Advisory

Category: Capital **NOTICE***

Subject: Innovative Tier 1 and Other Capital Clarifications – Revised Version

Date: June 2007

This Advisory, which applies to federally regulated entities (FREs)[1], replaces the previous Advisory "*Innovative Tier 1 and Other Capital Clarifications – Revised Version, December 2006"* and complements the following OSFI guidance:

- Guideline A, Capital Adequacy Requirements (CAR) Banks/T&L
- Guideline A, Minimum Continuing Capital and Surplus Requirements (MCCSR) Life
- The Capital Regime for Regulated Insurance Holding Companies and Non-operating life Companies
- Interim Appendix to Guideline A-2 (Banks/T&L/Life)
- July 2003 Advisory: Innovative Tier 1 Instruments and Accounting Guideline 15 (AcG 15)
- February 2004 Advisory: Section 3860 of the CICA Handbook and the Regulatory Capital Treatment of Preferred Shares and Innovative Tier 1 Instruments

Statement of Regulatory Principles

This Advisory builds upon the following:

Reliance on Generally Accepted Accounting Principles (GAAP): Unless specific exceptions are provided, the assessment of capital instrument eligibility for FREs takes into account the instrument's treatment under GAAP.

[1] In this Advisory, the term FRE refers to bank holding companies, banks, federally regulated trust and loan companies, federally incorporated or regulated life insurance companies and insurance holding companies. The Advisory does not, however, apply to property and casualty insurance companies.

Consolidation: The capital rules are applied to each FRE on a consolidated basis. More specifically, unless specific exemptions are provided in this Advisory, to be included in regulatory capital of a FRE, capital instruments must be issued by the FRE or by a subsidiary of the FRE that is consolidated with the FRE under GAAP.

Economic Consistency and Transparency: For purposes of determining if an instrument qualifies as regulatory capital, it is critical that the rights and interests of independent investors be - and remain - consistent with the rights and obligations of the FRE. Furthermore, the methods used to transfer or convey these rights, interests, and obligations must be transparent and well-understood by investors and the regulatory supervisor(s). Regulatory capital raised using methods which are more difficult to understand, will generally be limited to the Innovative Tier 1 or Innovative Overflow categories as described in this Advisory. Instruments and structures that are unclear will not qualify as capital for regulatory purposes.

Definitions

For the purposes of this Advisory, the terms "Financing Entity" and "Non-Consolidated Financing Entity" are defined as follows:

Financing Entity: A Financing Entity is an entity controlled[2] by a FRE, the business of which shall be raising subordinated debt capital and other financing for the FRE or its subsidiaries. The term Financing Entity includes any entity wholly owned, directly or indirectly, by such an entity.

Non-Consolidated Financing Entity: A Non-Consolidated Financing Entity is a Financing Entity that does external financing and does not consolidate with the FRE due to AcG 15.

1. Innovative Tier 1 Instruments, Tier 2 Capital Instruments and AcG 15

The *Interim Appendix to Guideline A-2 (Banks/T&L/Life), "Principles Governing Inclusion of Innovative Instruments in Tier 1 Capital",* requires, among other things, that a Special Purpose Vehicle (SPV) issuing innovative instruments be consolidated with the FRE in order for those instruments to be recognized as Tier 1 capital of the FRE.

The CAR and the MCCSR provide that subordinated debt issued to independent investors by subsidiaries will be included in the capital of the FRE, on consolidation, provided the instruments meet the criteria applicable to the capital category and the instruments do not rank equally or ahead of the claims of policyholders, depositors and other senior creditors of the FRE due to a parent guarantee or any other contractual means.

The adoption and current interpretation of the Accounting Standards Board's Accounting Guideline 15 (AcG 15) results in Canadian "loan-based" innovative Tier 1 SPVs no longer being consolidated with the sponsoring FRE that owns the common securities and the interpretation also results in certain Financing Entities used by FREs to issue Tier 2 capital instruments no longer being consolidated with the FRE.

[2] For greater certainty, controlled for this purpose means ownership of all the voting securities in a body corporate or being the general partner of a limited partnership.

OSFI has determined that:

- For "loan-based" innovative Tier 1 instruments, the SPV will no longer be required to be consolidated as a precondition for the public issue to be treated as innovative Tier 1 capital of the FRE.

- Within the limits described in Section 4 of this Advisory, subordinated debt issued by Non-Consolidated Financing Entities of FREs on or after December 1, 2006 may count as Tier 2B capital of the FRE provided the conditions set out in Section 5 of this Advisory are met.

