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

Unclassified

June 18, 2007

By Mail

Ms. Karen Michell
Vice-President, Banking Operations
Canadian Bankers Association
Box 348, Commerce Court West
199 Bay Street, 30th Floor
Toronto, Ontario M5L 1G2

Re: April 2007 Draft Advisory – Innovative Tier 1

Dear Ms. Michell,

Thank you for your letter to Bob Hanna on May 28, 2007 which provided comments on the April 2007 *Draft Advisory – Innovative Tier 1 and Other Capital Clarifications*. Your letter sought further clarification with regard to the limit on the innovative overflow category and the criteria used to assess proposed instruments. Our response to these items is provided below.

Limit on Inclusion of Innovative Overflow

OSFI continues to believe that it would be inappropriate to allow unlimited inclusion of innovative instruments in Tier 2 capital. OSFI has reserved the innovative overflow category in Tier 2B for regulatory capital raised using methods which are more difficult to understand, consistent with our regulatory principle on economic consistency and transparency found in the Draft Advisory. Furthermore, this category is used for instruments that are dependant on a conversion to achieve subordination to the claims of policyholders, depositors and other senior creditors in liquidation. As such, OSFI believes that the current 5% limit imposed on the inclusion of the innovative overflow in Tier 2B is adequate and should be maintained.

With respect to combining Tier 1 and Tier 2 instruments in the overflow category, OSFI believes that combining the two types of instruments provides industry with greater flexibility relative to other more restrictive options. Given that the types of Tier 1 and Tier 2 instruments that are permitted to be included in this category are generally raised using

methods that are more difficult to understand and/or are dependant on a conversion to achieve subordination in liquidation (e.g., RBC's Trust Subordinated Notes issue in April 2007), OSFI believes that it is logically consistent to combine both types of instruments in the overflow category.

Ability to Conserve Resources

Clarification was sought on one of the criteria used by OSFI to assess a proposed instrument, specifically: "[f]or preferred shares in Tier 1, a non-declaration of a dividend shall not trigger restrictions on the issuer other than the need to seek approval of the holders of the preferred shares before paying dividends on other shares or before retiring other shares."

In respect of the above criteria, OSFI interprets "issuer" to mean the issuing financial institution, and in certain cases, also its parent. This interpretation generally applies in the traditional case of a direct issuance and also in the case of an indirect issuance via a trust or other special-purpose vehicle (SPV). In the latter case, restrictions respecting dividends on, and the retirement of, the issuing trust's or SPV's other shares will not necessarily be permitted and will instead be assessed by OSFI, on a case-by-case basis, in the context of its review of the overall structure. OSFI does not believe it is necessary to revise the language in the Advisory to reflect this interpretation.

Additionally, the last sentence in this section will not be revised to specifically reference only debt service obligations as Tier 2A-eligible instruments must allow either debt service obligations (in the case of 99-year debentures) or dividend payments (in the case of cumulative, perpetual preferred shares) to be deferred where the profitability of the institution would not support payment.

Appendix B – Preferred Shares Issued by a REIT

For clarification purposes, OSFI will revise the second paragraph of the question related to deferability in Appendix B to read:

> To address this issue, an option was developed to utilize a "consent dividend" to pay dividends for tax purposes to the REIT's controlling shareholder (ultimately the foreign bank) without requiring the payment of a dividend to the preferred shareholders. The dividend is then considered reinvested in the REIT, increasing the controlling shareholder's equity investment in the REIT. This "consent dividend" addressed the aforementioned regulatory concern.

We anticipate publicly issuing a final Advisory in the near future, which will incorporate the additional point of clarification in Appendix B as discussed above. In the meantime, if you or your members have any further questions, please feel free to contact me at (613) 990-8081.

Sincerely,

Gilbert Ménard
Managing Director, Capital Division