Office of the Superintendent of Financial Institutions Canada
Bureau du surintendant des institutions financières Canada

Guideline

Subject: **Capital Adequacy Requirements**

No: **A** **Date: December 2010**

Subsection 409(1) of the Cooperative Credit Associations Act (CCAA) requires cooperative credit associations to maintain adequate capital. The Capital Adequacy Requirements Guideline is not made pursuant to subsection 409(1) of the Act. However, the capital standards set out in this guideline provide the framework within which the Superintendent assesses whether a cooperative credit association maintains adequate capital pursuant to subsection 409(1). Notwithstanding that a cooperative credit association may meet these standards, the Superintendent may direct the company to increase its capital under subsection 409(3) of the CCAA.

This guideline sets out the key elements of the borrowing multiple test that is applied to federally regulated cooperative credit associations that act primarily as liquidity providers (centrals).

The capital adequacy tests set out in *Guideline A - Capital Adequacy Requirements – Simpler Approaches, Basel II* will apply to other federally regulated cooperative credit associations. Where the term "holding association" is used in this guideline it refers to such an association.

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The Entity

Capital adequacy requirements will be applied to each regulated financial institution. For this purpose, subsidiaries, other than subsidiaries that are regulated financial institutions, should be consolidated.

Borrowing Multiple

Federally regulated centrals are expected to meet a borrowing multiple test. The borrowing multiple is calculated by dividing the central's total borrowings by its total capital. Borrowings are comprised of total deposit liabilities and other loans payable. The definition of total capital to be used for this purpose is described below and expanded upon in the annexes.

Under this test, total borrowings should be no greater than 20 times capital, although this multiple can be exceeded with the Superintendent's prior approval to an amount no greater than 23 times. Alternatively, the Superintendent may prescribe a lower multiple. In setting the borrowing multiple for individual centrals, the Superintendent will consider such factors as operating and management experience, strength of its members, diversification of assets, type of assets, appetite for risk, and quality of capital.

OSFI will consider applications for authorized borrowing multiples in excess of 20 times from a central that can demonstrate that, in substance, it has:

- adequate capital management processes and procedures that include stress testing and setting internal targets for the borrowing multiple
- management reports that allow tracking of compliance with the borrowing multiple between quarter ends
- a robust oversight function
- prudent limits on large exposures to individual counterparties and a demonstrated ability to monitor exposures against limits
- operations that focus on very low risk market segments
- a stage rating of 0 for at least the four most recent consecutive quarters
- no undue risk concentrations

Increased authorized multiples will not exceed 23 times capital.

A central that receives approval to increase its borrowing multiple above 20 times will be expected to meet these conditions on a continuous basis. Failure to do so will cause an automatic reduction in the authorized level to 20 times. Where the authorized multiple is automatically reduced, the central will be required to file an action plan for achieving and maintaining the lower multiple that is acceptable to its relationship manager. The central will be required to operate at or below the 20 times level for four consecutive quarters before being reconsidered for an increase to its authorized multiple.

Borrowings

Borrowings are comprised of total deposit liabilities and other loans payable, including:

- deposits, investment certificates, debentures that are effectively deposits
- other borrowings including bank loans, borrowings from the deposit insurance funds, mortgages owed by the association and overdrafts
- borrowings by a subsidiary that have been guaranteed by the parent
- subordinated bonds, notes, debentures and other debt instruments and subordinated members' loans not assigned to the capital base
- liabilities related to derivatives contracts[1]
- accrued interest on these borrowings

For capital adequacy purposes, the reported values of borrowings should not reflect changes to an institution's own creditworthiness that have occurred subsequent to issuance.

Insured mortgages securitized through the Canada Mortgage and Housing Corporation's (CMHC) National Housing Act Mortgage - Backed Securities (NHA_MBS) and Canada Mortgage Bond (CMB) Programs, as well as the Insured Mortgage Purchase Program (IMPP) (collectively referred to as CMHC programs) will likely be brought on balance sheet as centrals adopt International Financial Reporting Standards (IFRS).

Borrowings do not include:

- liabilities related to mortgages securitized through CMHC programs up to and including March 31, 2010 that come onto the balance sheet when IFRS is adopted
- for CMB/IMPP transactions completed up to and including March 31, 2010, the liabilities corresponding to all existing and future reinvestments newly reported on the balance sheet[2] as a result of IFRS

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[1] Liabilities related to derivative contracts with member credit unions may be excluded from Borrowings where these contracts:

- are mirrored with offsetting contracts with a regulated financial institution that have the same reference terms (e.g., assets, indices, strike price) with any mismatch no greater than customary and reasonable fees for intermediation on this type of business; and
- include an indemnity clause that protects the Co-operative Credit Association in the event of a default by the regulated financial institution. The indemnity clause must be direct, explicit, irrevocable and unconditional.