- Subordinated debt and similar instruments issued by Non-Consolidated Financing Entities of FREs prior to December 1, 2006 will be counted in the regulatory capital of the FRE until July 31, 2007 and will not be subject to the limitations described in Section 4 of this Advisory, provided the instruments meet all the criteria applicable to that regulatory capital category. After July 31, 2007, these instruments will be counted in the regulatory capital of the FRE only if the conditions set out in Section 5 of this Advisory are met and only within the limits set out in Section 4 of this Advisory.

The fundamental principle that the FRE must own and control the SPV will continue to be required. Specifically, to meet this principle going-forward, the FRE must, at all times, have clear ownership and control (both legal and *de facto*) of the SPV. The FRE must directly hold, at all times, all of the voting securities of the SPV in the case of Canadian-style innovative Tier 1 instruments. Tier 2B Non-Consolidated Financing Entities will be subject to similar expectations.

2. Public Disclosure of the Main Features of Regulatory Capital Instruments

The adequacy of disclosure of regulatory capital is essential, particularly when a security issued by an SPV that is not consolidated by the FRE is to be included in regulatory capital.

Principle #9(b) under the *Interim Appendix to Guideline A-2 (Banks/T&L/Life), "Principles Governing Inclusion of Innovative Instruments in Tier 1 Capital"* states that "the main features of innovative instruments, including those features designed to achieve Tier 1 capital status (for example, the triggers and mechanisms used to achieve loss absorption), must be publicly disclosed in the FRE's annual report to shareholders."

This disclosure requirement is even more important now that capital will include innovative Tier 1 capital instruments that do not appear on the FRE's balance sheet. In future, regulatory approvals for the issuance of loan-based innovative Tier 1 instruments will be conditional on acceptable plans for adequate disclosure of the main regulatory capital features of these instruments in the annual report to shareholders.

3. Exclusion of "Soft-Retractable" Securities in the Innovative Tier 1 Category

OSFI would like to confirm that it will not permit, in the innovative Tier 1 category, new issues of "soft-retractable" securities (i.e., securities which, at the option of the holder, convert at a later date, directly or indirectly via intermediate securities, into other securities the number of which is based wholly or partially on the then prevailing credit-worthiness of the FRE).

However, a moderate step-up in innovative Tier 1 instruments continues to be permitted if it occurs at least 10 years after the date of the issue.

4. Tier 1-qualifying Innovative Instruments and Certain Capital Instruments Issued by Non-Consolidated Financing Entities Eligible for Limited Inclusion in Tier 2B

The maximum amount of innovative instruments that a FRE can have outstanding is being increased to 20% of net Tier 1 capital. A maximum of 15% of net Tier 1 can be included in the innovative Tier 1 category with the balance, a maximum of 5% of net Tier 1 eligible for inclusion in Tier 2B. Any portion of the innovative Tier 1 instruments permissible within Tier 2B can thereafter be transferred to the innovative Tier 1 category as room becomes available.

In addition, and without limiting the application of the preceding paragraph, subordinated debt issued by Non-Consolidated Financing Entities will be eligible for inclusion in Tier 2B capital provided the conditions set out in Section 5 of this Advisory are met. The sum of this subordinated debt and innovative Tier 1 instruments included in Tier 2B capital of the FRE must not exceed the greater of 5% of net Tier 1 of the FRE or the dollar amount obtained when the 5% limit is calculated at its ultimate controlling FRE (the "innovative overflow"). Any portion of the "innovative overflow" composed of subordinated debt issued by Non-Consolidated Financing Entities permissible within Tier 2B cannot, at any time, be transferred to the innovative Tier 1 category.

Tier 2B capital in aggregate will continue to be limited to 50% of net Tier 1 capital. OSFI's Interim Appendix to Guideline A-2 (Banks/T&L/Life) states that "[a] strongly capitalized FRE should not have innovative instruments and perpetual non-cumulative preferred shares that, in aggregate, exceed 25% of its net Tier 1 capital." FREs need not include the amounts of innovative Tier 1 instruments that are included in Tier 2B, in the calculation of the 25% limitation on preferred shares and innovative instruments in Tier 1.

