Advisory

Category: **Capital** **NOTICE***

Subject: **Non-Viability Contingent Capital**

Date: ~~February~~ August 2011

This Advisory, which applies to federally regulated deposit-taking institutions (DTIs)[1], complements the following OSFI guidance:

- Guideline A and A-1, Capital Adequacy Requirements (CAR) Banks/T&L/BHC
- Advisory: Treatment of Non-qualifying Capital ~~[~~February 2011~~]~~

All regulatory capital must be able to absorb losses in a failed ~~bank.~~ financial institution. During the recent crisis, however, this premise was challenged as certain non-common Tier 1 and Tier 2 capital instruments did not absorb losses for a number of foreign financial institutions that would have failed in the absence of government support. To address this, on January 13, 2011, the Basel Committee on Banking Supervision (BCBS) released the *Minimum requirements to ensure loss absorbency at the point of non-viability* (the "NVCC requirement"). These requirements augment the BCBS' recently published revised capital standards, *Basel III: A global framework for more resilient banks and banking systems*[2] (Basel III) to ensure that investors in non-common regulatory capital instruments bear losses before taxpayers where the government determines that it is the public interest to rescue a non-viable ~~financial institution.~~bank[3].

This Advisory outlines OSFI's expectations in respect of the issuance of non-viability contingent capital (NVCC) by DTIs. Section 1 specifies the principles governing inclusion of NVCC instruments in regulatory capital. Section 2 provides an overview of the process by which OSFI would confirm that such instruments qualify as Additional Tier 1 or Tier 2 capital. Section 3 outlines the treatment of capital instruments issued after the release of this Advisory and prior to January 1, 2013. Finally, Section 4 provides an overview of the criteria the Superintendent will consider prior to triggering the conversion of NVCC.

~~Section 1:~~ Section 1: Principles Governing NVCC

OSFI has determined that, effective January 1, 2013 (the Cut-off Date), all non-common Tier 1 and Tier 2 capital instruments issued by DTIs must comply with the following principles to satisfy the NVCC requirement:

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1 In this Advisory, the term DTI refers to banks, bank holding companies, and federally-regulated trust and loan companies.

2 Released by BCBS on December 11, ~~2010.~~2010 and revised June 1, 2011.

3 Other resolution options, including the creation of a bridge bank, could be used to resolve a failing DTI, either as an alternative to NVCC or in conjunction with or following a NVCC conversion, and could also subject capital providers to loss.

Principle # 1: Non-common Tier 1 and Tier 2 capital instruments must have, in their contractual terms and conditions, a clause requiring a full and permanent conversion[4] into common shares of the DTI upon a trigger event~~.~~[5] . As such, ~~original~~the terms of non-common capital ~~providers~~instruments must not ~~have~~provide for any residual claims that are senior to common equity following a trigger event. OSFI will consider and permit the inclusion of NVCC instruments with alternative mechanisms, including conversions into shares of a parent firm or affiliate, on a case-by-case basis.

Principle # 2: All NVCC instruments must also meet all other criteria for inclusion under their respective tiers as specified in Basel III. For certainty, the classification of an instrument as either Additional Tier 1 capital or Tier 2 capital will depend on the terms and conditions of the NVCC instrument in the absence of a trigger event.

Principle # 3: ~~All~~The contractual terms of all Additional Tier 1 and Tier 2 capital instruments must, at a minimum[6], include the following trigger events:

(a) ~~a.~~ the Superintendent of Financial Institutions (the "Superintendent") ~~advises~~publicly announces that the DTI has been advised, in writing, that ~~she~~the Superintendent is of the opinion that the DTI has ceased, or is about to cease, to be viable and that, after the conversion of all contingent ~~capital~~ instruments and taking into account any other factors or circumstances that ~~she~~are consider~~s~~ed relevant or appropriate, it is reasonably likely that the viability of the DTI will be restored or maintained; or

(b) ~~b.~~ a federal or provincial government in Canada publicly announces that the DTI has accepted or agreed to accept a capital injection, or equivalent support[6], from the federal government or any provincial government or political subdivision or agent or agency thereof without which the DTI would have been determined by the Superintendent to be non-viable[7].

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4 The BCBS rules permit national discretion in respect of requiring contingent capital instruments to be written off or converted to common stock upon a trigger event. OSFI has determined that conversion is more consistent with traditional insolvency consequences and reorganization norms and better respects the legitimate expectations of all stakeholders.

