FSRA Update for the Directors' Forum

FSRA

Financial Services Regulatory Authority of Ontario

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Agenda

1. FSRA Overview
2. Principles Based Regulation (PBR)
3. Credit Unions and Caisses Populaires Act 2020, FSRA Rules and Guidance
4. Risk Based Supervisory Framework (RBSF)
5. Regulatory Compliance vs Supervisory Expectations
6. Recovery Planning

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1. FSRA Overview

Creation of FSRA

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- The province appointed an expert panel in 2015 to review three agencies important to the financial well-being of Ontarians: FSCO, the Financial Services Tribunal (FST), and DICO
- Following stakeholder consultations and looking at best practices the expert panel recommended the establishment of a new regulator with a modernized governance and accountability framework and a mechanism to ensure individuals' perspectives are considered
- The government adopted the recommendation and created FSRA
- While FSRA's mandate includes broad responsibilities - like fostering strong, sustainable, competitive and innovative financial services sectors – its core role is to **protect consumers**
- FSRA was designed to respond rapidly to an evolving commercial and consumer environment so it can:
  - Promote high standards of business conduct
  - Foster a sustainable, competitive financial services sector
  - Respond to market changes quickly
  - Encourage innovation

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Vision and Mission

Vision	• Safety • Fairness • Choice
Mission	• Public service through dynamic, principles-based and outcomes-focused regulation
Key Enablers	• Principles-based • Rule making • Clear guidance • Risk-based, evidence-driven and outcome-focused • Dynamic; use discretion • Collaborative, consultative and transparent culture • Operational independence from, and continuous collaboration with, government

FSRA's Statutory Objects

FSRA's **objects relevant to credit unions** include:

- Regulate, generally supervise, monitor and evaluate developments and trends in, and contribute to public confidence in the regulated sectors
- Foster strong, sustainable, competitive and innovative financial services sectors
- Promote high standards of business conduct
- Cooperate and collaborate with other regulators where appropriate
- Protect the rights and interests of consumers
- Promote and otherwise contribute to the stability of the credit union sector in Ontario with due regard to the need to allow credit unions to compete effectively while taking reasonable risks
- Provide insurance against the loss of part or all of deposits with credit unions
- Pursue the above two objects for the benefit of persons having deposits with credit unions and in such manner as will minimize the exposure of the DIRF to loss

2. Principles Based Regulation

Principles-Based Regulation

- FSRA is a principles-based and outcomes-focused Regulator. We have moved away from prescriptive checklists and a compliance focus. We evaluate regulated entities by whether they achieve the desired outcomes
- Entities are expected to understand and achieve the desired outcomes, but they can do so in a way that is best suited to the unique size and complexity of their business
- Principles-based regulation is fundamental to FSRA's rules, guidance and regulatory decisions, but it comes to life in how regulated entities are supervised – by using principles-based regulation FSRA evaluates whether the public good is being furthered by their activities
- For principles-based regulation to work effectively in practice, we will place an emphasis on open communication, collaboration, feedback, and transparency with those we regulate

Principles Based Regulation

> “A principles-based approach “moves away” from reliance on detailed, prescriptive rules and relies more on high level, broadly stated rules or principles to set standards by which regulated firms/individuals must conduct business.”
>
> - Julia Black, *Making a Success of Principles-based Regulation* (2007) 1:3 L. & Financial Markets, Rev. 191 at 197

Principles-based regulation can have “rules” (statutory provisions, regulations, etc.) which are implemented in a principles-based manner.

A principles-based approach to regulation typically has three main defining elements:

- Greater reliance on broad-based standards in preference to detailed rules
- A move to outcomes-based regulation
- **Increasing Board accountability** and senior management responsibility

3. Credit Unions and Caisses Populaires Act, 2020, FSRA Rules and Guidance

Credit Unions and Caisses Populaires Act 2020 (CUCPA)

The highlights of the new, modern framework, which came into force March 1, 2022, include:

- Enabling FSRA to operate as a principles-based regulator that maintains the stability of the credit unions and caisses populaires sector, while giving institutions some flexibility
- Enhancing consumer protection by enabling FSRA to have better oversight of the sector through an industry-led market code of conduct and strengthened supervisory and compliance regimes
- Removing restrictions that currently limit credit unions' ability to invest and offer services to consumers
- Allowing the sale of property and casualty insurance in branches and online, which will provide opportunities for insurance intermediaries and credit unions to seek mutually beneficial business relationships that could reduce costs and increase competition

