REGULATORY DIRECTIVE AND PRUDENTIAL STANDARD

PROVINCIAL SYSTEMICALLY IMPORTANT FINANCIAL INSTITUTIONS

CREDIT UNION COMMUNICATION NUMBER
Directive 2018-01

SASKCENTRAL COMMUNICATION NUMBER
Prudential Standard 2018-01

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1. OBJECTIVE

CREDIT UNIONS

This regulatory directive is a regulatory guidance document as contemplated by the Standards of Sound Business Practice (the Standards). It supplements and expands upon section 2, Control Environment of the Standards and must be adhered to by Saskatchewan credit unions.

The Standards specify the principles and requirements for an effective financial management framework. This directive prescribes regulatory requirements that contribute to mitigating the risks associated with systemically important financial institutions in Saskatchewan.

SASKCENTRAL

Pursuant to Part XIII of *The Credit Union Central of Saskatchewan Act, 2016*, 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.

This Standard prescribes regulatory requirements that contribute to mitigating the risks associated with systemically important financial institutions in Saskatchewan.

2. BACKGROUND

The Basel Committee on Banking Supervision (BCBS) issued the rules text on the assessment methodology for global systemically important banks (G-SIBs) and their additional loss absorbency requirements in 2011.[1] The following year, the BCBS set out a principles-based framework for identifying and dealing with domestic systemically important banks (D-SIBs).[2] The framework indicates that systemic importance should be assessed with reference to the impact that a financial institution's failure could have on the financial system and economy. In determining systemic importance, regulatory authorities should consider specific characteristics, including:

- size
- interconnectedness
- substitutability/financial institution infrastructure
- complexity

The rationale for adopting additional policy measures is based on the "negative externalities" (i.e., adverse side effects) created by systemically important institutions which current regulatory policies do not fully address. These negative externalities include the impact of the failure or impairment of large, interconnected financial institutions that can send shocks through the financial system, which in turn can harm the economy.

In 2013, the Office of the Superintendent of Financial Institutions (OSFI) designated the six largest banks as systemically important to the Canadian financial system. These institutions

[1] Global systemically important banks: assessment methodology and the additional loss absorbency requirement (BCBS: November 2011).

[2] A framework for dealing with domestic systemically important banks (BCBS: October 2012).

are subject to increased prudential oversight, a common equity tier 1 capital surcharge of 1% of risk-weighted assets, and are required to develop recovery and resolution plans in the event of a financial crisis or potential insolvency.[3] The requirements applied to these institutions are intended to limit the adverse side effects on the financial system and economy.

Similar issues can apply at a provincial level. Certain provincially regulated financial institutions have an important impact on the provincial financial system and economy. The Corporation considers it appropriate to address the unique issues posed by provincial systemically important financial institutions (P-SIFIs).

3. CRITERIA FOR DETERMINING SYSTEMIC IMPORTANCE

The framework for dealing with systemically important financial institutions indicates that the assessment should consider institution-specific characteristics of systemic importance which are correlated with the impact of failure. This section describes the various measures of systemic importance. It is a principles-based framework from which the Corporation will apply judgement in determining which institutions are systemically important, and whose risk of failure poses the greatest impact to the credit union system and the deposit guarantee fund.

SIZE

In general, a financial institution’s distress or failure is more likely to damage the financial system or economy if its activities comprise a large share of the system’s activity.

As outlined in the Basel text, regulators may choose to include jurisdictional-specific factors such as the size of a financial institution relative to gross domestic product (GDP) when determining systemic importance. Another factor regulators may consider is the size of an individual institution relative to the assets held by all financial institutions in a particular jurisdiction.

INTERCONNECTEDNESS

The more interconnected a financial institution is to other financial institutions, the greater the potential for the failure of that institution to transmit problems throughout the financial system and broader economy.

SUBSTITUTABILITY

The systemic impact of a financial institution’s distress or failure is greater the less easily it can be replaced as a market participant and a financial service provider. This criteria examines whether, from an economic and practical perspective, other service providers can step in and replace the activity of a failed financial institution.

[3] Capital Adequacy Requirements (OSFI: November 2016).

COMPLEXITY

The Corporation considers the business, structural and operational complexity of a financial institution as indicators of the time and cost associated with its resolution. In general, larger financial institutions have more complex business models than their smaller counterparts.

