V.

APPENDIX I

Non-Membership Shares (Tier 1)

Other types of shares may qualify as tier 1 instrument depending on their **form** and **substance**. Factors to consider include:

- subordination;
- relative permanence; and
- freedom from mandatory fixed charges.

Subordination

These shares must be subordinated to an institution's depositors and unsecured creditors. If shares are issued by a subsidiary to fund the regulated parent company and are to qualify for capital (minority interest), the terms and conditions of the issue, as well as the inter-company transfer, must ensure that investors are placed in the same position as if the instrument were issued by the regulated parent company.

Permanence

To ensure that these shares are permanent, the following features are not permitted:

- retraction by the holder except under death or expulsion of a member;
- obligation for the issuer to redeem more than 10% of the outstanding shares.

For example, an issue would not be considered non-cumulative if it had a conversion feature that compensated for undeclared dividends. Similarly, a conversion feature that provided a return of capital or compensation for unpaid dividends would be unacceptable.

Free of Mandatory Fixed Charges

Shares included in tier 1 capital cannot offer:

- cumulative dividends;
- compensation to shareholders other than a dividend;
- sinking or purchase funds.

In addition, the non-declaration of a dividend cannot trigger restrictions on the credit union/caisse populaire other than requiring shareholder's approval before paying dividends on or retiring other shares.

To conform with accepted practice, in the event of non-declaration of a dividend, shareholder's approval of shares may be sought before:

- 1) paying dividends on any shares ranking junior to the shares (other than stock dividends in any shares ranking junior to the shares); or
- 2) redeeming, buying, or otherwise retiring any share ranking junior to the shares (except out of the net cash proceeds of a substantially concurrent issue of shares ranking junior to the shares); or
- 3) redeeming, buying, or otherwise retiring less than all such shares; or

- 4) except pursuant to any purchase obligation, sinking fund, retraction privilege, or mandatory redemption provisions attached to any series of shares, redeeming, buying, or otherwise retiring any shares at parity with such shares.

Example of Acceptable Features

Outlined below are some share features that may be acceptable in tier1 capital instruments:

- A dividend that floats at some fixed relationship to an index or the highest of several indices as long as the index or indices are linked to general market rates and not to the financial condition of the credit union/caisse populaire;
- A dividend rate that is fixed for a period of years and then shifts to a rate that floats over an index, plus an additional amount tied to the increase in share dividends if the index is not based on the credit union/ caisse populaire’s financial condition and the increase is not automatic nor of an exploding rate nature; and
- Conversion of shares to another form of shares where the minimum conversion value or the way it is to be calculated is established at the date of issue.

Examples of Unacceptable Features

Examples of unacceptable features in tier 1 capital include:

- An exploding rate share, where the dividend rate is fixed or floating for a period and then sharply increases to an uneconomically high level; and
- An auction rate share in which the dividend is reset periodically based, in whole or part, on the institution’s financial condition.

Amortization

Tier 2 capital components are subject to straight-line amortization in the last five years before maturity or the effective dates governing the holders’ retraction rights. As redeemable shares and subordinated debentures of the credit union/ caisse populaire,- or minority interest shares and qualifying instruments issued by a subsidiary approach maturity, redemption or retraction, such outstanding balances are to be amortized as follows:

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

Similarly for capital instruments that have sinking funds, amortization of the amount paid into the sinking fund should begin five years before payment is made. This is required because the amount in the sinking fund is not subordinated to the rights of depositors.

APPENDIX II

Off-Balance Sheet Categories

The definitions in this section apply to off-balance sheet exposures.

Direct Credit Substitutes (100% conversion factor)

Direct credit substitutes include guarantees or equivalent instruments backing financial claims. With a direct credit substitute, the risk of loss to an institution is directly dependent on the creditworthiness of the counterparty.

Direct credit substitutes include:

- Guarantees given by the institution on behalf of members to stand behind a member's financial obligations and to satisfy these obligations should the member fail to do so. For example a guarantee of:
 - existing indebtedness for services;
 - purchase agreements;
 - leases, loans or mortgage payments;
 - certified cheques;
 - sales taxes to the government;
 - existing indebtedness for merchandise purchased;
 - payment of unfunded pension liability;
 - reinsurance of financial obligations.
- Standby letters of credit or other equivalent irrevocable obligations, serving as financial guarantees, such as letters of credit supporting the issue of commercial paper.
- Risk participation in bankers' acceptance and risk participation in financial letters of credit. Risk participation constitutes guarantees by the participating institutions such that, if there is a default by the underlying obligor, they will indemnify the selling institution for the full principal and interest attributable to them; securities lending transactions, where the institution is liable to its customer for any failure to recover the securities lent; and credit derivatives in the book where an institution is selling credit protection.

APPENDIX III

Long Term Rating Table for Commercial Loans

In most cases, commercial loans under paragraph 15(6)1 are risk weighted at 100% unless a credit rating from a specified external credit rating agency is applicable.

The following are the risk weightings to be applied on commercial loans which exceed 0.035% of the institution's total assets and \$1.25 million per regulation 15(8) where a credit rating as specified is applicable.

Risk Weight %	DBRS	S&P/FITCH	Moody's
20	AAA to AA (low)	AAA to AA -	Aaa to Aa3
50	A(high) to A (low)	A+ to A-	A1 to A3
100	BBB (high) to B (low)	BBB+ to B-	Ba1 to B3
150	CCC	Below B-	Below B3

APPENDIX IV

Operational Risk

An institution's capital charge for operational risk is calculated as 15% of the average net interest income and all of its other non interest income over the most recent 3 years. A simple example of the calculation is provided.

<p>Example: Net interest income and all of its other non interest income for years 1, 2, and 3 are \$100,000, \$125,000 and \$150,000 respectively.</p>	<p>O.Reg 76/95 as amended to O.Reg 560/06</p> <p>Paragraph 15(10):</p>
<p>The average over 3 years is $[\\$100,000 + \\$125,000 + \\$150,000] \div 3 = \\$125,000$</p>	$\frac{E+F+G}{H}$
<p>The capital charge for operational risk is 15% of \$125,000 = \$18,750 (D)</p>	$D = [(E+F+G)/H] \times 0.15$

Note: For periods of less than three years, the average is calculated by using the number of years applicable.

APPENDIX V

Interest Rate Risk (IRR)

An institution's capital charge for "Interest Rate risk" is calculated as 15% of the exposure to interest rate risk. The Corporation's Guidance Note on "Structural (Interest Rate) Risk Measurement and Measurement" provides techniques and criteria to be used by Class 2 institutions to measure the potential IRR impact, expressed in dollars.

Example: Interest Rate risk exposure. Largest amount that results in a negative impact on earnings. Calculated as \$25,000 (K)	O.Reg 76/95 as amended to O.Reg 560/06 Paragraph 15(12)
The capital charge for interest rate risk 15% of \$25,000 = \$3,750 (J)	$J = K \times 0.15$