Unclassified

February 20, 2007

By Mail

Ms. Karen Michell
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Re: Draft Advisory on Transition for Certain Definition of Capital Changes in Basel II

Dear Ms. Michell:

Thank you for your letter dated December 1, 2006 which provided comments on OSFI's draft Advisory on Transition for Certain Definition of Capital Elements of Basel II. Your letter sought further clarification on certain aspects of the proposed transition measures and on how these changes would be implemented going forward. Our response to these items is provided below.

Parallel Reporting

OSFI expects that institutions will report the transitional deductions related to investments in insurance subsidiaries and substantial investments during the parallel reporting period, beginning with the Q1-2007 BCAR filing. OSFI has committed to withholding revisions to the BCAR return until the parallel reporting period concludes. As a result, existing data points will be used to capture adjustments for the transitional deductions. OSFI does not intend to provide an updated BCAR template or instruction guide reflecting these changes in the interim.

While the transition measures are in effect, and during the parallel reporting period, institutions are expected to continue to report deductions related to investments in insurance subsidiaries and substantial investments as "50/50" deductions on Schedule 3, Part C. The transitional measures are to be reflected in Schedule 3, Part A as adjustments that transfer all or part of the Tier 1 deduction to a Tier 2 deduction. OSFI's transitional treatment of goodwill and other intangible assets related to subsidiaries deconsolidated for regulatory capital purposes is described below.

For Tier 1 capital, the line item called 'Back-to-back inter-institutional placements of new Tier 1 capital issues' (data point identifier #1540)[1] will be used to capture the aforementioned adjustment. Institutions are expected to include on this line an offsetting negative deduction equal to 50% of the total investment(s) captured by the transition measures. This will ensure that transitional deductions are not taken from Tier 1 capital. For clarification, a numerical example is presented below.

For Tier 2 capital, the line item called 'Back-to-back inter-institutional placements of new Tier 2 capital issues' (data point identifier #1567)[1] will be used to capture the adjustment. Institutions are expected to include a deduction equal to 50% of the total investment(s) captured by the transition measures. This acts to ensure that all of the deductions related to investments captured under the transition measures are taken from Tier 2 capital.

For example, Bank A has $800 million of total deductions eligible for 50/50 treatment from Tier 1 and Tier 2 capital where $300 million of this total is related to investments in deconsolidated subsidiaries, which are subject to the transition measures. In the calculation of Adjusted Net Tier 1 Capital on Schedule 3, Part A, the bank would report a value of $400 million under '50/50 deduction from each of Tier 1 and Tier 2' (data identifier #1541). To adjust for the impact of the transition measures, Bank A would include an offsetting value of ($150) million (i.e. negative) as part of the value reported under 'Back-to-back inter-institutional placements of new Tier 1 capital issues' (data identifier #1540).

Similarly, in the calculation of Adjusted Tier 2 Capital, Bank A would report a value of $400 million under '50/50 deduction from each of Tier 1 and Tier 2' (data identifier #1568). To adjust for the impact of the transition measures, Bank A would report $150 million as part of the value reported under 'Back-to-back inter-institutional placements of new Tier 2 capital issues' (data identifier #1567).

Investment in Insurance Subsidiaries

Increases in the investment value of insurance subsidiaries (accounted for under the equity method of accounting) that arise from equity pick-up of earnings on existing capital investments held prior to January 1, 2007 will be treated as a deduction from Tier 2 capital under the transition measures. However, increases in the investment value of insurance subsidiaries that arise from new capital investments on or after January 1, 2007 will not be treated as a deduction from Tier 2 capital under the transition measures and, as such, will be subject to the application of the 50% from Tier 1 capital and 50% from Tier 2 capital deduction upon implementation of Basel II.

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1 After the parallel run period, OSFI will change this line item on BCAR to read 'Other deductions from Tier 1 capital', which will include deductions related to back-to-back inter-institutional placements of new Tier 1 capital issues, adjustments related to deductions captured under the transition measures and excess Tier 2 deductions.