5 The non-common capital of a DTI that does not meet the NVCC requirement but otherwise satisfies the Basel III requirements may be, as permitted by applicable law, amended to meet the NVCC requirement.

6 Additional Tier 1 instruments classified as liabilities for accounting purposes must also include an additional capital trigger pursuant to criterion # 11 of the criteria for inclusion in Additional Tier 1 specified in paragraph 55 of Basel III.

~~6 OSFI, after consulting with its FISC partner agencies, will provide guidance to DTIs upon request whether a particular form of government support being offered to such DTI is considered equivalent to a capital injection. For example, the Bank of Canada's Emergency Liquidity Assistance (ELA) does not constitute equivalent support as it is targeted at solvent institutions experiencing temporary liquidity problems.~~

7 Any capital injection or equivalent support from the federal government or any provincial government or political subdivision or agent or agency thereof would need to comply with applicable legislation, including any prohibitions related to the issue of shares to governments.

The term "equivalent support" in the above second trigger constitutes support for a non-viable DTI that enhances the DTI's risk-based capital ratios or is funding that is provided on terms other than normal terms and conditions. For greater certainty, and without limitation, equivalent support does not include:

(i) Emergency Liquidity Assistance provided by the Bank of Canada at or above the Bank Rate;

(ii) open bank liquidity assistance provided by CDIC at or above its cost of funds; and

(iii) support, including conditional, limited guarantees, provided by CDIC to facilitate a transaction, including an acquisition or amalgamation.

In addition, shares of an acquiring DTI paid as non-cash consideration to CDIC in connection with a purchase of a bridge institution would not constitute equivalent support triggering the NVCC instruments of the acquirer as the acquirer would be a viable financial institution.

Principle # 4: The ~~method of effecting the conversion must ensure that, through the conversion, NVCC investors receive voting rights commensurate with their resulting substantial common equity ownership position. In addition, the conversion method should~~* ~~result in the significant dilution of~~ *~~original common shareholders~~conversion terms of new NVCC instruments must reference the market value of common equity on or before the date of the trigger event[8]. The conversion method must also include a limit or cap on the number of shares issued upon a trigger event.

Principle # 5: The conversion method~~ology~~ should ~~reflect~~take into account the hierarchy of claims in liquidation~~, should consider the market value of common equity and may also consider the market value of other instruments in the capital structure[8].~~ and* result in the significant dilution of *pre-existing common shareholders. More specifically, the conversion should demonstrate that former subordinated debt holders receive economic entitlements ~~which~~that are more favourable than those provided to former preferred shareholders, and that former preferred shareholders receive economic entitlements ~~which~~that are more favourable than those provided to pre-existing common shareholders.

Principle # 6: The issuing DTI must ensure that, to the extent that it is within the DTI's control, there are no impediments to the conversion so that conversion will be automatic and immediate. Without limiting the generality of the foregoing, this includes the following:

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[8] As liquidation is the baseline resolution mechanism for a failed DTI, it is expected that the market values for capital instruments of a non-viable DTI should, where such instruments are traded in a deep and liquid market, incorporate information related to the probability of insolvency and the likely recovery upon liquidation.

~~[8] As liquidation is the baseline resolution mechanism for a failed DTI, it is expected that the market values for capital instruments of a non-viable DTI should, where such instruments are traded in a deep and liquid market, incorporate information related to the probability of insolvency and the likely recovery upon liquidation. It is expected that the market value of the common equity should be a factor in the conversion methodology; the market value of the other instruments may also be a relevant consideration.~~

(a) ~~a.~~ the DTI's by-laws or other relevant constating documents must permit the issuance of common shares upon conversion without the prior approval of existing capital providers;

(b) ~~b.~~ the DTI's by-laws or other relevant constating documents must permit the requisite number of shares to be issued upon conversion;

(c) ~~c.~~ the terms and conditions of any other agreement must not provide for the prior consent of the parties in respect of the conversion;

(d) ~~d.~~ the terms and conditions of capital instruments must not impede conversion; and

(e) ~~e.~~ if applicable, the DTI has obtained all prior authorization, including regulatory approvals and listing requirements, to issue the common shares arising upon conversion.

