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Guidance Note

Subject: **1) Tier 1 Preferred Shares – Dividend Reset Features**
2) Step-ups in Tier 2B Capital

Guideline A, Capital Adequacy Requirements (Banks/T&L)
Guideline A, Minimum Continuing Capital and Surplus Requirements (Life)

Date: **May 2001**

It has come to OSFI's attention that preferred shares with dividends that are fixed for a period of time and then shift to a floating rate ("Fixed-Floaters") may contain embedded step-ups. This guidance note reiterates OSFI's position concerning the use of step-ups in tier 1 preferred shares and clarifies our position regarding the methodology to be used in determining the existence of a step-up. Further, it clarifies OSFI's policy regarding the inclusion of instruments with a step-up in tier 2B capital. This guidance note applies to all banks, federally regulated trust and loan companies and federally regulated life insurance companies (FRFIs). The guidance is effective immediately.

1) Tier 1 Preferred Shares – Dividend Reset Features

OSFI must be satisfied that dividend reset features do not impair permanence of the shares. Permanence is impaired when there are features that create an incentive to redeem. OSFI believes a dividend reset feature that results in a step-up from the initial rate signals intent to redeem. Accordingly, OSFI's policy has been - and continues to be - that step-ups, at any level and any time, are not acceptable in a tier 1 preferred share instrument. OSFI's Guidance Note of June 2000 reaffirmed this policy and requires applicants to demonstrate that a proposed dividend reset feature does not give rise to a step-up of any amount.

It has come to OSFI's attention that some Fixed-Floaters may contain embedded step-ups. Fixed-Floaters that are determined to contain a step-up will be subject to the specific treatment that is established by OSFI with the issuing FRFI.

For purposes of determining the existence of a step-up, international standards employ the "swap spread" methodology outlined in OSFI's *Draft Appendix on Innovative Tier 1 Capital (December 2000)* (or subsequent versions). In situations where the index that is the basis for the reset rate differs from that of the initial rate, this methodology uses the public swap markets to enable a comparison of the two rates. FRFIs wishing to include a dividend reset mechanism in a preferred share instrument must demonstrate, using the swap spread methodology, that no embedded step-up exists. However, for this analysis to be conclusive, a public swap market should exist between the two reference rates. Without such a market, it will be difficult for a FRFI objectively to demonstrate to OSFI's satisfaction that no step-up exists. In these circumstances, OSFI believes that only a public swap market between the two reference rates contained in the instrument provides certainty as to the intent of the dividend reset mechanism.

The only capital instruments that could qualify as tier 1 capital and contain a step-up feature are instruments that meet the requirements of current or prospective rules for innovative instruments.[1] In those limited circumstances, the instrument may have a step-up only after 10 years.

2) Step-ups in Tier 2B Capital

Future issues of preferred shares containing embedded step-ups at any level will be considered for inclusion only in tier 2B capital. Future issues of preferred shares or subordinated debt with embedded step-ups will be eligible for inclusion in tier 2B capital, subject to the following requirements (and subject to meeting all other requirements of tier 2B capital set out in CAR/MCCSR):

1. The step-up must be calculated using the “swap spread” methodology.

2. The step-up cannot be combined with any other feature that causes an economic incentive to redeem.

3. The terms of the instrument must not provide for more than one step-up over the life of the instrument.

4. The instrument must not have a step-up of any amount in the first five years.

5. Capital instruments with step-ups greater than 100 basis points will be treated for amortization purposes as term debt that matures at the date the step-up comes into effect.

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[1] Moderate step-ups are permitted in instruments qualifying as “innovative Tier 1” capital pursuant to OSFI's *Draft Appendix on Innovative Tier 1 Capital (December 2000)* (or subsequent versions).