



Advisory

Subject: Section 3860 of the CICA Handbook and the Regulatory Capital Treatment of Preferred Shares and Innovative Tier 1 Instruments

Category: Capital

Date: February 2004

Final revisions to CICA Handbook Section 3860, *Financial Instruments – Disclosure and Presentation*, provide guidance for classifying certain financial instruments that embody obligations that may be settled by the issuance of the issuer’s equity shares. These revisions are effective for fiscal periods beginning on or after November 1, 2004.

When the revisions come into effect, certain outstanding Tier 1-qualifying preferred shares whose features provide for their potential conversion into common shares will be accounted for as liabilities under Canadian Generally Accepted Accounting Principles (GAAP). OSFI has determined that preferred shares accounted for as liabilities do not meet the conditions for non-innovative (or “core”) Tier 1 treatment.

OSFI confirms that any such preferred shares outstanding as of January 31, 2004 will continue to be eligible for core Tier 1 treatment for as long as they remain outstanding. However, no such preferred shares issued after January 31, 2004, will be afforded core Tier 1 treatment. Any preferred shares accounted for as equity capital under GAAP and meeting all other conditions for core Tier 1 treatment outlined in *Guideline A, Capital Adequacy Requirements* (Banks/T&L) or *Guideline A, Minimum Continuing Capital and Surplus Requirements* (Life) (Capital Guidelines), as applicable, will continue to be recognized as core Tier 1 capital.

The Section 3860 revisions also will affect the accounting treatment of outstanding capital instruments currently qualifying for innovative Tier 1 capital recognition under the *Interim Appendix to Guideline A-2* (Banks/T&L/Life), “*Principles Governing Inclusion of Innovative Instruments in Tier 1 Capital*” (Interim Appendix). Because of the conversion features of these capital instruments, GAAP will require certain of them to be accounted for as liabilities of the issuing trusts when the revisions come into effect. In any event, where consolidation of the issuing trust will be required under Accounting Guideline 15 (AcG 15), the capital instruments will be accounted for as liabilities (other than minority interest) of the FRFI that caused the

issuing trust to be established. Thus, capital instruments issued through a trust and having conversion features that result in liability treatment under GAAP may not meet the conditions for innovative Tier 1 recognition.

OSFI is reviewing whether preferred shares or other capital instruments whose conversion features cause them to be accounted for as liabilities are eligible for innovative Tier 1 or Tier 2 capital treatment. The results of this review will be communicated upon its completion.

Regardless of the outcome of this review, OSFI confirms that all such innovative Tier 1 instruments outstanding as of January 31, 2004 will continue to be eligible for innovative Tier 1 treatment for as long as they remain outstanding. Pending the outcome of this review: (i) no such capital instruments issued after January 31, 2004, will be afforded innovative Tier 1 treatment; and (ii) innovative instruments issued after January 31, 2004, must be accounted for as minority interest or recorded in shareholders' equity on consolidation by a FRFI in accordance with GAAP – taking into account the impact of AcG15 – and meet all other conditions for innovative Tier 1 treatment outlined in the Interim Appendix to be recognized as innovative Tier 1 capital of the FRFI.

Going forward, FRFIs interested in raising Tier 1-qualifying preferred share capital or capital qualifying for innovative Tier 1 treatment are encouraged to consider the potential impact of the Section 3860 revisions on the ability of those instruments to meet the applicable requirements for regulatory recognition. OSFI is prepared to work with FRFIs and their advisors to consider alternative preferred share instruments and innovative instruments that have the potential to qualify as core or innovative Tier 1 regulatory capital, respectively.

This Advisory relates only to the impact of the Section 3860 revisions on the preferred shares and innovative Tier 1 instruments described herein and does not restrict OSFI's ability to reconsider the recognition of these instruments in the light of other accounting, tax or regulatory guidance that may be introduced in the future. Furthermore, OSFI's decision regarding the impact of the Section 3860 revisions on other capital-related matters will not be affected by the positions outlined in this Advisory.

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