4. REGULATORY IMPLICATIONS

REGULATORY CAPITAL - HIGHER LOSS ABSORBENCY TARGETS
(Applicable only to Credit Unions)

The goal of a higher loss absorbency target is to reflect the greater impact that the failure of a P-SIFI may have on the provincial financial system and economy. A capital surcharge takes into account the structure of the provincial credit union system, the importance of large credit unions to this financial architecture and the expanded regulatory toolkit required to resolve a troubled credit union.

Canadian banks designated as D-SIBs are subject to a common equity tier 1 capital (CET1) surcharge of 1% of risk-weighted assets. Consistent with this approach, credit unions designated as P-SIFIs will also be subject to a CET1 surcharge of 1%. The surcharge will be periodically reviewed in light of national and international developments.

The surcharge is in addition to the regulatory minimum capital ratios outlined in the Capital Standards of Sound Business Practice and will be implemented through an extension of the capital conservation buffer (i.e., 3.5% total conservation buffer, including the P-SIFI surcharge). The capital targets for P-SIFIs will be expressed as single target ratios rather than a conservation buffer plus surcharge. The following table contains regulatory minimum capital ratios for credit unions designated as P-SIFIs.

	Regulatory Limits (as a % of risk-weighted assets)		
	Common Equity Tier 1	Total Tier 1	Total Eligible Capital
Minimum	4.5%	6.0%	8.0%
Minimum plus conservation buffer	8.0%	9.5%	11.5%

The Corporation expects credit unions designated as P-SIFIs to formalize capital targets through the internal capital adequacy assessment process that exceed regulatory minimum ratios plus the capital conservation buffer. Credit unions are expected to formally demonstrate that capital levels and internal capital targets are aligned with the board's risk appetite, and adequate to support the nature and level of the credit union's risk.

Information pertaining to capital distribution constraints, capital restoration plans and intervention thresholds can be found in Appendix 1.

NET CUMULATIVE CASH FLOW REPORTING
(Applicable only to Credit Unions)

Credit unions designated as P-SIFIs are required to report to the Corporation on a quarterly basis the net cumulative cash flow (NCCF) liquidity management tool. The NCCF is a liquidity metric that measures a credit union's survival horizon through the identification of potential funding mismatches between contractual inflows and outflows during a stress event. The Corporation will provide affected credit unions with a template and instructions for NCCF submission.

RECOVERY PLANS

Financial institutions designated as P-SIFIs are required to develop and maintain an adequate, credible and executable recovery plan to restore stakeholder's confidence in the financial soundness of the institution following an extreme stress event. Information pertaining to recovery plans for financial institutions is contained in Appendix 2.

5. SUPERVISORY IMPLICATIONS

Saskatchewan P-SIFIs are expected to have more advanced practices in terms of the design and operation of oversight functions and internal controls. The Corporation expects these practices to continue to improve and evolve over time. The organizations designated as P-SIFIs have historically had, and will continue to be subject to, more intensive supervision. The Corporation's enhanced supervision of P-SIFIs includes the following:

- greater frequency and intensity of on- and off-site monitoring of activities, including more granular forms of risk management reporting to the Corporation and more structured interactions with boards and senior management;
- more extensive use of specialist expertise relating to corporate governance and enterprise-wide risk management;
- regular use of stress tests to inform capital and liquidity assessments; and
- assessment of the appropriateness of recovery plans that are intended to inform the Corporation's resolution plans.

6. IMPLEMENTATION

Financial institutions designated as P-SIFIs will be required to comply with the requirements contained in this directive by January 1, 2019.

7. DISCLOSURE

Saskatchewan P-SIFIs are expected to have public information disclosure practices covering their financial condition and risk management activities that are among the best of their peers in the credit union system. Enhanced disclosure of risk models and risk management practices can play a helpful role in enhancing stakeholder confidence. P-SIFIs may find the recommendations of the Financial Stability Board's Enhanced Disclosure Task Force[4] useful when working to improve and evolve disclosure practices.

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[4] Enhancing the Risk Disclosures of Banks (FSB: October 2012)

APPENDIX 1 - CAPITAL DISTRIBUTION CONSTRAINTS, RESTORATION PLANS AND INTERVENTION THRESHOLDS

CAPITAL DISTRIBUTION CONSTRAINTS

When the conservation buffer for P-SIFIs comes into effect, a credit union will implement capital distribution constraints when its capital buffer is drawn down. While subject to increased regulatory attention and requirements, credit unions will otherwise be permitted to conduct business as normal when their capital levels fall into the conservation range. Imposed constraints will apply only to distributions (i.e., patronage, dividend payments and discretionary staff bonuses) and not to credit union operations. Capital distribution constraints will remain in place until capital ratios have been restored.

