



Office of the Superintendent of Financial Institutions Canada

255 Albert Street Ottawa, Canada K1A 0H2

Bureau du surintendant des institutions financières Canada

255, rue Albert Ottawa, Canada K1A 0H2

## www.osfi-bsif.gc.ca

# **Advisory**

#### Subject: 1) Moderate Step-ups in Tier 2A Capital 2) Automatic Conversion Triggers in Tier 2A-Qualifying Debentures

**Category:** Capital

Date: June 2004

This Advisory amends and clarifies OSFI's policy regarding the inclusion of moderate step-ups in Tier 2A-qualifying capital instruments and introduces an additional acceptable trigger for initiating the automatic conversion of a Tier 2A-qualifying subordinated debenture to common or perpetual preferred shares. This Advisory, which is effective immediately, is applicable to all banks, federally regulated trust and loan companies and federally incorporated life insurance companies.

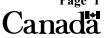
This Advisory complements the following OSFI guidance:

- Guideline A, Capital Adequacy Requirements (Banks/T&L) (CAR) •
- Guideline A, Minimum Continuing Capital and Surplus Requirements (Life) (MCCSR)
- Interim Appendix to Guideline A-2 (Banks/T&L/Life) (Interim Appendix) ٠
- May 2001 Guidance Note: (1) Tier 1 Preferred Shares Dividend Reset Features; (2) Step-ups in Tier 2B Capital (Banks/T&L/Life) (May 2001 Guidance Note)

## 1) Moderate Step-ups in Tier 2A Capital

OSFI defines a step-up as a pre-set increase at a specified future date in the dividend or distribution rate to be paid on a capital instrument. OSFI's current capital guidance permits stepups in innovative Tier 1- and Tier 2B-qualifying capital instruments, subject to conditions outlined in the Interim Appendix and the May 2001 Guidance Note, respectively.

The May 2001 Guidance Note states that preferred shares containing embedded step-ups at any level are eligible for inclusion only in Tier 2B capital. Upon further review, OSFI has determined that it would be acceptable to include in Tier 2A capital preferred shares or perpetual subordinated debentures with moderate step-ups, subject to the requirements outlined below and provided that those instruments meet all of the other conditions for Tier 2A treatment set out in CAR/MCCSR. The conditions that must be met for moderate step-ups to be included in Tier 2A-qualifying capital instruments are:



- (i) The step-up cannot result in an increase of more than 100 basis points over the initial rate.
- (ii) The step-up must be calculated using the "swap spread" methodology outlined in the Interim Appendix.
- (iii) The step-up cannot occur before 10 years from the date on which the capital is issued.
- (iv) The terms of the instrument must not provide for more than one step-up over the life of the instrument.
- (v) The step-up cannot be combined with any other feature that causes an economic incentive to redeem.

A capital instrument with a step-up feature that does not meet all of the above conditions may be eligible for Tier 2B treatment, provided it meets the step-up conditions outlined in the May 2001 Guidance Note and all other conditions for Tier 2B treatment set out in CAR/MCCSR.

OSFI reaffirms its policy that a step-up at any level and any time is not acceptable in a non-innovative (or "core") Tier 1 capital instrument.

### 2) Automatic Conversion Triggers in Tier 2A-Qualifying Debentures

To be eligible for Tier 2A capital treatment, OSFI's current capital guidance requires, among other things, that a debenture be available to participate in losses while the issuer is still a going concern. The only means of meeting this requirement permitted in OSFI's current capital guidance is for the principal amount of the debt and unpaid interest to automatically convert to common shares or perpetual preferred shares when the retained earnings of the issuer become negative.

OSFI has determined that an alternative conversion trigger may be acceptable for meeting this requirement for Tier 2A-qualifying debentures. Specifically, it may be acceptable for the principal amount of the debt, together with any unpaid interest, to be deemed for all purposes to have automatically converted to common shares or perpetual preferred shares immediately before the Superintendent takes control of the issuer or steps are initiated for the winding-up of the issuer so that the holder will no longer be a holder of Tier 2A-qualifying debentures but a holder of common or preferred shares. OSFI will consider the acceptability of this alternative conversion trigger on a case-by-case basis in the context of a debenture's other principal features.

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