FSRA Rules and Guidance

Rule-Making Authority in CUCPA 2020

- Four Credit Union rules to date (These 4 rules capture 11 of the 63 areas of rule-making authority)

Standards of Sound Business and Financial Practices Rule	Capital Adequacy Requirements Rule	Liquidity Adequacy Requirements Rule	Deposit Insurance Advertising Rule

FSRA Guidance

- Moving away from a "prescriptive" approach
- FSRA Guidance that has been published since PBR was introduced include:
  - Residential Mortgage Lending Guidance (2021) (Link)
  - Liquidity Guidance (2021) (Link)
  - Market Conduct Framework Guidance (2021) (Link)
  - Recovery Planning Guidance (2021) (Link)
  - Resolution Planning (2022) (Link)
  - Risk Based Supervisory Framework Guidance (2022) (Link)

CUCPA Modernization

- The CUCPA, 2020 provides the ability for credit unions to provide retail insurance products and to enter new businesses (that were previously not authorized) with FSRA approval
- New flexibility means that credit unions may seek entry into non-traditional lines of business (e.g. prescriptive list of subsidiaries removed)
- Removal of the prescriptive list means credit unions may take advantage of all business opportunities, with FSRA approval, to remain competitive and sustainable
  - Approval or Authorization of Business and Investment Activities under the Credit Unions and Caisses Populaires Act, 2020 (2022) (Link)
- Expanded business powers for credit unions requires a more modern, principles-based and outcomes focused Regulator with more knowledge, expertise, and resources
- A critical success factor to this evolution of the credit union sector and PBR is a commensurate enhanced level of credit union Board oversight

PBR and Outcomes Focused Regulation – SBFP Rule Examples

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- Section 5(1). The board of the credit union shall discharge its responsibilities in a manner which, (i) results in independent oversight of the credit union's management, and (ii) permits and encourages directors to provide effective oversight of the decisions, plans, processes and policies proposed by the credit union's senior management and implemented by its management
- Section 5(2). The board of the credit union shall establish and maintain a clear division between the roles and responsibilities of the board and those of senior management, to ensure the board complies with the Act's prohibition on the board directly managing, or being involved in, the day-to-day activities of the credit union
- Section 5(3)(i)(a). The board of the credit union is responsible for providing oversight, supervision and direction to management, and shall oversee and approve the credit union's short-term and long-term business plan and strategy
- Section 5(5). The board of the credit union shall approve (i) delegations of authority by the board, and (ii) a policy which defines the thresholds for what constitutes a material decision made outside of the normal course of the credit union's operations, having regard to the nature, size, complexity, operations and risk profile of the credit union
- Proportionality s10(3). The credit union may, if appropriate, as determined by its nature, size, complexity, operations and risk profile, combine any or all its risk management function, compliance function and finance function, which may also include the head of such function (except for the internal audit function)

Outcomes Focused Regulation – Residential Mortgage Lending Guidance

Outcomes-focused regulation practical example - Residential Mortgage Lending Guidance provides four key principles:

- Framework: The credit union, through its Board and Senior Management, must develop and maintain an efficient and effective framework for residential mortgage risk management
- Underwriting Policy: The credit union, through its Board and senior management, should develop, regularly review and approve a comprehensive residential mortgage underwriting policy or set of policies
- Portfolio Management: The credit union, through its Board and Senior Management, should implement appropriate processes and systems for the effective on-going administration, control and oversight of its residential mortgage portfolio
- Risk Management: The Framework, Underwriting Policy and portfolio management activities should fully integrate with the credit union's overall strategic planning, enterprise risk management, capital management and liquidity management activities

Outcomes Focused Regulation – Capital Adequacy Rule

Capital Adequacy Rule contains requirements related to the calculation of minimum capital ratios but is still principles-based as the credit union ultimately determines how much capital it should hold. For example:

- Capital Conservation Buffer – section 14(1)
  If a credit union's capital conservation buffer ratio is below the minimum capital conservation buffer ratio, the credit union must immediately implement a plan to meet or exceed the minimum capital conservation buffer ratio, and such plan must include, (i) the strategy the credit union will use to complete the plan; (ii) the timeframe for the plan; and (iii) if the credit union expects to complete the plan promptly, assurances that the capital conservation buffer ratio recovery is not temporary