2 After the parallel run period, OSFI will change this line item on BCAR to read 'Other deductions from Tier 2 capital', which will include deductions related to back-to-back inter-institutional placements of new Tier 2 capital issues and adjustments related to deductions captured under the transition measures.

With respect to international competitiveness issues, OSFI agrees that such issues should be considered when implementing these transition measures. Thus, OSFI's transitional treatment of deductions of goodwill and other intangible assets related to investments in insurance subsidiaries will follow the same approach as that undertaken by the Financial Services Authority in the United Kingdom. Specifically, goodwill and other intangible assets related to investments in insurance subsidiaries should be deducted from gross Tier 1 capital upon implementation of Basel II; however, only the remaining investment in insurance subsidiaries held prior to January 1, 2007 will be captured by the transition measure delaying the application of the "50/50" deduction to fiscal year 2012.

Further to the example presented in your December 1, 2006 letter, under Basel I, Bank A may currently deduct $1 billion for insurance subsidiaries from total capital and this figure may include $200 million of imputed goodwill and other intangibles. Under the current Basel II rules, Bank A would deduct the goodwill and other intangibles component (i.e., $200 million) from Tier 1 capital, and deduct 50% of the remaining $800 million from Tier 1 capital and 50% from Tier 2 capital. Alternatively, under the transition measure, Bank A would still deduct the goodwill and other intangibles component (i.e., $200 million) from Tier 1 capital; however, the Bank would deduct the remaining $800 million from Tier 2 capital.

Significant Investments in Other Entities That Are Not Consolidated ("Substantial Investment")

With respect to increases in the investment value of substantial investments held prior to 2007, OSFI will permit institutions to use the balance sheet carrying value of the substantial investment as at the reporting date to determine the deduction from Tier 2 capital during the transition period. For increases in the carrying value of substantial investments accounted for using the equity method of accounting that result from equity pick-up of earnings, OSFI will permit institutions to use the balance sheet carrying value of the substantial investment as at the reporting date to determine the deduction from Tier 2 capital during the transition period.

Increases in the investment value of substantial investments that arise from new capital investments on or after January 1, 2007 will not be treated as a deduction from Tier 2 capital during the transition period and, as such, will be subject to the application of the 50% from Tier 1 capital and 50% from Tier 2 capital deduction upon implementation of Basel II.

If an institution, via new capital investments made on or after January 1, 2007, gains control (i.e., more than 50% of voting interest) of an entity in which it held a substantial investment prior to 2007, OSFI expects that the institution would treat the entity as a subsidiary and would consolidate it into the institution's capital calculations. Accordingly, the investment would no longer be eligible for the any transitional treatment.

Investments Denominated in Foreign Currencies

The impact of the transition measures for investments in insurance subsidiaries and substantial investments in other entities that are not consolidated apply to investments denominated in foreign currencies. It is OSFI's expectation that institutions reporting such investments will use the CAD equivalent as at the reporting date to determine the deduction from capital. As such, the reference in the draft Advisory to investments held prior to January 1, 2007 does not refer to the specific CAD amount on the banks' books as of that date.

Excess Tier 2 Deductions

OSFI confirms that where deductions from Tier 2 capital exceed the amount of Tier 2 capital, institutions will have to deduct the excess from Tier 1 capital. The application of this requirement can be treated in aggregate for cases of deductions related to investments in insurance subsidiaries and other substantial investments.

In instances where the deduction from Tier 2 capital exceeds the amount of Tier 2 capital, the excess should be deducted from the Net Tier 1 Capital sub-total on BCAR. As it is not OSFI's intention to provide an updated BCAR template or instruction guide reflecting this change until after the parallel reporting period concludes, it is expected that, in the interim, institutions will include transitional excess Tier 2 deductions in the calculation of the value presented on the line 'Back-to-back inter-institutional placements of new Tier 1 capital issues' (data point identifier #1540) found on Schedule 3, Part A, as per the Parallel Reporting section above.

We anticipate publicly issuing a final Advisory in the near future, which will set out the transition measures and incorporate some additional points of clarification noted above. In the meantime, if you or your members have further questions, please do not hesitate to contact me at (613) 990-8081.

Sincerely,

Gilbert Ménard
Director, Capital Division