PRUDENTIAL STANDARDS

# Capital Adequacy Requirements

SASKCENTRAL COMMUNICATION NUMBER
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## INTRODUCTION

Pursuant to Part XIII of *The Credit Union Central of Saskatchewan Act, 2016* (the Act), Credit Union Deposit Guarantee Corporation (the Corporation) may make Prudential Standards that apply to SaskCentral. The Prudential Standard (Standard) contained herein must be adhered to by SaskCentral.

Pursuant to section 14-1 of the Act, the capital adequacy requirements set out in this document provide the framework within which the Corporation assesses whether SaskCentral maintains adequate capital. Notwithstanding that SaskCentral complies with this Standard, the Corporation may direct SaskCentral to increase its capital pursuant to subsection 14-2(1)(a) of the Act.

This Standard sets out the key elements of the borrowing multiple test that is applied to SaskCentral acting primarily to provide liquidity support to credit unions.

## THE ENTITY

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

## BORROWING MULTIPLE

SaskCentral is expected to meet a borrowing multiple test. The borrowing multiple is calculated by dividing total borrowings by 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 appendices.

Under this test, total borrowings should be no greater than 20 times capital, although this multiple can be exceeded with the Corporation's prior approval. Alternatively, the Corporation may prescribe a lower multiple. In setting the borrowing multiple for SaskCentral, the Corporation will consider such factors as operating and management experience, strength of member credit unions, diversification of assets, type of assets, appetite for risk, and quality of capital.

The Corporation will consider applications for authorized borrowing multiples in excess of 20 times from SaskCentral if it 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

If SaskCentral receives approval to increase its borrowing multiple above 20 times, it 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, SaskCentral will be required to file an action plan for achieving and maintaining the lower multiple that is acceptable to the Corporation. SaskCentral 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 Corporation's deposit guarantee fund, mortgages owed by the association and overdrafts
- borrowings by a subsidiary that have been guaranteed by SaskCentral
- 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 SaskCentral's own credit worthiness that have occurred subsequent to issuance.

## 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[2], and retained earnings[3]
- qualifying non-cumulative perpetual preferred shares

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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 SaskCentral in the event of a default by the regulated financial institution. The indemnity clause must be direct, explicit, irrevocable and unconditional.

[2] Where repayment is subject to the Corporation's approval.

[3] Accumulated Other Comprehensive Income is not included in retained earnings.

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

- accumulated net after-tax fair value gains or losses arising from changes to SaskCentral’s own credit risk under the Fair Value Option
- 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)

## GROSS TIER 2: SUPPLEMENTARY CAPITAL[4]

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 Corporation would not normally prevent such redemptions by SaskCentral as a healthy and viable financial institution when the instrument is or has been replaced by equal or higher quality capital including an increase in retained earnings, or if SaskCentral 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[5] 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 SaskCentral has a substantial investment.
  - where the investment is accounted for under the equity method of accounting, the amount to be deducted excludes the pickup of elements of Accumulated Other Comprehensive Income (AOCI).

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[4] 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.

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

- where the investment is measured at fair value through other comprehensive income (FVOCI), the amount to be deducted excludes that portion of the investment that represents the net after-tax unrealized gain/loss recognized in AOCI
- SaskCentral is not required to deduct investments in the Canadian Credit Union Association (CCUA)

- other facilities that are treated as capital by unconsolidated subsidiaries and by corporations, excluding the CCUA, in which SaskCentral 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

## LIMITATIONS[6]

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

[6] 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 SaskCentral.

# APPENDIX 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 SaskCentral.

## 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 SaskCentral
- 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 Corporation, 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

## APPENDIX 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 Corporation:

- hybrid (debt/equity) capital instruments that, at a minimum, have these characteristics:
  - 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 Corporation
  - 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 SaskCentral 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
  - no redemptions in the first five years

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

## APPENDIX C - TIER 2A PERPETUAL DEBENTURES

Perpetual[7] debentures meeting the criteria for hybrid capital instruments and with the following characteristics will be eligible for tier 2A capital:

- 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 Corporation.
- 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 Corporation
- are free from special restrictive covenants or default clauses that would allow the holder to trigger acceleration of repayment in circumstances other than insolvency

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

## APPENDIX D - HEDGING OF SUBORDINATED DEBENTURES

When SaskCentral 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, SaskCentral 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, SaskCentral 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.

## APPENDIX 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 SaskCentral 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 Corporation's approval, amortization should begin after year 5 for a 20-year debenture or share that can be redeemed at SaskCentral’s option any time after the first 10 years. This would not apply when redemption requires the Corporation's approval.

Where there is an option for the issuer to redeem an instrument subject to the Corporation's approval, the instrument would be subject to straight-line amortization in the final 5 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 December 31, 2015, 20% amortization of the issue would occur January 1, 2010 and be reflected in the March 31, 2011 capital adequacy return. An additional 20% amortization would be reflected in each subsequent March 31 report.

## APPENDIX F - ASSETS OF LITTLE OR NO REALIZABLE VALUE

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

- deferred charges[8] 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 debt securities measured at FVOCI, 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 Corporation

[8] 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.