Principle # 7: The terms and conditions of the non-common capital instruments must specify that conversion does not constitute an event of default under that instrument. Further, the issuing DTI must take all commercially reasonable efforts to ensure that conversion is not an event of default or credit event under any other agreement entered into by the DTI, directly or indirectly, on or after ~~[~~the date of this Advisory~~ was first issued for public consultation]~~, including senior debt agreements and derivative contracts.

Principle # 8:~~ The issuing DTI must provide a trust arrangement or other mechanism to hold shares issued upon the conversion for non-common capital providers that are not permitted to own common shares of the DTI due to legal prohibitions.~~ The terms of the NVCC instrument should include provisions to address NVCC investors that are prohibited, pursuant to the legislation governing the DTI, from acquiring common shares in the DTI upon a trigger event. Such mechanisms should allow such capital providers to comply with~~ such~~ legal prohibitions while continuing to receive the economic results of common share ownership and should allow such persons to transfer their entitlements to a person that is permitted to own shares in the DTI and allow such transferee to thereafter receive direct share ownership.

Principle # 9: For DTIs, including Schedule II banks, that are subsidiaries of foreign financial institutions that are subject to Basel III capital adequacy requirements, any NVCC issued by the DTI must be convertible into common shares of the DTI ~~rather than those of the parent or an~~or, subject to the prior consent of OSFI, convertible into common shares of the DTI's parent or affiliate[9]. In addition, the trigger events in a DTI's NVCC instruments must not include triggers that are at the discretion of a foreign regulator or are based upon events applicable to an affiliate (such as an event in the home jurisdiction of a DTI's parent).

Principle # 10: For DTIs that have subsidiaries in foreign jurisdictions that are subject to the Basel III capital adequacy requirements, the DTI may, to the extent permitted by the Basel III rules[~~9~~10],

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[9] For greater clarity, OSFI expects that such consent would be granted primarily in respect of conversions to common shares of the ultimate parent. OSFI will consider conversions into shares of other affiliates under exceptional circumstances only, including where the shares of an affiliate are listed or where the DTI has no controlling parent.

[~~9~~ 10] For further reference, please refer to paragraphs 62 to 65 of Basel III which relate to minority interests.

include the NVCC issued by foreign subsidiaries in the DTI's consolidated regulatory capital provided that such foreign subsidiary's NVCC complies with the NVCC requirements according to the rules of its host jurisdiction.[10] This treatment is permitted NVCC instruments issued by foreign subsidiaries must, in their contractual terms, include triggers that are equivalent to the triggers specified in Principle # 3 above. OSFI will only activate such triggers in respect of a foreign subsidiary after consultation with the host authority where 1) the subsidiary is non-viable as determined by the host authority and 2) the parent DTI is, or would be, non-viable, as determined by OSFI, as a result of providing, or committing to provide, a capital injection or similar support to the subsidiary. This treatment is required irrespective of whether the host jurisdiction has implemented the NVCC requirements on a contractual basis or on a statutory basis.

Section 2: **Section 2: Information Requirements to Confirm Quality of NVCC Instruments**

While not mandatory, DTIs are strongly encouraged to seek confirmations of capital quality from OSFI's Capital Division prior to issuing NVCC instruments.[11] . In conjunction with such requests, the DTI is expected to provide the following information.

1. An indicative term sheet specifying indicative dates, rates and amounts and summarizing key provisions should be provided in respect of all proposed instruments.

2. The draft and final terms and conditions of the proposed NVCC instrument supported by relevant documents (i.e. Prospectus, Offering Memorandum, Debt Agreement, etc.).

3. A copy of the DTI's current by-laws or other constating documents relevant to the capital to be issued.

4. Where applicable, for all debt instruments only:

   (a) the draft and final Trust Indenture; and

   (b) the terms of any guarantee relating to the instrument.

5. An external legal opinion addressed to OSFI confirming that the contingent conversion feature is enforceable, that the issuance has been duly authorized and is in compliance with applicable law[12] and that there are no impediments to the automatic conversion of the NVCC instrument into common shares of the DTI upon a trigger event.

6. Where the DTI expects to deduct interest or other* distributions payable on*terms of the instrument *for *tax purposesinclude a redemption or similar feature upon a tax event, an

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[10] For the avoidance of doubt, such foreign subsidiary NVCC instruments need not comply with this Advisory, as they are intended to capitalize such subsidiary for its risks and not for the risks elsewhere in the DTI's consolidated group.