- Internal Capital Adequacy Assessment Process – section 17(1)
  If a credit union has less than $500 million in assets and takes appropriate compensating actions and implement controls to allow the credit union to appropriately manage its capital risk, senior management and the board may determine that the credit union is not required to establish an internal capital adequacy assessment process and section 17 does not apply to that credit union

4. Risk Based Supervisory Framework (RBSF)

Risk Based Supervisory Framework for Credit Unions

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- In April 2022, FSRA implemented the integrated Risk Based Supervisory Framework (RBSF) that includes market conduct and prudential assessments
- RBSF sets out guidance for FSRA supervisory staff for assessing the risk profiles of credit unions and determining the required level of supervisory engagement and intervention
- The primary focus is to determine the impact of current and potential future events, in both the internal and external environments, on the risk profile of credit unions
- Risk-based supervision (RBS) increases the effectiveness of supervision through articulating and meeting supervisory outcomes while increasing efficiency through improved resource allocation and processes to the areas of greatest risk
- RBS is outcomes-focused, forward-looking, and seeks to assess:
    - the most important prudential and conduct risks posed by credit unions' business activities and
    - the extent to which Credit Unions can manage and mitigate these risks
- FSRA now has higher expectations and articulated accountabilities of credit union Boards

Learnings from RBSF Assessments

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- Operational management (first line of defense) most often found to be adequate – good people doing good work every day
- Risk Management (second line of defense, FSRA SBFP Rule, S. 10) is often a challenge, particularly for smaller institutions, because of:
  - Scarce skills and experience
  - Low budget
  - Lack of independence from Operational Management
- Internal Audit (third line of defense, FSRA SBFP Rule, S. 11) is often outsourced
  - Not an issue in itself – but third-party risk could be (FSRA is working on a policy response)
  - Budget constraints impact negatively the quality and frequency of audits – and hence IA's effectiveness
  - A compliance approach usually leads to budget under-allocation – rather than seeing risk management as a business investment
- The role of Senior Management and the Board ("where the buck stops")

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Corporate Governance Weaknesses and Expectations

- The Board needs to set clear expectations to Senior Management, which in turn sets expectations for the rest of the business
  - Sets Risk Appetite (Board-level limits)
    - e.g. an incomplete definition of the Risk Appetite is dangerous
  - Approves strategy and plans
  - Monitors business performance against Risk Appetite, strategy and plans
- The Board oversees Senior Management (FSRA SBFP Rule, S. 5)
  - Appropriate incentive structure for the CEO ("show me the incentives and I will show you the person's behaviour" – Warren Buffett) (FSRA SBFP Rule, S. 9)
  - Appropriate performance measures for the CEO and senior management
    - e.g. growth- and sales-only targets, not measured against risk taken, are dangerous
  - Appropriate reporting of business results to enable performance assessment
- Board skills and experience (FSRA SBFP Rule, S. 4)
  - Director selection, training, and support (third-party)

5. Regulatory Compliance vs Supervisory Expectations

Regulatory Compliance vs Supervisory Expectations

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Requirements for Regulatory Compliance

- Actions and measures that a credit union **must** undertake to comply with the CUCPA (the Act), FSRA Rules (e.g. SBFP Rule), and FSRA Interpretation Guidance (e.g. Residential Mortgage Lending Guidance)
- Failure to comply with the Act, FSRA Rules and Interpretation Guidance may result in elevation of the credit union's risk profile rating, higher intervention level, intensified supervisory engagement, higher deposit insurance premiums, and sanctions/monetary and administrative penalties (AMPs)

Example of Requirement resulting from a supervisory review by FSRA

- "The Board and the Audit Committee must enhance their oversight over the Internal Audit function including assessing its independence and ensuring appropriate, adequate, and comprehensive risk-based internal audit planning. (SBFP Rule Section 5, Responsibilities of the Board of the Credit Union)"

Regulatory Compliance vs Supervisory Expectations (cont'd)

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Recommendations for Meeting Supervisory Expectations

- Actions and measures a credit union is **expected** to take to be aligned with industry/sector practices and other supervisory expectations
- Not meeting supervisory expectations can impact the credit union’s risk profile rating and result in increased level of supervisory engagement. Unresolved recommendations may lead to higher intervention levels and increased deposit insurance premiums