To support credit unions, the table below supplements the Capital Standards and sets out minimum capital conservation constraints a credit union must apply at various levels of total eligible capital.

Total Eligible Capital (% risk-weighted assets)	**Minimum Capital Conservation Ratios (% of after-tax earnings)**
8% - 8.875%	100%
>8.875% - 9.75%	80%
>9.75% - 10.625%	60%
>10.625% - 11.50%	40%
>11.50%	0%

When the conservation buffer for P-SIFIs is drawn down, constraints will vary depending on the degree to which the buffer has been breached. For example, a credit union with a total eligible capital ratio in the range of 10.625% to 11.50% will be required to retain at least the equivalent of 40% of its earnings[5] in the subsequent financial year (i.e., payment of no more than 60% in terms of patronage, dividend payments and discretionary staff bonuses).

CAPITAL RESTORATION PLANS

In addition to capital distribution constraints, credit unions will be required to implement a capital restoration plan for rebuilding buffers within a reasonable timeframe. Credit unions will be required to provide capital restoration plans to the Corporation for review and approval.

INTERVENTION THRESHOLDS

Formal intervention thresholds will remain based on minimum regulatory ratios, excluding the conservation buffer. However, consistent with current supervisory practices, the Corporation will increase regulatory interaction with credit unions whose capital is trending negatively well before the capital conservation buffer is drawn down.

[5] Earnings are defined as distributable profits calculated prior to the deduction of elements subject to the restriction on distributions. Earnings are calculated after tax which would have been reported had none of the distributable items been paid. As such, any tax implications of making such distributions are reversed out. Where a credit union does not have positive earnings and has a total eligible capital ratio of less than 8.0%, it would be restricted from making positive net distributions.

APPENDIX 2 – ESSENTIAL ELEMENTS OF RECOVERY PLANS

A summary of essential elements of recovery plans is highlighted below. For additional information on recovery plans, institutions are encouraged to review the Financial Stability Board's, Key Attributes of Effective Resolution Regimes for Financial Institutions.[6]

OBJECTIVES AND GOVERNANCE OF RECOVERY PLANS

- The recovery plan should take account of the specific circumstances of the institution and reflect its nature, complexity, interconnectedness, level of substitutability and size.
- The underlying assumptions of the recovery plan and stress scenarios should be sufficiently severe. Both organization (group) specific and system-wide stress scenarios should be considered taking into account the potential impact of contagion in crisis scenarios, as well as simultaneous stress situations. Recovery plans should make no assumption that taxpayers' funds can be relied on to resolve the institution.
- The recovery plan should serve as guidance to financial institutions and the Corporation in a recovery or resolution scenario. They do not in any way imply that the Corporation would be obliged to implement them, or be prevented from implementing a different strategy in the event that the organization needs to be resolved.

Recovery Plan

- The recovery plan serves as a guide to the recovery of a distressed financial institution. In the recovery phase, the organization has not yet met the conditions for resolution or entered the resolution regime. There should be a reasonable prospect of recovery if appropriate recovery measures are taken. The recovery plan should include measures to reduce the risk profile of the institution and conserve capital, as well as strategic options, such as the divestiture of business lines and balance sheet restructuring.
- The responsibility for developing and maintaining, and where necessary, executing the recovery plan lies with the institution's senior management. The Corporation will review the recovery plan as part of the overall supervisory process, assessing its credibility and ability to be effectively implemented.
- P-SIFIs are required to update the recovery plan at regular intervals, and upon the occurrence of events that materially change the organization's structure or operations, its strategy or aggregated risk exposure. They are expected to regularly review the assumptions the recovery plans are based on, and assess on an ongoing basis the relevance and applicability of the plans. If necessary, P-SIFIs should adapt their recovery plan accordingly.

Financial Institutions

- P-SIFIs are required to have in place a robust governance structure and sufficient resources to support the recovery planning process. This includes clear responsibilities of business units, senior managers up to and including board members. This also includes identifying a senior level executive responsible for ensuring the organization is and remains in compliance with recovery plan requirements; and for ensuring that recovery planning is integrated into the organization's overall governance processes.
- P-SIFIs are expected to have systems in place to generate, on a timely basis, the information required to support the recovery planning process, to enable both the

[6] Key Attributes of Effective Resolution Regimes for Financial Institutions. (FSB: October 2014)

institution and the Corporation to effectively carry out recovery and resolution planning, and where necessary, implement the recovery plan or the resolution plan.
- P-SIFIs are required to draw up concrete organization-specific stress scenarios, including both idiosyncratic and market-wide stress and, upon request, provide strategy and scenario analysis.
- P-SIFIs should also engage in periodic simulation or scenario exercises to assess whether the recovery plans are feasible and credible.