If, at any time after issuance, a FRE's ratio of innovative instruments (included in a FRE's innovative Tier 1 category) to net Tier 1 capital exceeds 15%, and/or if the "innovative overflow" exceeds the allowable level as described above, the FRE must immediately notify OSFI. The FRE must also provide a plan, acceptable to OSFI, showing how the FRE proposes to eliminate the excess (or excesses if it breaches both limits) as soon as possible. A FRE will generally be permitted to continue to include such excess(es) in the respective category(ies) until such time as the excess(es) is (are) eliminated in accordance with its plan.

Only those excesses arising after issuance and as a result of operating losses and/or the payment of normal dividends will normally be eligible for continued inclusion in the respective categories. However, an excess resulting from (1) common share repurchases or (2) common share repurchases and losses within the same fiscal quarter would not qualify for continued inclusion in capital.

A FRE's fiscal quarter-end will be the relevant date for the purpose of determining the maximum issuing capacity or monitoring the existence of excesses in the innovative or innovative overflow categories.

The above treatment of excesses, taking into consideration this guidance on Tier 1-qualifying innovative instruments and certain capital instruments issued by Non-Consolidated Financing Entities eligible for limited inclusion in Tier 2B, remains consistent with the April 2003 Capital Advisory, "Tier 1 Capital Clarifications", and the Interim Appendix to Guideline A-2 for (Banks/T&L/Life).

5. Non-Consolidated Financing Entities (Tier 2B)

Subordinated debt issued by a Non-Consolidated Financing Entity may be included in the Tier 2B capital of a FRE subject to the limitations set out in Section 4 of this Advisory, provided that the FRE has sought and obtained from OSFI a capital quality confirmation and that, at a minimum, the following conditions are met at inception and on an ongoing basis.

1. The ultimate controlling FRE must at all times have legal and *de facto* control of the Non-Consolidated Financing Entity.

2. The terms and conditions of the instrument issued by the Non-Consolidated Financing Entity to the independent investors must meet the requirements for Tier 2B capital.

3. The external financing must achieve, through conversion or other means, a priority after the claims of the policyholders, depositors and other senior creditors of the FRE, or of a regulated financial institution subsidiary of the FRE, in liquidation.

   The inter-company securities must have a term to maturity that is at least as long as the term to maturity of the subordinated debt issued to independent investors.

4. Any other capital of the Financing Entity must be invested in accordance with paragraph 3 above.

5. The FRE must provide OSFI with an external legal opinion at the time of issuance confirming that in an insolvency, the claims of the external investors will be no more favorable than if the FRE or the relevant regulated financial institution subsidiary had issued the instruments directly to the external investors and that the claims of the external investors will be, in all cases, subordinated to the rights of depositors, policyholders and other senior creditors of the FRE or of the regulated financial institution subsidiary in which the proceeds are ultimately invested.

6. The public disclosure to the external investors in the Financing Entity must clearly indicate that the funds are being used as capital for regulated entities and, that in an insolvency, the claims of the external investors are intended to be no more favorable than if the FRE or the relevant regulated financial institution subsidiary had issued the instruments directly to the investors and that the claims of the external investors will be, in all cases, subordinated to the rights of depositors, policyholders and other senior creditors of the FRE or the relevant regulated financial institution subsidiary.

7. The notes to the consolidated financial statements of the FRE must include a description of the Financing Entity, including its material contractual arrangements with third parties as well as relevant affiliates, and a description of the instruments issued by the Financing Entity to independent investors. It must be made clear that the instrument appearing on the balance sheet of the FRE, taking into account the overall financing structure, is economically subordinated to the claims of the policyholders, depositors and other senior creditors of the FRE, or of a regulated financial institution subsidiary of the FRE, in liquidation.

8. The subordinated debt issued to the independent investors must not contain mechanisms for acceleration nor cross-default provisions to other instruments, whether issued by the Financing Entity or other affiliated entities.

9. The Financing Entity must not provide security to the independent investors of the subordinated debt qualifying as Tier 2B capital (however, the holders of the subordinated debt may have the benefit of a subordinated guarantee from a controlling shareholder which is a FRE).

10. The Financing Entity or other non-operating subsidiaries involved in the transfer of the funds from the issue to external investors to the operating company must not hold significant assets that would result in the over collateralization or protection of the holders of subordinated debt from loss. These entities will be permitted to maintain liquid assets to facilitate payment of normal expenses including interest in the process of payment. Where acceptable conversion or exchange features are incorporated into an acceptable financing structure, the limits set out in 2(a) of the Interim Appendix to Guideline A-2 apply.