Example of Recommendation resulting from a supervisory review by FSRA

- “The Board is expected to enhance its oversight over the Risk Management function by ensuring policies and reporting requirements are aligned with the Board’s expectations and regulatory requirements, including FSRA’s Guidance and Rules. (FSRA supervisory expectations)”

6. Recovery Planning

Recovery Planning

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- FSRA issued the final *Recovery Planning Guidance*, No. CU0069INT, effective in July 2021 after public consultation.
- The guidance is applicable to all credit unions (in 4 peer groups). Credit unions (CUs) will have a transition period to develop credible recovery plans to be submitted to FSRA by January 2023.
- CUs submitted their interim submissions in 2022 and received directional feedback from FSRA.
- The purpose of recovery planning is to **enhance crisis preparedness** and **resilience** of CUs and the sector, reducing the likelihood of failures and potential losses in the Deposit Insurance Reserve Fund (DIRF).
- **Principles** of recovery planning as outlined in the Interpretation Section of the Guidance include:

1. ***Effective Recovery Plan Development and Implementation****: The CU, through its Board and Senior Management, should create a recovery plan to prepare the CU to manage adversity.*
2. ***Transparent Governance****: The CU, through its Board and Senior Management, should evaluate risks in adverse scenarios and prepare to implement identified actions, if necessary.*
3. ***Periodic Reassessment****: The recovery plan should be periodically reassessed to ensure it is up to date with current information.*
4. ***Proportionality****: Recovery Plans should be developed based on the size, complexity, and risk profile of a CU.*

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Assessment of Recovery Planning under FSRA's RBSF Resilience Framework

- FSRA will assess resilience from a characteristic and performance perspective.
  - **Resilience characteristics** are demonstrated during a business-as-usual (BAU) environment. CU enhances its crisis preparedness through improving its ability to ***monitor*** and ***anticipate*** any escalation of risks.
  - **Resilience performance** of a CU is demonstrated based upon its ability to ***respond*** to stress after risks materialization by taking feasible and timely action, leveraging pre-determined processes under pre-established protocols to facilitate streamlined and effective recovery. FSRA will also consider the extent to which the CU ***learns*** from past failures and successes for continuous improvements towards achieving resiliency.
- **Examples of Resilience Characteristics in Recovery Planning (Monitor and Anticipate <u>during BAU)</u>:**
  - Board approved list of metrics (with key measures and associated triggers appropriately calibrated)
  - Board periodically reviewed dashboard reporting of actual results measured against the triggers identified
  - Senior Management proposed and Board approved recovery options.
  - Senior Management designed / Board approved scenarios testing the existential risks affecting CU viability
  - Periodic communication between the Board and Senior management on Recovery Planning
- **Examples of Resilience Performance in Recovery Planning (Respond and Learn <u>during Severe Stress)</u>:**
  - In the event of a crisis/materialization of a severe scenario, activation of the Recovery Plan by the Senior Management and/or the Board, based on protocol and criteria described in the Recovery Plan
  - Continuous assessment / Improved awareness of CU's recovery capacity based on lessons learned.

Applying Principle of Proportionality in FSRA's Assessment

- Board and Senior Management are required to demonstrate ownership, understanding and accountability of the Recovery Plan. Generic templates by consultants are not acceptable.
- Requirements of certain elements of the Recovery Plan are the same for CUs of all sizes. For example,
  - On **Key Measures and Triggers**, FSRA expects dashboard reporting of actual results from all CUs (can be through CU's existing or enhanced enterprise risk reporting process). Board and Senior Management are fully aware of the CU's overall health
- FSRA will apply the principle of proportionality in assessing other elements.
  - On **Recovery Options**, FSRA does not expect the same breadth and depth of recovery options (capital replenishment options, liquidity replenishment options, cost-reduction options) available to all CUs. For example, small CUs' menu of recovery options are expected to be mostly liquidity-focused. Larger CUs are expected to demonstrate their financial, operational and legal readiness on executing these options.
  - On **Scenarios**, FSRA expects 1-3 hypothetical storyline narrations based on size, complexity and risk profile of CUs with multiple events happening simultaneously threatening a CU's long-term viability. Stress events are different than scenarios.
    - For CUs> $500MM, one of the scenarios can be aligned with ICAAP's Reverse Stress Test breaching minimum regulatory capital requirements. The analysis then goes beyond ICAAP, outlining the execution of selected recovery options to restore the CU's financial health.
    - For CUs >$4 billion, analysis is expected to be the most comprehensive and granular (e.g. with detailed financial modelling and analysis)

