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

Advisory

Category: Capital **NOTICE***

Subject: Transition for Certain Definition of Capital Elements of Basel II

Date: January 2008

This Advisory, which applies to banks and federally regulated trust and loan companies, complements the guidance contained in the Capital Adequacy Requirements Guideline (CAR Guideline), January 2008.

Definition of Capital under Basel II

The 2005 revised capital framework issued by the Basel Committee on Banking Supervision sets capital requirements that are more reflective of the underlying risks in banking and provides stronger incentives for improved risk management. While Basel II sets capital requirements, it also deals with the definition of capital.

Specifically, Basel II (as reflected in the CAR Guideline, January 2008) stipulates that significant minority investments in banking, securities and other financial entities and investments in insurance entities that are not consolidated for regulatory capital purposes will have to be deducted 50% from Tier 1 and 50% from Tier 2 capital. Currently, these investments are deducted from total capital. Basel II does not provide for any type of transition or phasing-in of the deduction measures.

This Advisory sets out some transition measures relating to certain definition of capital elements of Basel II.

Status in Other Countries

OSFI considered the approach taken in other countries to assess whether transition should be provided in respect of the implementation of certain definition of capital elements of Basel II. On June 30, 2006, the European Union issued a directive providing member countries with the option to delay to 2012 the implementation of the 50/50 per cent deduction in respect of investments in insurance companies that were on the books of a bank in 2006 (Directives 2006/48/EC and 2006/49/EC of the European Parliament). Many European countries have decided to implement the delay.

Transition Measures

OSFI has decided to introduce transition measures for certain deductions from capital under Basel II. Specifically:

- The application of the 50% from Tier 1 capital and 50% from Tier 2 capital deduction for investments in insurance subsidiaries held prior to January 1, 2007 will be delayed to fiscal year 2012. Until fiscal year 2012, these investments in insurance subsidiaries will be deducted from Tier 2 capital.

- The application of the 50% from Tier 1 capital and 50% from Tier 2 capital deduction for significant investments in other entities that are not consolidated and held prior to January 1, 2007 will be delayed to fiscal year 2009. For fiscal year 2008, these significant investments in other entities that are not consolidated will be deducted from Tier 2 capital.

OSFI will permit institutions to use the balance sheet carrying value of the investment in insurance subsidiaries and/or substantial investment as at the reporting date to determine the deduction from Tier 2 capital during the transition period.

Increases in the value of investments in insurance subsidiaries and/or of substantial investments in other entities that are not consolidated (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 transitional measures.

Increases in the investment value of insurance subsidiaries and/or of substantial investments in other entities that are not consolidated 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 transitional measures and, as such, will be subject to the application of the 50% from Tier 1 capital and 50% from Tier 2 capital deduction.

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, other than an insurance company, 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.

Goodwill and other intangible assets related to investments in insurance subsidiaries should be deducted from gross Tier 1 capital; however, only the remaining investment in such entities held prior to January 1, 2007 should be deducted from Tier 2 capital. Any increase in the remaining investment value of insurance subsidiaries and/or of substantial investments in other entities that are not consolidated that arise from new capital investments on or after January 1, 2007 will not be afforded this treatment as described above.

For investments denominated in foreign currencies, the CAD equivalent as at the reporting date should be used to determine the deduction from capital. As such, the above references to investments held prior to January 1, 2007 do not refer to the specific CAD amount on the banks' books as of that date.

For the transition measures mentioned above, if the deductions from Tier 2 capital in aggregate exceed the amount of Tier 2 capital, the excess should be deducted from Tier 1 capital.

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