2 Obligations related to assets sold under repurchase agreements executed by centrals for reinvestment purposes are not included in the transition provision, Such obligations are recorded on balance sheet and would have been included in the borrowing multiple calculation before conversion to IFRS.

Capital Elements

The three primary considerations for defining the capital of a financial institution for purposes of measuring capital adequacy are:

- its permanence
- its being free of mandatory fixed charges against earnings
- its subordinated legal position to the rights of depositors and other creditors of the institution

Total capital will comprise two tiers. Tier 1 ("core capital") comprises the highest quality capital elements. Tier 2 elements ("supplementary capital") fall short in meeting either of the first two capital properties listed above, but contribute to the overall strength of a financial institution as a going concern. Summarized below are the capital elements comprising tiers 1 and 2, as well as the various limits, restrictions and deductions to which they are subject:

Gross Tier 1: Core Capital

- Members' equity, defined to include membership shares, contributed surplus[3], and retained earnings[4]
- Qualifying non-cumulative perpetual preferred shares

The amount of retained earnings reported for capital adequacy purposes exclude:

- accumulated net after-tax fair value gains or losses arising from changes to an institution's own credit risk under the Fair Value Option.[5]-
- after-tax fair value gains (losses) on own use property on conversion to IFRS where the cost model is used
- accumulated net after-tax revaluation losses on own use property accounted for using the revaluation model
- accumulated net after-tax fair value gain on investment property (included in Tier 2A capital)

Centrals may elect to phase in the one time impact of IFRS 1 on retained earnings for regulatory capital purposes. The election must be made at the time of conversion to IFRS and is irrevocable; its impact on regulatory capital must be disclosed.

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3 Where repayment is subject to the Superintendent's approval.

4 Accumulated Other Comprehensive Income is not included in retained earnings.

5 Unrealized fair value gains and losses for assets meeting the criteria in OSFI's Accounting Guideline D-10 Accounting for Financial Instruments Designated as Fair Value Option will be included in the determination of tier 1 capital through retained earnings. Institutions are expected to meet OSFI's criteria in Accounting Guideline D-10, which includes the Basel Committee on Banking Supervision's guidance. Institutions are expected to have in place appropriate risk management systems prior to initial application of the Fair Value Option for a particular activity or purpose and on an ongoing basis per the Basel Committee on Banking Supervision's guidance.

The phase-in period begins at the date of conversion to IFRS, (i.e., in the fiscal quarter ending March 31, 2011) and must be completed by the quarter ending on December 31, 2012. Phase-in is made on a straight-line basis.

The amount that may be phased in is the difference between year end 2010 retained earnings as determined under the previous accounting standards and year end 2010 retained earnings as determined under IFRS.

This amount includes:

- the impact associated with any reversal of prior period gains on sales associated with CMHC programs
- any losses resulting from bringing assets back on balance sheet when previously securitized assets are no longer derecognized.

It excludes impacts related to:

- own use property
- the reversal of gains on sale related to securitizations other than CMHC program transactions.

Gross Tier 2: Supplementary Capital[6]

- A. Hybrid (debt/equity) capital instruments:
  - cumulative perpetual preferred shares
  - qualifying perpetual debentures

Accumulated net after-tax fair value gains on investment property are included in tier 2A capital.

- B. Limited life instruments:
  - limited life redeemable preferred shares
  - qualifying capital instruments issued in conjunction with a repackaging arrangement
  - qualifying term debentures and subordinated debt issued to parent association
  - other debentures and subordinated debt

Tier 1 capital instruments and preferred shares qualifying as hybrid instruments in tier 2A are intended to be permanent. Where tier 1 preferred shares or hybrid instruments provide for redemption by the issuer after five years with supervisory approval, the OSFI would not normally prevent such redemptions by healthy and viable financial institutions when the

[6] Tier 2 capital components are subject to straight-line amortization in the five years prior to maturity or the effective dates governing holders' retraction rights.

instrument is or has been replaced by equal or higher quality capital including an increase in retained earnings, or if the financial institution is downsizing.

