Office of the Superintendent
of Financial Institutions Canada

255 Albert Street
Ottawa, Canada
K1A 0H2

Bureau du surintendant
des institutions financières Canada

255, rue Albert
Ottawa, Canada
K1A 0H2

www.osfi-bsif.gc.ca

Advisory

Subject: **Tier 1 Capital Clarifications**

Category: **Capital**

Date: **April 2003**

OSFI has reviewed a number of Tier 1 capital issues in relation to recent international developments and proposals from federally regulated financial institutions (FRFIs). These reviews have highlighted the need to clarify our practice or amend our capital rules in three specific areas. For the purposes of this Advisory, FRFIs include all banks, federally regulated trust and loan companies and federally incorporated or regulated life insurance companies.

This advisory complements the following OSFI guidance.

- Guideline A, Capital Adequacy Requirements (Banks/T&L)
- Guideline A, Minimum Continuing Capital and Surplus Requirements (Life)
- Interim Appendix to Guideline A-2 (Banks/T&L/Life)

1. Treatment of Excess Tier 1-qualifying Preferred Shares

OSFI's Interim Appendix to Guideline A-2 (Banks/T&L/Life) states that "[a] strongly capitalized FRFI should not have innovative instruments and perpetual non-cumulative preferred shares that, in aggregate, exceed 25 per cent of its net Tier 1 capital. Tier 1-qualifying preferred shares issued in excess of this limit can be included in Tier 2 capital."

In the interest of clarifying our practice with respect to the above limit, Tier 1-qualifying preferred shares (i.e., perpetual non-cumulative preferred shares) in excess of the limit of 25 per cent of net Tier 1 capital can be included in Tier 2a capital. However, where a FRFI plans to include a significant amount of such shares in tier 2 capital, the FRFI should obtain the agreement of its Relationship Manager in advance. The FRFI would be expected to explain how such plans contribute to an efficient and sound overall capital structure. The amount of excess Tier 1-qualifying preferred shares included in Tier 2 capital is to be combined with other Tier 2 capital amounts to determine whether an institution is within its aggregate Tier 2 capital limit. Industry associations in Canada were notified previously that this clarification became effective as at October 31, 2002.

In circumstances where such excess preferred shares are included in Tier 2a capital, OSFI would expect any capital-related disclosures by a FRFI to be consistent with the regulatory treatment afforded such shares.

2. Excess Innovative Tier 1 Instruments and Tier 1-qualifying Preferred Shares Eligible for Inclusion in Tier 1 Capital

a) Excess Innovative Tier 1 Instruments Eligible for Inclusion in Tier 1 Capital

OSFI's Interim Appendix to Guideline A-2 for Banks/T&L/Life states that "[i]nnovative instruments must not, at the time of issuance, make up more than 15 per cent of a FRFI's net Tier 1 capital. Any excess cannot be included in regulatory capital. If, at any time after issuance, a FRFI's ratio of innovative instruments to net Tier 1 capital exceeds 15 per cent, the FRFI must immediately notify OSFI. The FRFI must also provide a plan, acceptable to OSFI, showing how the FRFI proposes to eliminate the excess quickly. A FRFI will generally be permitted to include such excesses in its Tier 1 capital until such time as the excess is eliminated in accordance with its plan." For greater clarity, 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 Tier 1 capital.

b) Excess Tier 1-qualifying Preferred Shares Eligible for Inclusion in Tier 1 Capital

OSFI's approach to recognizing excess Tier 1-qualifying preferred shares in Tier 1 capital will be similar to the approach for innovative Tier 1 instruments. Only Tier 1-qualifying preferred shares that were previously included in Tier 1 capital (i.e., they were within the 25 per cent aggregate limit as at issuance) but which subsequently exceed the 25 per cent aggregate limit due to operating losses and/or the payment of normal dividends will be considered eligible for continued inclusion in Tier 1 capital. A FRFI that wishes to include such excess preferred share amounts in Tier 1 capital must obtain OSFI's prior confirmation that this treatment is acceptable. To obtain confirmation, the FRFI must demonstrate that operating losses and/or the payment of normal dividends created the excess amount. The FRFI must also provide a clear and supportable plan, acceptable to OSFI, outlining how it proposes to eliminate the excess quickly. This approach to the treatment of excess Tier 1-qualifying preferred share amounts is effective as at March 31, 2003.

c) Tier 1 Treatment of Excesses is on an Exception Basis

OSFI will consider each proposal for Tier 1 treatment of excess amounts on its own merits and may disallow or otherwise restrict such treatment. For example, OSFI generally would not allow an excess amount to continue to be included in Tier 1 capital if the excess arose due to a combination of operating losses and common share repurchases in the same fiscal quarter.

d) Relevant Date for Calculating Excesses

OSFI wishes to clarify that, in all circumstances, a FRFI's fiscal quarter-ends will be the relevant dates for the purpose of determining the existence of excess Tier 1-qualifying preferred shares or

innovative Tier 1 instruments (i.e., Tier 1-qualifying preferred shares in excess of the limit of 25 per cent of net Tier 1 capital and innovative Tier 1 instruments in excess of the limit of 15 per cent of net Tier 1 capital, respectively). In the case of new issues, OSFI will define the "time of issuance" to be the last day of the fiscal quarter in which an issuance of Tier 1-qualifying preferred shares or innovative Tier 1 instruments takes place.

3. Conversion of Innovative Tier 1 Instruments in the Context of an Unregulated Holding Company

The August 2001 revision to the Interim Appendix to Guideline A-2 for Banks/T&L/Life, (OSFI's rules governing innovative Tier 1 instruments) introduced a clause permitting the indirect conversion of innovative Tier 1 instruments to the common shares of a FRFI's OSFI-regulated holding company. The intent of this clause was to allow the issuance of innovative Tier 1 instruments by a FRFI owned directly by a holding company with a material float of common shares listed and posted for trading on a recognized stock exchange (a "material public common float") when the FRFI has no such float of its own. Upon further review of various proposals, OSFI has concluded that structures permitting the indirect conversion of an innovative Tier 1 instrument into the common shares of an unregulated holding company may be submitted for review and approval, provided the following conditions are met:

- the unregulated holding company has a material public common float and the FRFI does not;
- the unregulated holding company is the direct parent and controlling shareholder of the FRFI; and
- the unregulated holding company is a non-operating holding company (as that term is defined in the Interim Appendix).

OSFI reserves the right to require additional conditions or restrictions, consistent with the proposed regulatory capital treatment of an instrument, to address the particular nature of proposals presented for our consideration. If, subsequent to the issuance of an innovative Tier 1 instrument that has a structure involving an unregulated holding company, material changes occur in the activities of that holding company or the nature of its relationship to the FRFI, the FRFI should seek OSFI's confirmation that the original capital treatment of the instrument continues to apply. In those circumstances, OSFI reserves the right to reassess the quality of the instrument and, where appropriate, to introduce additional conditions or restrictions to maintain the original regulatory capital treatment of the instrument. Industry associations in Canada were notified previously that this clarification became effective as at October 31, 2002.

- END -