Appendix

Open Banking

- FSRA is currently working with Fed Finance and other provincial regulators in working groups to better understand the Open Banking requirements
- We are waiting for the federal government to publish a report outlining more specific details for Canada's open banking framework, including a governance structure, to oversee accreditation and certification
- There are two levels to participation in open banking:
  - Certification is required of all entities (we think by an external party), to show that the technical infrastructure conforms to the standards of the system
  - Accreditation is required of third parties and functions like a business authorization to enter the system
- Questions
  - Should FSRA play a role in ensuring consistent accreditation criteria for all credit unions?
  - Would FSRA restrict a credit union that wanted to participate in open banking if it doesn't meet the criteria (data protection, IT infrastructure, risks management)?

Prescriptive vs Principles-based

Prescriptive	Principles-based
• "Do not drive faster than 90 km/hr."	• "Do not drive faster than is reasonable and prudent in all of the circumstances"
• The "regulator" determines whether the driver was operating the vehicle faster than 90 km/hr.	• The "regulator" investigates the range of relevant driving conditions and applies the background principle of reasonableness to the situation
• The "driver" can point to adherence to the "rule" regardless of the outcome (regulatory arbitrage)	• The "driver" determines how best to achieve the requirement of driving no faster than is reasonable and prudent in the circumstances

Recovery Plan Elements

- FSRA considers the following elements essential in a CU's recovery planning process and output (in accordance with international regulatory standards). Recovery Plans will be assessed by FSRA for Completeness, Quality, and Credibility.

A. Institutional Analysis

Describe a CU's legal, organizational and business structure, its businesses and support functions, sources of risk and profitability, and external and internal dependencies.

Identifies core businesses.

B. Key Measures and Associated Triggers*

Identify qualitative and quantitative key measures that can serve as early warning indicators (the metrics) of escalating risks.

Outline, upon any breach of the triggers, protocols to activate the recovery plan, process for escalation to Senior Management or its Board for decision-making

C. Recovery Options*

Identify a menu of recovery options to take increasingly aggressive actions in response to any deterioration of the key measures.

Describe rationale for prioritization of recovery options (e.g. based on financial conditions, time and ease of execution, and potential negative impact on confidence and/or reputation.)

Describe post-recovery conditions

D. Scenario Analysis*

Describe Reverse Stress Test Scenarios

Analyze capital and liquidity sufficiency, and overall financial health post recovery actions.

(should include one or more scenarios that focus on idiosyncratic stress, systemic stress, or blended, based on proportionality)

E. Framework and Governance

Articulate decision-making process by Senior Management if one or more triggers are breached.

Outline process for executing recovery options under Board oversight and Senior Management accountability

Establish communication plan that includes both internal and external other stakeholders

F. Information Management

Monitor and report key metrics identified in its recovery plan.

(e.g. dashboard shared with the Board and integrated with parts of the risk reporting/appetite framework.)

Identify any gaps in data, articulate challenges and implement remedial actions.

