Internal Capital Target

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BC CREDIT UNIONS

British Columbia
Financial Institutions Commission

PURPOSE

This guideline summarizes the regulatory capital standards considered in the assessment of credit union capital adequacy. It outlines the Financial Institutions Commission's (FICOM)[1] expectations that credit unions establish their own internal capital target and develop and follow capital management policies; these standards apply within the context of FICOM's Supervisory Framework[2].

INTRODUCTION

FICOM uses three key capital indicators to supervise a credit union's capital adequacy:

1. ***Regulatory Requirement*** (8%): a credit union with capital below the Regulatory Requirement is subject to immediate statutory restrictions on its business operations and may be considered non-viable by FICOM;

2. ***Supervisory Target*** (10%): a credit union with capital below the Supervisory Target will be staged[3] by FICOM and expected to immediately improve its capital position; and

3. ***Internal Target*** (>10%): a credit union with capital below its Internal Target will be expected to initiate corrective action to return its capital position back above the Internal Target.

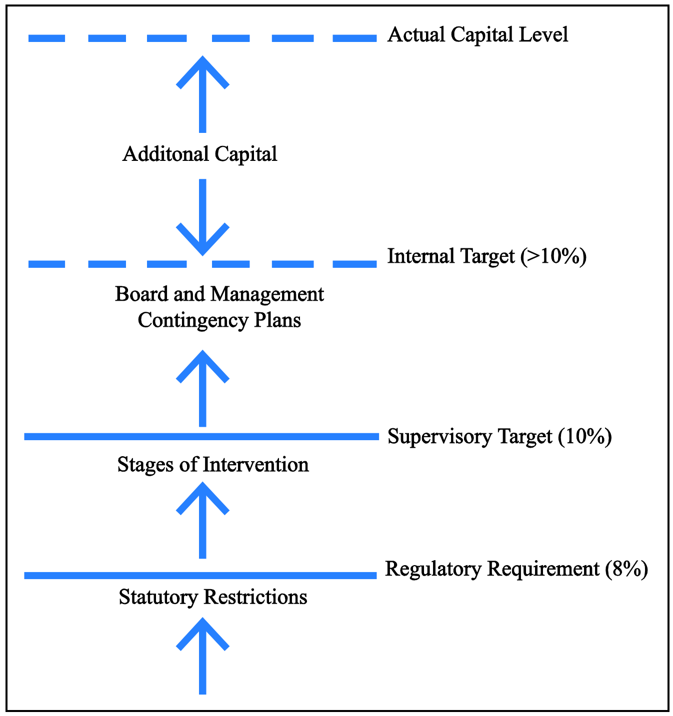

Figure 1: Key Capital Indicators

BOARD OF DIRECTORS AND OVERSIGHT OF INTERNAL TARGET

Board Responsibility

To protect the financial stability of a credit union, a board of directors should pay close attention to capital requirements and a credit union's capital adequacy. This includes establishing a credit union's risk appetite and its overall risk management program. It is the board's responsibility to approve a credit union's internal target and it is expected to oversee senior management's process for determining an internal target. The board should also conduct an annual review on the appropriateness of the internal target.

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[1] References to FICOM may include staff, the Superintendent and/or the Commission.
[2] More detail regarding FICOM's Supervisory Framework, including assessment criteria, can be found at FICOM's website: www.fic.gov.bc.ca.
[3] More detail regarding FICOM's intervention stages can be found in its Guide to Intervention.

In the event that a credit union falls below its internal target, the board should monitor corrective actions taken by management to restore a credit union's capital level to its internal target within an appropriate timeframe.

FICOM's RISK ASSESSMENT PROCESS

FICOM uses a risk-based approach to supervise credit unions. FICOM evaluates the inherent risk of each significant activity in a credit union and assesses the quality of risk management over that activity. These risk assessments result in an overall net risk rating (ONR) for a credit union. The ONR reflects the assessed risk that significant activities pose to a credit union's capital and earnings.[4]

FICOM then assesses the capital, earnings and liquidity of a credit union to develop a composite risk rating (CRR) which represents the overall safety and stability of the credit union.

Capital is one of the key components assessed in developing and establishing the CRR. While the regulatory capital ratio is an important factor in FICOM's capital assessment, it is not the only factor considered. Other assessment criteria include:

- the quality of capital and its ability to absorb losses;
- capital adequacy to support the credit union's risk profile and strategic plan;
- the sustainability and volatility earnings and its impact on capital;
- the ability to grow capital from future earnings, or to raise capital from members, to meet projected needs;
- the credit union's capital management processes, as well as the roles and effectiveness of the board and senior management;
- the quality or strength of the credit union's capital management policy, including its capital management processes;
- past and emerging trends, including the outlook for capital, earnings and liquidity, as well as the credit union's preparedness to deal with potential capital deficiencies; and
- consideration of risks that may not be fully captured in the regulatory capital calculation.

FICOM also expects the quantity and quality of a credit union's capital and its capital management processes to be appropriate to its circumstances, factoring in the credit union's risk profile, risk tolerance and operating environment.

[4] Please refer to the Supervisory Framework p.11

REGULATORY CAPITAL RATIOS

FICOM uses a number of regulatory capital ratios to guide its supervisory work:

Regulatory Requirement (8%)

Section 67 (1) of the *Financial Institutions Act* (FIA) states that a credit union must at all times ensure that it has an adequate capital base in relation to the business carried on by it, in accordance with the regulations. The Capital Requirements Regulation requires a credit union to have a capital ratio of at least 8 per cent in order for the credit union to operate without any statutory restrictions.

Appendix 1 contains a listing of statutory restrictions on credit activities if the capital ratio falls below the 8 per cent level.

