Notice relating to transitional arrangements for capital treatment for expected loss provisioning published on Mars 31, 2020

The Autorité des marchés financiers (the "AMF") notice to trust companies, savings companies and other deposit institutions, credit unions not members of a federation, member credit unions of a federation and federations of credit unions governed, respectively, by the *Trust Companies and Savings Companies Act*[1] (TCSCA, the *Act respecting financial services cooperatives*[2] (FSCA) and the *Deposit Institutions and Deposit Protection Act*[3] (DIDPA) (the "financial institutions concerned") that was issued on March 31, 2020[4] introduced a capital adjustment for expected credit loss (ECL) provisioning. This document describes the calculation of this adjustment and the related disclosure on the Basel Capital Adequacy Reporting (BCAR).

1. Regulatory capital treatment

1.1 Treatment under the Standardized Approach (SA)

Each quarter, the financial institutions concerned should compare Stage 1 and Stage 2 allowances allocated to the SA at the end of that quarter with the baseline amount of Stage 1 and Stage 2 allowances. The baseline amount is the Stage 1 and Stage 2 allowances allocated to the SA as at the quarter ending December 31, 2019 (for financial institutions with a December 31, 2019 year-end), January 31, 2020 (for financial institutions with an October 31, 2019 year-end) or January 1, 2020 (for financial institutions with a September 30, 2019 year-end).

The financial institutions concerned should multiply that increase in allowances by (100% less the institution's tax rate), and multiply the result by the scaling factor for the reporting period. The scaling factor is set at 70% in fiscal 2020, 50% in fiscal 2021 and 25% in fiscal 2022.

The resulting amount should be added to Tier 1A capital. The allowances that may be included in Tier 2 capital under the SA are the total eligible allowances as per paragraph 1 of section 2.1.2.6 of Chapter 2 of the *Ligne directrice sur les normes relatives à la suffisance du capital de base applicable aux coopératives de services financiers* (Base Capital Adequacy Guideline) applicable to financial services cooperatives (COOP GL) and section 2.1.2.6 of Chapter 2 of the *Capital Adequacy Guideline* applicable to credit unions not member of a federation, trust companies and savings companies (TCSC GL), less allowances included in Tier 1A capital under the SA.

The transitional adjustment to Tier 1A capital will be made to gross Tier 1A and therefore will affect deductions that use 10% of Tier 1A as a threshold, Total capital, and Total Loss Absorbing Capacity (TLAC).

1.2 Exposures treated under the Internal Ratings Based (IRB) approach

Each quarter, the financial institutions concerned should compare Stage 1 and Stage 2 allowances allocated to IRB portfolios at the end of that quarter with the baseline amount of

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[1] CQLR, c. C-67.3
[2] CQLR, c. S-29.02
[3] CQLR, c. I-13.2.2
[4] https://lautorite.qc.ca/fileadmin/lautorite/reglementation/assurances-inst-depot/2020/2020mars31-avis-allegement-institution-depots-fiducie-covid19-en.pdf

Stage 1 and Stage 2 allowances. The baseline amount is Stage 1 and Stage 2 allowances allocated to IRB portfolios as at the quarter ending December 31, 2019.

This increase should be multiplied by (100% less the tax rate of the financial institution concerned) and then multiplied by the scaling factor for the period considered. The scaling factor is set at 70% in fiscal 2020, 50% in fiscal 2021 and 25% in fiscal 2022. The financial institutions concerned should then take the lower of:

- this result: and
- excess allowances eligible for inclusion in Tier 2 capital;

and add this amount to Tier 1A capital. The allowances that may be included in Tier 2 capital are the total eligible allowances under the IRB approach (as per COOP GL Chapter 2, section 2.1.2.6, paragraphs 2 and 3) less allowances included in Tier 1A capital.

As noted for SA exposures, the transitional adjustment will increase Tier 1A capital, with resulting impacts to calculations based off of Tier 1A capital. In addition, allowances subject to this transitional adjustment should continue to be included in the allowances for the capital floor (COOP GL Chapter 1), as the floor adjustment for allowances does not differentiate between Tier 1A and Tier 2 capital.

2. Treatment for Basel Capital Adequacy Reporting (BCAR)

When completing the BCAR regulatory return, the financial institutions concerned must report the above-noted adjustments as follows.

2.1 Exposures treated under the SA

Step 1: Compare the Net Stage 1 and 2 allowances allocated to SA portfolios (Schedule 4 – Allowances: DPA_40005 with the same DPA reported in the baseline period (i.e., December 31, 2019).

Step 2: If the result from step 1 is positive, adjust for taxes and scale the result based on the fiscal period as follows: [increase in allowances from step 1] * [1 - tax rate] * [Scaling factor]. If the result from step 1 is negative, there is no transitional adjustment for the current period under the SA.

Step 3: Add the result from step 2 to Tier 1A capital by reporting it on Schedule 3 in the placeholder DPA_30237.

Step 4: Subtract the amount added to Tier 1A capital in step 3 from allowances eligible for inclusion in Tier 2 capital to determine SA allowances included in Tier 2 capital. As a result,, DPA_30156 (allowances included in Tier 2 capital under the SA) will equal DPA_40006 from Schedule 4 (allowances eligible for inclusion in Tier 2 capital) less any amount added to DPA_30237 in respect of SA portfolios.

2.2 Exposures treated under the IRB approach

Step 1: Compare the Net Stage 1 and Stage 2 allowance allocated to IRB portfolios on Schedule 4 – Allowances: Capital treatment in DPA_40008 with the same DPA reported in the baseline period.