GENERAL OUTLINE OF RECOVERY PLANS

Structure of Recovery Plans

- To support rapid execution, recovery plans are to include:
    - a high-level substantive summary of the key recovery strategies and an operational plan for implementation;
    - the strategic analysis that underlies the recovery strategies;
    - conditions describing necessary and sufficient prerequisites for triggering the implementation of recovery actions;
    - concrete and practical options for recovery measures;
    - preparatory actions to ensure that the measures can be implemented effectively and in a timely manner;
    - details of any potential material impediments to an effective and timely execution of the plan; and
    - responsibilities for executing preparatory actions, triggering the implementation of the plan and the actual measures.

Recovery Strategies

- Recovery plans are to contain a high-level substantive summary of the key recovery strategies and an operational plan for their implementation. This should include the identification of the organization’s essential and systemically important functions (e.g., illustrated with an organizational chart of the institution’s major operations), a description of the critical measures to implement the key recovery strategies, and an assessment of potential impediments to their successful implementation. As well, this should include any material changes or actions taken since the organization’s last submitted recovery plan.

Strategic Analysis

- A key component of a recovery plan is a strategic analysis that identifies the organization’s essential and systemically important functions and sets out the key steps to maintaining them in recovery scenarios. Elements of such analysis should include:
    - identification of essential and systemically important functions, mapped to the legal entities under which they are conducted;
    - actions necessary for maintaining operations of, and funding for, those essential and systemically important functions;
    - assessment of the viability of any business lines and legal entities which may be subject to separation in a recovery scenario, as well as the impact of such separation on the remaining group structure and its viability;
    - assessment of the likely effectiveness and potential risks of each material aspect of the recovery actions, including potential impact on members, counterparties, and other stakeholders;

- estimates of the sequencing and the time needed to implement each material aspect of the plan;
- underlying assumptions for the preparation of the recovery plan;
- potential material impediments to effective and timely execution of the plan; and
- processes for determining the value and marketability of the material business lines, operations, and assets.

ESSENTIAL ELEMENTS OF A RECOVERY PLAN

- P-SIFIs are to identify possible recovery measures and the necessary steps and time needed to implement such measures and assess the associated risks. The range of possible recovery measures should include:
  - actions to strengthen the capital situation, for example, recapitalization after extraordinary losses, capital conservation measures such as suspension of dividends and payments of variable remuneration;
  - possible sales of subsidiaries and spin-off of business units; and
  - measures to secure sufficient funding while ensuring sufficient diversification of funding sources and adequate availability of collateral in terms of volume, location and quality.
- P-SIFIs should assess the additional requirements to which they may potentially become subject during crisis situations in order to maintain access to clearing and settlement systems.
- P-SIFIs are to ensure that they have in place appropriate contingency arrangements (e.g., functioning of internal processes, IT systems, clearing and settlement facilities, supplier and employee contracts) that enable them to continue to operate as they implement recovery measures.
- P-SIFIs are expected to define clear backstops and escalation procedures, identifying the criteria (both quantitative and qualitative) which would trigger implementation of the recovery plan or individual measures by the management of the organization, in consultation with the Corporation. Such triggers should be designed to prevent undue delays in the implementation of recovery measures.
- P-SIFIs are required to develop a proper communication strategy to support interaction with the Corporation, the public, staff and other stakeholders.

INFORMATION REQUIREMENTS FOR RECOVERY PLANNING

P-SIFIs should have the capacity to provide the essential information needed to implement the recovery plan on a timely basis for the purpose of recovery planning, as well as in crisis situations, including information on the following:

- intra-group inter-linkages, for example, dependencies of the organization’s legal entities on other group entities for liquidity or capital support as well as other (e.g., operational) support
- operational data (e.g., the extent of asset encumbrance, amount of liquid assets, off-balance sheet activities)
- organization and operations that support the execution of recovery measures (e.g., hedging strategies, custody of assets, information on payment, clearing and settlement systems, and inventory of the key management information systems, including accounting, position keeping and risk systems)
- key crisis-management roles and responsibilities (e.g., contact information, communication facilities for in-crisis communication, and the organization’s procedures for providing the Corporation with access to information) both in normal times and during a crisis