Office of the Superintendent of Financial Institutions Canada
Bureau du surintendant des institutions financières Canada

255 Albert Street
Ottawa, Canada
K1A 0H2

255, rue Albert
Ottawa, Canada
K1A 0H2

Guidance Note

Subject: **Capital Instruments**
Guideline A, Capital Adequacy Requirements

Date: **June 2000**

OSFI's *Guideline A, Capital Adequacy Requirements*, sets out the primary considerations for defining the capital of an institution for purposes of measuring capital adequacy. This guidance note modifies and clarifies OSFI's position regarding the acceptability of certain features pertaining to Tier 1 preferred shares and Tier 2a hybrid instruments. It also sets out OSFI's position on including innovative instruments in Tier 2.

Early Redemption

OSFI's Capital Adequacy Requirements Guideline does not permit redemption of a Tier 1 preferred share or Tier 2a hybrid instrument within the first five years of issuance. Although OSFI continues to believe in the need to restrict redemption during the initial five years, there are certain circumstances under which we would consider redemption during this period. These circumstances are limited to:

(i) tax laws change, adversely affecting the tax advantage of the preferred shares/hybrid instrument; or
(ii) OSFI's capital adequacy rules change, such that the preferred shares/hybrid instrument could no longer be included in calculating the risk-based capital of the institution on a consolidated basis.

OSFI continues to require the Superintendent's consent for redemption at any time.

Dividend Reset

The Capital Adequacy Requirements Guideline requires Tier 1 capital to be permanent. OSFI's position is that permanence is impaired by a preferred share in which the dividend is reset periodically based, in whole or in part, on the issuer's credit rating or financial condition. In keeping with this policy, a dividend-reset mechanism that does not specify a cap, consistent with the institution's credit quality at the original date of issue, is not acceptable because it raises the possibility that the dividend would be reset based on the future credit quality of the institution. Any existing preferred shares containing such a feature and previously approved for inclusion in Tier 1 are grandfathered.

It is OSFI’s position that a dividend reset feature appearing in a directly issued Tier 1 instrument must not give rise to any level of step-up. OSFI expects institutions wishing to include a dividend reset feature in a directly issued Tier 1 instrument to demonstrate that the reset rate does not constitute a step-up, given the institution’s credit quality at the original date of issue. OSFI’s *Innovative Tier 1 Capital (July 30, 1999)* (the “Appendix”) permits a moderate step-up in the dividend rate paid to investors after 10 years. A formula appears in the Appendix for computing the maximum allowable step-up. Step-ups are only permitted in the category of innovative Tier 1 capital, which is limited to indirect issues done through a special purpose vehicle. Innovative Tier 1 capital is also subject to certain limits that are set out in the Appendix. Direct issues must continue to meet the *Capital Adequacy Requirements Guideline* without reference to the Appendix.

Innovative Instruments in Tier 2

OSFI has received enquiries about whether it would, for inclusion in Tier 2, accept instruments having attributes similar to those appearing in innovative Tier 1 capital. OSFI introduced the innovative Tier 1 guideline pursuant to the Basel Committee interpretation of November 1998, which allowed these instruments to be included in Tier 1, subject to certain conditions. However, OSFI recognizes that this form of capital is inherently riskier than traditional direct issues. This added risk is one of the reasons for placing limits on including these instruments in Tier 1. At this time, OSFI is not prepared to introduce instruments into Tier 2, that are inherently riskier and more complex as is the case with innovative Tier 1 capital. OSFI believes that further experience is needed with innovative Tier 1 capital before a similar policy could be considered for Tier 2.

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