Supervisory Target (10%)

While the FIA sets out the regulatory requirement for capital threshold[5], FICOM's supervisory target capital ratio (Supervisory Target) sits above that threshold. Managing to the target provides sufficient time for FICOM to address any threats to the solvency of the credit union before the credit union's capital position falls to regulatory requirement and statutory restrictions.

From a supervisory perspective, a credit union's inability to maintain a capital level above the supervisory target indicates safety and stability concerns and a vulnerability to adverse business and economic conditions.

FICOM will place increasing attention on a credit union as its capital level approaches the supervisory target and should the target be breached, the credit union will be staged. Regulatory enforcement may be required.

Internal Target (>10%)

Credit unions should not rely on regulatory and supervisory capital target ratios alone. Each credit union is expected to establish an internal capital target ratio (Internal Target). The internal target is used as a trigger for a credit union to take its own corrective action before capital erodes to the supervisory target. The internal target should take into account the credit union's enterprise-wide risk appetite, risk profile and external conditions.

The internal target should be set above the supervisory target in order to provide the board and management adequate time to resolve unexpected financial issues or absorb unexpected losses.

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[5] As well, there are less prescriptive provisions of the FIA which provide the Commission with authority to order increased liquidity and capital (section 67(2)), the general overriding power to take remedial action where the credit union is conducting its business in a way that might harm the interests of depositors (section 244), and the more intrusive powers of supervision (section 275) where, for example, a credit union's liquidity or capital have reached a level or are eroding in a manner that may detrimentally affect the interests of depositors.

ESTABLISHING AN INTERNAL CAPITAL TARGET

Process

A credit union should have a process for determining its internal target. The process should identify, measure and appropriately consider all material risks to the credit union, and quantify the potential impact of these risks on capital. Although the complexity of this process will differ among credit unions, each credit union is expected to have a systematic and reasonable approach to determining its internal target.

Factors

The factors that should be considered in determining the internal target include:

- the business strategy (particularly respecting anticipated acquisitions or divestitures, the introduction of new business lines, products or services as well as other anticipated areas of growth);
- the nature, size and significance of the risks to which the credit union is potentially exposed;
- risk concentrations;
- deductions from capital;
- the capacity of credit union's risk management policies and procedures to identify and mitigate risks;
- potential changes in historical correlations among exposures and risks;
- current and forecast business and regulatory environments;
- stress scenarios and business cycles;
- expected changes to the risk profile resulting from the potential volatility of exposures as well as from changes in risks or strategies;
- expectations for a capital cushion against unexpected events and uncertainties in risk measurements;
- expectations to fund capital needs of subsidiaries (including central credit unions);
- the capacity of the credit union to replace or raise capital;
- the regulatory capital requirements; and
- patronage and dividends.

CAPITAL CONSIDERATIONS FOR AN INTERNAL TARGET

Capital Composition

A credit union's determination of its internal target should consider the capacity of various capital components to absorb losses. Typically a credit union's capital combines the following components:

- retained earnings;
- contributed surplus;
- equity shares (membership and other);
- subordinated debt; and
- system capital.

Capital Quality

Capital strength is measured by these three important properties:

- permanence;
- freedom from mandatory fixed charges against earnings; and
- legal subordination to the rights of depositors and other creditors.

These properties permit the credit union to conserve resources when it is under stress. Capital with the highest capacity to absorb losses and provide protection to the credit union will have these three properties and should be the dominant component of capital. Credit unions should avoid undue reliance on capital that does not encompass these properties and should consider excluding that capital in the determination of its internal target.

Capital availability from future extraordinary events, one-time revenues, or potential future injections or other management actions should not be assumed when setting an internal target. However, it could be considered when determining the level at which the credit union will operate above the internal target.

Communicating with FICOM

If the capital level of a credit union falls, or is anticipated to fall, below its internal target, a credit union needs to inform its FICOM relationship manager. The credit union will be expected to begin corrective action, based on its contingency planning, to manage risks and restore its capital level to its internal target within a reasonable period of time. FICOM may increase its attention on a credit union based on its assessment of the timeliness and appropriateness of a credit union's remedial actions.

Appendix 1

Capital Level	FIA/Regulation Section	Restrictions
At and below 8%	s.10 of the Capital Requirements Regulation	If the amount of a credit union's capital base does not, at all times after its financial year end, comprise at least 8% of the calculated value of the credit union's risk-weighted assets, then, unless it first receives the written approval of the Commission, the credit union must not: • locate one or more additional offices; • directly or indirectly acquire or acquire control of more than 10% of the voting shares in any corporation; • make or invest in commercial loans or, in respect of commercial activity, give guarantees or indemnities if, as a result, the aggregate amount outstanding under all such loans, investments, guarantees and indemnities would exceed 7.5% of the total amount of the credit union's assets; or • acquire land for investment purposes, except in settlement or partial settlement of loans, if, as the result of the acquisition, the aggregate book value of land held by the credit union would exceed 2% of the credit union's assets. The Commission must not give approval under subsection (2) unless the commission is satisfied that the approval will assist the credit union to improve its capital base, and the approval is not likely to increase the risk of claims against the fund.
At and below 6%	s.9 (2) of the Capital Requirements Regulation	The amount that under section 67 of the Act constitutes an adequate capital base of a credit union is the amount determined by multiplying the calculated value from time to time of the credit union's risk-weighted assets by 6%.
At and below 5%	s.277 (g) of the FIA	The Commission may make orders, if an administrator has been appointed and the capital base of the credit union is less than 5%, requiring: • one credit union to amalgamate with another credit union; • the credit union to dispose of all or substantially all of its assets and liabilities to another credit union; or • that the credit union be wound up.

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