Step 2: If the result from step 1 is positive, adjust the increase for taxes and scale the result based on the fiscal period according to the lower of:

- [increase in allowances from step 1] * [1 - tax rate] * [Scaling factor]; and
- the excess IRB allowances included in Tier 2 capital (DPA_30157).

Step 3: Add the result from step 2 to Tier 1A capital by including it on Schedule 3 in the placeholder DPA_30237 (adding it to allowances in Tier 1A capital for SA portfolios).

Step 4: As under the SA treatment, surplus allowances net of those included in Tier 1A capital in step 3 remain eligible for inclusion in Tier 2 capital. DPA_30157 (allowances included in Tier 2 capital under IRB) will equal DPA_40223 from Schedule 4 (excess allowances under IRB eligible for inclusion in Tier 2 capital) less any amount added to DPA_30237 in respect of IRB portfolios. Overall, [DPA_30157 + DPA_30156 + DPA_30237] will equal [DPA_40006 + DPA_40223] from Schedule 4.

Changes to validation rules

Validation rules require the placeholder DPA_30237 to be zero, and DPA_30156 and DPA_30157 in Schedule 4 will be disabled. The floor calculation on Schedule 2A – Summary Capital Floor Risk-weighted Assets is based on allowance amounts from Schedule 4, which are unaffected by this transition. Therefore, no validation rule change or adjustment to the calculation is required with respect to the risk-weighted assets floor.

3. Public disclosure

Transparency surrounding these adjustments is important. The AMF expects the financial institutions concerned to present the applied transitional arrangements for each of the Tier 1A, Tier 1, Total capital, TLAC and Leverage ratios separately, in accordance with the Pillar 3 Disclosure Requirements Guideline. Additional details on the specific disclosure requirements will be communicated at a later date, if required.

4. Illustrative examples

Example 1

A financial institution concerned at the end of the baseline period (Q4 2019) had $75 million of Stage 1 and 2 allowances allocated to its SA portfolios and included as part of its Tier 2 capital. The Stage 1 and 2 allowances allocated to its SA portfolios increase to $175 million as of Q1 2020.

The incremental $100 million is subject to this transitional adjustment. Assuming a 25% tax rate,[5] and after applying a 70% factor, $52.5 million would be included in Tier 1A capital. The balance of $47.5 million would be added to Tier 2 capital. This results in the total allowances included in Total capital in Q1 2020 of $175 million: $75 million in Tier 2 as of the baseline plus $52.5 million added to Tier 1A and $47.5 million added to Tier 2.

[5] These examples assume a 25% tax rate; however, the financial institutions concerned should apply their own marginal tax rate when performing these calculations, which should be the same tax rate as is used for the creation of deferred tax assets that relate to expected credit losses.

Example 2

A financial institution concerned at the end of the baseline period (Q4 2019) had $75 million of Stage 1 and 2 allowances allocated to its SA portfolios and included as part of its Tier 2 capital. The Stage 1 and 2 allowances allocated to its SA portfolios decrease to $50 million as of Q1 2020.

As the Stage 1 and 2 allowances allocated to SA portfolios in the reporting period have declined relative to the baseline period, no allowances will be included in Tier 1A capital in relation to the SA portfolios of the financial institution concerned.

Example 3

A financial institution concerned has $75 million of Stage 1 and 2 allowances allocated to its IRB portfolios at the end of the baseline period (Q1 2020). The financial institution reported an overall shortfall in allowances and this shortfall results in a deduction from Tier 1A capital in the baseline period. The Stage 1 and 2 allowances allocated to its IRB portfolios increase to $175 million as of Q2 2020.

If the financial institution concerned remains in an allowance shortfall position, then the incremental $100 million is not subject to the transition and no allowances will be included in Tier 1A capital in relation to the financial institution's IRB portfolios

Example 4

A financial institution concerned has $75 million of Stage 1 and 2 allowances allocated to its IRB portfolios at the end of the baseline period (Q1 2020). The financial institution reported an overall shortfall in allowances and this shortfall results in a deduction from Tier 1A capital in the baseline period. The Stage 1 and 2 allowances allocated to its IRB portfolios increase to $175 million as of Q2 2020.

If the financial institution is now in a surplus position of $150 million partially due to an increase in Stage 3 allowances, then the incremental $100 million increase in Stage 1 and 2 allowances allocated to IRB portfolios are subject to this transition. Assuming a 25% tax rate, and after applying a 70% factor, the result is $52.5 million. The lower of $52.5 million and the financial institution's surplus position is $52.5 million, which would be included in Tier 1A capital. The balance of $97.5 million would be included in Tier 2 capital (resulting in the full $150 million excess allowances being included in Total capital).

Example 5

A financial institution concerned using the IRB approach has $75 million of Stage 1 and 2 allowances allocated to its IRB portfolios at the end of the baseline period (Q1 2020). The financial institution reported an overall shortfall in allowances and this shortfall results in a deduction from Tier 1A capital in the baseline period. The Stage 1 and 2 allowances allocated to its IRB portfolios increase to $175 million as of Q2 2020.

If the financial institution is now in a surplus position of $50 million due to an increase in IRB expected loss, then the $50 million of the $100 million increase in Stage 1 and 2 allowances is subject to the transition. After adjusting the $100 million increase for tax and the 70% factor, the result is $52.5 million. The lower of $52.5 million and the allowance surplus for the quarter is $50 million. The surplus allowances are allocated to Tier 1A capital and no allowances are included in Tier 2 capital under the IRB approach (resulting in the full $50 million excess allowances being included in the financial institution's Total capital).

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April 9, 2020