G. Implementation Plan

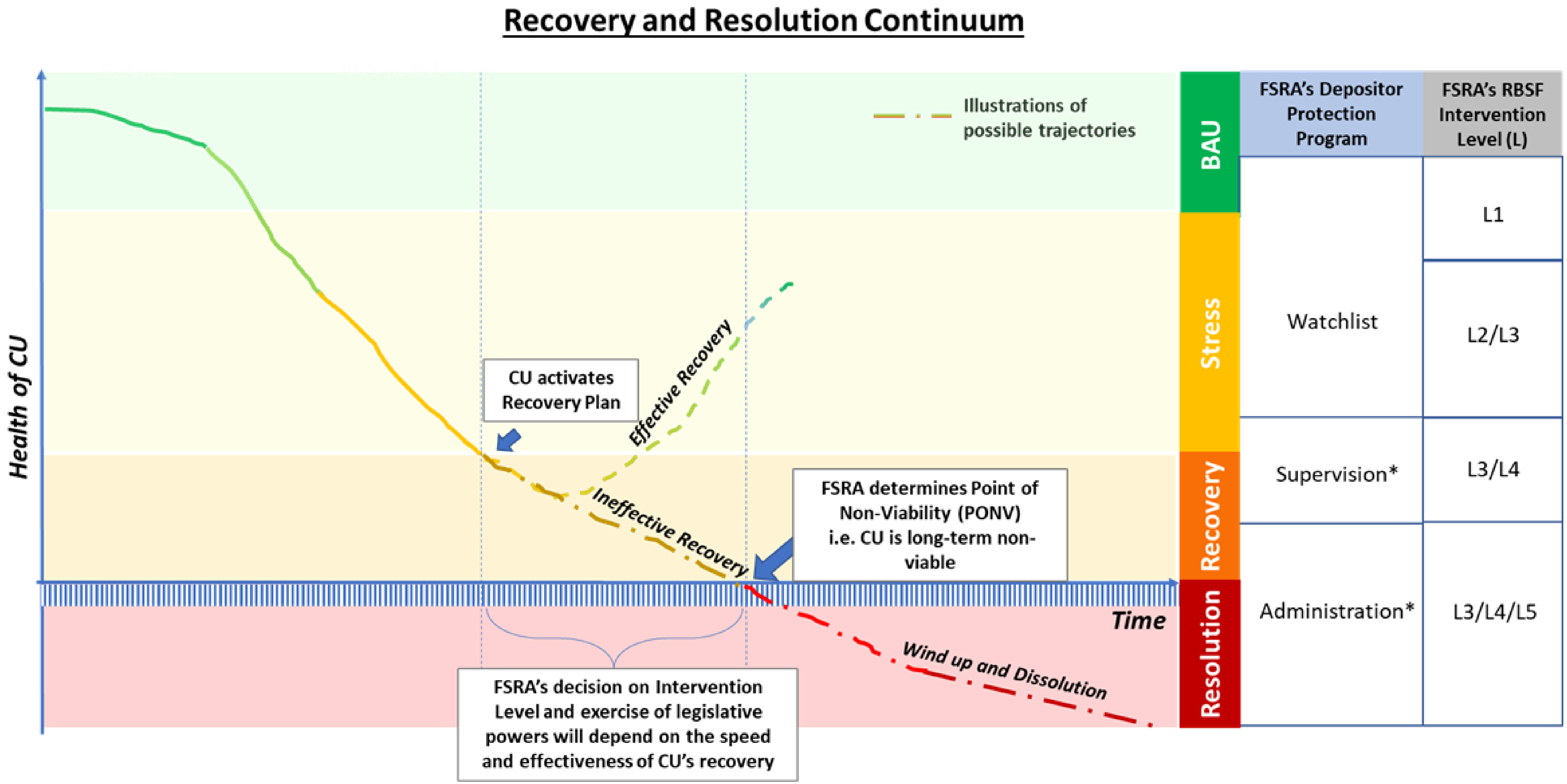
Demonstrate overlay of integration of recovery plan on other key policies, processes, and frameworks; and, when triggered takes precedence.

Address potential impediments to the successful execution of the recovery options

*Elements B, C, D are required in the Interim Submission

Note: Above is for illustrative purposes only. Please also refer to the Recovery Planning Guidance posted on the FSRA website

Mapping Recovery and Resolution to the FSRA's Powers under the Credit Union and Caisses Populaires Act (CUCPA), 2020 and RBSF Intervention Levels



*A CU can be put under Supervision or Administration for reasons other than deterioration of financial health, e.g. misconduct, fraud, negligence

Anticipated Timeline for Recovery and Resolution Plans Submissions

	Filing Group	#CUs	2022	2023	2024	2025
			J F M A M J J A S O N D	J F M A M J J A S O N D	J F M A M J J A S O N D	J F M A M J J A S O N D
Recovery Plans	CUs < $100MM	17				
	CUs $100MM-$500MM	22				
	CUs $500MM-$4BN	15				
	CUs >$4BN	6				
	All CUs	60				
Resolution Plans	CUs >$10BN	2*				
	CUs $4BN-$10BN	5*				
	CUs $1BN-$4BN	7*				

Interim Submissions   Final Submissions

* Total asset categories are determined based on total assets of the CU as reported in the consolidated audited financial statements for the first fiscal year ending after April 30, 2022