11. All other requirements referred in the MCCSR and the CAR must continue to be satisfied.

6. Consolidated Regulatory Treatment of Certain Instruments Issued by Foreign Banking or Insurance Subsidiaries

OSFI will consider for recognition in consolidated regulatory capital certain instruments issued by a foreign regulated banking or insurance entity, that are accorded capital treatment by a recognized foreign regulator (when the foreign entity has or is issuing these instruments to support its own business activities). Where such instruments do not explicitly meet all of OSFI's capital rules for a category of capital that appears equivalent to its foreign regulatory treatment,

FREs interested in recognizing these instruments in consolidated capital should seek OSFI's prior approval.

In order for OSFI to allow the instrument to be recognized in consolidated regulatory capital at an equivalent level of capital quality, the proposed instrument should meet the substance of OSFI's capital rules. The detailed criteria upon which OSFI will assess the instrument are provided below. If these criteria are not all and/or fully met, OSFI will still consider the instrument for consolidated treatment. Ultimately, however, OSFI may not afford the instrument an equivalent level of capital quality or may not accept the instrument as regulatory capital.

Appendix A describes a particular situation related to trust preferred securities issued by an intermediate holding company that OSFI has reviewed and accepted as capital. Limitations set out in Section 4 of this Advisory are generally not expected to apply in such cases.

Appendix B presents an example of the considerations used by OSFI to assess the treatment of REIT preferred shares issued by a wholly-owned subsidiary of a foreign regulated bank that were considered for recognition in the consolidated regulatory capital of a Canadian FRE.

Considerations

Unless otherwise clarified below, OSFI will assess the proposed instrument based on the following criteria, each of which is discussed in greater detail in Guideline A, Capital Adequacy Requirements, Chapter 2 and Appendix 2-I; or Guideline A, Minimum Continuing Capital and Surplus Requirements, Chapter 2 and Appendix 2-A-1.

Permanence

Tier 1 instruments are intended to be permanent and Tier 2A instruments are intended to be essentially permanent in nature.

Capacity to Absorb Losses on an Ongoing Basis

Tier 1 and Tier 2A capital instruments must enable the FRE to absorb losses without triggering the cessation of ongoing operations or the start of insolvency proceedings.

Capacity to Absorb Losses in Liquidation

All capital instruments must be subordinated to policyholders/depositors and other (non-subordinated) creditors of the institution that issues the instrument.

Ability to Conserve Resources

Tier 1 eligible instruments must allow the FRE to have full discretion over the amount and timing of distributions. Rights to receive distributions must clearly be non-cumulative and must not provide for compensation in lieu of undeclared distributions. The FRE must have full access to undeclared payments.

For 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.

Tier 2A eligible instruments must allow service obligations to be deferred where the profitability of the institution would not support payment.

Consolidation

OSFI's capital rules are applied to each FRE on a consolidated basis, consistent with the aforementioned regulatory principle on consolidation.

Economic Consistency and Transparency

For purposes of determining if an instrument qualifies as consolidated regulatory capital, the instrument will also be assessed against the regulatory principle of economic consistency and transparency described above.

7. "Make-whole" Provisions in Tier 2 Capital

A FRE has recently approached OSFI regarding the inclusion of a "make-whole" provision in the terms and conditions of a Tier 2-qualifying instrument issued into a foreign market. The provision states that, if tax laws change such that the FRE is required to withhold or account for any present or future tax, assessment or governmental charge by any Canadian tax authority, the FRE will pay noteholders an additional amount needed so that the net amount received by the noteholders, after such a withholding, will equal the amount that would have been received had no such withholding been required.

OSFI has assessed this provision and determined that it will permit such "make-whole" provisions in Tier 2 capital.

8. Tier 2A-Qualifying Debentures and Events of Default Occurring Only After Conversion to Shares

Guideline A, CAR and MCCSR state that "Tier 2 capital instruments must not contain restrictive covenants or default clauses that would allow the holder to trigger acceleration of repayment in circumstances other than the insolvency, bankruptcy or winding-up of the issuer."

The June 2004 Advisory *1) Moderate Step-ups in Tier 2A Capital, 2) Automatic Conversion Triggers in Tier 2A-Qualifying Debentures*, in reference to a Tier 2A-qualifying debenture states that "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."