Deductions from Capital

Goodwill is deducted from tier 1 capital and the following deductions are made from the total of tier 1 and tier 2 capital:

- investment in member shares (except special classes of shares) of a holding association and other facilities treated as capital by the holding association where an association holds 10% or more of the member shares of a holding association
- investment in special classes of shares issued by a holding association that represents a substantial investment[7] in the underlying company and other facilities provided to that underlying company that are treated as capital
- other investments in unconsolidated subsidiaries and investments in corporations or joint ventures in which the central has a substantial investment. Where the investment is accounted for under the equity method of accounting, the amount to be deducted excludes the pick up of elements of Accumulated Other Comprehensive Income (AOCI). Where the investment is designated as available-for-sale, the amount to be deducted excludes that portion of the investment that represents the net after-tax unrealized gain/loss recognized in AOCI. Provincial centrals are not required to deduct investments in Credit Union Central of Canada.
- other facilities that are treated as capital by unconsolidated subsidiaries and by corporations, excluding Credit Union Central of Canada, in which the institution has a substantial investment
- new capital issues between two or more financial institutions that represent either directly or indirectly back-to-back placements
- assets of little or no realizable value

[7] The term "substantial investment" used in this guideline is defined in section 12 of the *Cooperative Credit Associations Act*.

Limitations[8]

The following limitations apply to capital elements:

- the amount of capital, net of amortization, included in tier 2 may not exceed 100% of tier 1 capital after deducting goodwill
- tier 2B limited life instruments, net of amortization, included in tier 2 capital shall not exceed a maximum of 50% of tier 1 capital after deducting goodwill

8 Any capital instruments and limited life instruments issued in excess of these limitations will not be counted as capital for the purpose of these tests; however, they will be taken into account when reviewing the overall strength of the financial institution.

Annex A - Tier 1 Non-Cumulative Perpetual Preferred Shares

Preferred shares will be judged to qualify as tier 1 instruments based on whether they are, in form and in substance:

- subordinated
- permanent
- free of mandatory fixed charges

Subordination

Preferred shares must be subordinated to depositors and unsecured creditors of the financial institution.

Permanence

To ensure that preferred shares are permanent in nature, the following features are *not permitted*:

- retraction by the holder
- obligation for the issuer to redeem shares
- redemption within the first five years of issuance

Any conversion other than to common shares of the issuer or redemption is subject to supervisory approval and:

- redemption can only be for cash or the equivalent
- conversion privileges cannot be structured to effectively provide either a redemption of or return on the original investment

For example, an issue would not be considered non-cumulative if it had a conversion feature that compensates for undeclared dividends or provides a return of capital.

Free of Mandatory Fixed Charges

Preferred shares included in tier 1 capital are *not permitted* to offer the following features:

- cumulative dividends
- dividends influenced by the credit standing of the institution
- compensation to preferred shareholders other than a dividend
- sinking or purchase funds

In addition, the non-declaration of a dividend shall not trigger restrictions on the issuer other than the need to seek approval of the holders of the preferred shares before paying dividends on other shares or before retiring other shares. Non-declaration of a dividend would not preclude the issuer from making the preferred shares voting or, with the prior approval of the Superintendent, making payment in common shares.

Examples of Unacceptable Features

Examples of preferred share features that will not be acceptable in tier 1 capital are:

- an exploding rate preferred share, where the dividend rate is fixed or floating for a period and then sharply increases to an uneconomically high level
- an auction rate preferred share in which the dividend is reset periodically based, in whole or part, on the issuer's credit rating or financial condition

Annex B - Tier 2 Capital Instruments

The definition of tier 2 capital differentiates between what are referred to as hybrid (tier 2A) and limited life instruments (tier 2B). Hybrid capital includes instruments that are essentially permanent in nature and that have certain characteristics of both equity and debt. In contrast, limited life instruments are not permanent and include subordinated term debt and term preferred shares.

Tier 2 will include the following instruments subject to requirements established by the Superintendent:

- *Hybrid (debt/equity) capital instruments* that, at a minimum, have these characteristics:

  They

  - are unsecured, subordinated and fully paid up
  - are not redeemable at the initiative of the holder
  - may be redeemable by the issuer after an initial term of five years with the prior consent of the Superintendent of Financial Institutions
  - are available to participate in losses without triggering a cessation of ongoing operations or the start of insolvency proceedings
  - allow service obligations to be deferred (as with cumulative preferred shares) where the profitability of the financial institution would not support payment.