In the case of such a debenture, OSFI has determined that an event of default other than the insolvency, bankruptcy, or winding-up of the issuer, may be permissible if that event of default can only occur after the event that triggered a deemed conversion to shares has taken place. OSFI is of the view that such events of default would not impair the Tier 2A instrument's ability to absorb losses while the issuer remains a going-concern.

Appendix A

Trust Preferred Securities Issued by an Intermediate Holding Company

Situation: A junior subordinated debt instrument was issued by a consolidated U.S. bank holding company to a special purpose trust and the special purpose trust issued corresponding trust preferred securities to the public. This structure qualified as the equivalent of Tier 1 innovative capital under a recognized foreign regulator's (the U.S. Federal Reserve Board) capital rules for the holding company.

Question: Can the issue be included in the FRE's consolidated Tier 2B capital?

In its evaluation, OSFI considered the inter-company subordinated instrument and the related trust preferred security. Generally, OSFI reviews all aspects of a capital transaction including the public and inter-company components. In particular, the features of the inter-company junior subordinated instrument as well as the trust preferred securities were examined to assess how the Canadian bank could reflect this issue in regulatory capital. On balance, OSFI agreed that the structure of the trust preferred issue and inter-company subordinated loan, could qualify as part of consolidated regulatory capital.

In reviewing the foreign subordinated debt instruments that exist within Innovative structures, OSFI noted that holders could trigger acceleration of repayment in some circumstances but only after a five-year interest deferral period. Also, the 30-year term of the junior subordinated debenture is significantly longer than the minimum five-year term requirement for Tier 2B.

Decision

When considering these facts, OSFI concluded that it was prepared to accept the inter-company junior subordinated debt instrument as Tier 2B capital quality subject to the trust preferred security obtaining Tier 1 recognition in the U.S.

The amount of the junior subordinated debenture generally exceeds the amount of trust preferred securities issued by the amount of the holding company's common equity investment in the related trust. Therefore, only the net amount of junior subordinated debt will be included in Tier 2B, that is, the amount of junior subordinated debt issued less the equity contribution.

Appendix B

Preferred Shares Issued by a REIT

Situation: A real estate investment trust (REIT) issued non-cumulative preferred shares. The REIT is a wholly-owned consolidated subsidiary of a U.S. bank holding company. The holding company is a subsidiary of a Canadian bank. This structure qualified as the equivalent of innovative Tier 1 capital under two recognized foreign regulators' capital rules – the Federal Reserve Board and the Office of the Comptroller of Currency.

Question: Does the FRE's REIT preferred instrument sufficiently meet the deferability requirements in order to be permitted in innovative Tier 1 capital?

Under U.S. REIT tax laws, the REIT must annually distribute 90% of its income for a taxable year to shareholders to preserve its REIT tax status. Thus there may be an incentive to distribute the REIT's income in order to preserve its tax status, compromising the foreign bank's discretion to defer REIT dividend payments.

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.

Question: Does the FRE's REIT preferred instrument meet the requirement that the foreign bank must have full access to undeclared REIT dividends?

The FRE's proposal included, for the benefit of REIT preferred investors, only a clause whereby if the REIT does not declare a dividend on its preferred shares, the foreign bank will not declare on its common or preferred dividends. With respect to domestic innovative issuances, OSFI has required, and will continue to require, that a clause be included whereby if the operating company does not declare a dividend on its other preferred shares, then the yield on the trust security cannot be declared.

To date, U.S. Supervisors have not required such a clause in U.S. REIT preferred issuances nor have they required that the bank have immediate access to undeclared REIT dividends. Somewhat offsetting OSFI's concerns regarding the foreign bank's discretion over REIT distributions and its access to undeclared payments are the U.S. supervisory abilities to force conversion and to cease dividend payments via their 'prompt and corrective actions' regulations in circumstances where the foreign bank is undercapitalized.

Decision

On balance, considering U.S. regulatory and market practice, the REIT preferred instrument is permitted to be included in the innovative Tier 1 category of the Canadian FRE subject to the acceptance and maintenance of innovative Tier 1-equivalent recognition in the U.S. and the

adherence to OSFI quantitative limitations at the FRE consolidated level with respect to innovative Tier 1 instruments.

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* Advisories describe how OSFI administers and interprets provisions of existing legislation, regulations or guidelines, or provide OSFI's position regarding certain policy issues. Advisories are not law; readers should refer to the relevant provisions of the legislation, regulation or guideline, including any amendments that came into effect subsequent to the Advisory's publication, when considering the relevancy of the Advisory.