- *Limited life instruments that, at a minimum, have the following characteristics:*
  - subordination to deposit obligations and other senior creditors
  - an initial minimum term greater than five years, and
  - no redemptions in the first five years

Capital instruments issued in conjunction with a repackaging arrangement that are deemed by the Superintendent to be an effective amortization are to be treated as limited life instruments subject to their conforming with the criteria for tier 2B instruments.

Annex C - Tier 2A Perpetual Debentures

Perpetual[1] debentures meeting the criteria for hybrid capital instruments and with the following characteristics will be eligible for tier 2A capital: They

- are unsecured, subordinated and fully paid up
- are not redeemable at the initiative of the holder. They may be redeemed at the initiative of the issuer after an initial term of five years with the prior consent of the Superintendent
- are available to participate in losses while the issuer is still a going concern. Therefore, if the retained earnings of the issuer are negative, then the principal amount of the debt and unpaid interest must automatically convert to common or perpetual preferred shares
- must allow the issuer to defer principal and interest payments if the issuer does not report a net profit for the most recent combined four quarters and the issuer eliminates cash dividends on its common and preferred stock. Under no circumstances will the deferral of interest be allowed to compound.
- must not contain provisions for any form of compensation in respect of any unpaid payments, except subject to prior approval of the Superintendent
- are free from special restrictive covenants or default clauses that would allow the holder to trigger acceleration of repayment in circumstances other than insolvency

[1] Perpetual includes debentures with a 99 year term.

Annex D - Hedging of Subordinated Debentures

When a financial institution issues subordinated debentures and fully hedges (both in terms of duration and amount) these debentures against movements in another currency and the hedge is subordinate to the interest of the depositors, the institution should report the Canadian dollar value of the instrument, net of the accrued receivable or payable on the hedge. For limited life subordinated debentures (tier 2B), a hedge to within the last three years to maturity will qualify as a full hedge; hedges to a call date or to a period greater than three years before maturity will not.

In addition, the institution should disclose information on the hedging arrangement, the amount of the translation gains/losses and the accounting treatment accorded the translation gains/losses in a note to the capital adequacy returns.

Subordinated debentures denominated in a foreign currency that are not fully hedged, or where the hedge is not subordinated, should be translated into Canadian dollars at the value at the time of reporting.

Annex E - Amortization

Tier 2 capital components are subject to straight-line amortization in the final five years prior to maturity or the effective dates governing holders' retraction rights. Hence, as redeemable preferred shares and subordinated debentures of the financial institution approach maturity, redemption or retraction, such outstanding balances are to be amortized based on the following criteria:

Years to Maturity	*Included in Capital*
5 years or more	100%
4 years and less than 5 years	80%
3 years and less than 4 years	60%
2 years and less than 3 years	40%
1 year and less than 2 years	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 it is made. This is required because the amount in the sinking fund is not subordinated to the rights of depositors.

Note:

Where the redemption is not subject to the Superintendent's approval, amortization should begin after year 5 for a 20-year debenture or share that can be redeemed at the financial institution's option any time after the first 10 years. This would not apply when redemption requires the Superintendent's approval.

Where there is an option for the issuer to redeem an instrument subject to the Superintendent's approval, the instrument would be subject to straight-line amortization in the final five years to maturity.

Amortization should be computed at the end of each fiscal quarter based on the "years to maturity" schedule (above). Thus amortization would begin during the first quarter that ends within five calendar years of maturity. For example, if an instrument matures on October 31, 2000, 20% amortization of the issue would occur November 1, 1995 and be reflected in the January 31, 1996 capital adequacy return. An additional 20% amortization would be reflected in each subsequent January 31 report.

Annex F - Assets of Little or No Realizable Value

The following is a list of assets of little or no realizable value:

- deferred charges[1] other than deferred tax assets
- the amount by which deferred tax assets exceed deferred tax liabilities
- the amount, adjusted for the effect of income taxes, by which the aggregate balance sheet amounts of securities held at amortized cost, excluding securities of or guaranteed by Canada, a province, a territory or by a municipal corporation, exceeds their aggregate market values
- the accumulated net after-tax unrealized losses on available-for-sale debt securities, excluding securities of or guaranteed by Canada, a province, a territory or by a municipal corporation
- the amount by which the aggregate balance sheet value of investment real estate exceeds aggregate market value
- intangibles, other than goodwill and computer software, as specified by the Superintendent

[1] Deferred charges include assets that are expected to benefit future accounting periods but which otherwise have no recoverable value, and include start up costs, initial losses, financing costs and amortization of pension plan surpluses.