[11] If a DTI fails to obtain a capital confirmation (or obtains a capital confirmation without disclosing all relevant material facts to OSFI), OSFI may, in its discretion, at any time determine that such capital does not comply with these principles and is to be excluded from a DTI's available regulatory capital.

[12] Such legal opinion may contain standard assumptions and qualifications provided its overall substance is acceptable to OSFI.

external tax opinion confirming the availability of such deduction~~.~~ in respect of interest or* distributions payable on* the instrument *for *income tax purposes[13].

7. An accounting opinion describing the proposed treatment and disclosure of the NVCC instrument on the DTI's financial statements.[14]

8. Where the initial interest or coupon rate payable on the instrument resets periodically or the basis of the interest rate changes from fixed to floating (or vice versa) at a pre-determined future date, calculations demonstrating that no incentive to redeem, or step-up, will arise upon the change in the initial rate. Where applicable, a step-up calculation should be provided according to the swap-spread methodology[15] which confirms there is no step-up upon the change in interest rate.

9. Where the terms of the instrument provide for triggers in addition to the baseline triggers specified in *Principle # 2*, the rationale for such additional triggers and a detailed analysis of the possible market implications that might arise from the inclusion of such additional triggers or upon a breach of such triggers.

10. A detailed description outlining the rationale for the specified conversion method, including computations of the ~~expected~~indicative level of dilution of the DTI's common shares that would occur upon a trigger event, the ~~expected~~indicative relative allocation of common shares between original capital providers following the most probable trigger event scenario and an explanation of why such conversion methodology complies with these principles and ~~will~~would enhance the viability of an otherwise non-viable DTI.

11. Capital projections that demonstrate that the DTI will be in compliance with the DTI's internal target capital ratios, the DTI's authorized assets-to-capital multiple (ACM), applicable Basel III capital~~,~~ and leverage ~~and liquidity~~ ratios, and any capital composition requirements at the end of the quarter in which the NVCC instrument is expected to be issued and during the transition to full compliance with Basel III.

~~12. An outline of the precedent-setting aspects, if any, of the structure and the capital instruments and an explanation of such features.~~

12. ~~13.~~ An assessment of the features of the proposed capital instrument against the minimum criteria for inclusion in Additional Tier 1 capital or Tier 2 capital, as applicable, as set out in Basel III as well as the principles for NVCC instruments set out in Section 1 of this Advisory. For certainty, this assessment would only be required for an initial issuance or precedent and is not required for subsequent issuances provided the terms of the NVCC instrument are not materially altered.

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13 OSFI reserves the right to require a Canada Revenue Agency advance tax ruling to confirm such tax opinion if the tax consequences are subject to material uncertainty.

14 OSFI reserves the right to require such accounting opinion to be an external opinion of a firm acceptable to OSFI if the accounting consequences are subject to material uncertainty.

15 The swap-spread methodology is described in Appendix 2-I of the *Capital Adequacy Requirements Guideline*, January 2011.

~~Section 3:~~ **Section 3: Issuance of Capital Instruments prior to the Cut-off Date**

1. DTIs wishing to issue NVCC compliant Tier 1 and Tier 2 instruments prior to the Cut-off Date may do so following the ~~final~~ release of this Advisory.

2. DTIs may continue to issue capital instruments that do not comply with the NVCC requirement, but otherwise meet the Basel III criteria for inclusion as Additional Tier 1 or Tier 2 capital, until the Cut-off Date. Such instruments would be subject to phase-out beginning on January 1, 2013 as outlined in OSFI's Advisory *Treatment of Non-Qualifying Capital* published on February 4, 2011.

3. ~~DTIs are encouraged to~~Although it is not a requirement, DTIs may consider amending the terms of existing non-common instruments that do not comply with the NVCC requirement to thereby achieve compliance, or to otherwise take actions, including exchange offers, which would mitigate the effects of such non-compliance.

~~Section 4:~~ **Section 4: Criteria to be considered in Triggering Conversion of NVCC**

~~In triggering the conversion of NVCC, the Superintendent will exercise his or her discretion~~The decision to maintain a ~~financial institution~~DTI as a going~~-~~ concern where it would otherwise become non-viable~~. In doing so, the Superintendent will consider the below list of criteria and any other relevant OSFI guidance.[16] These criteria~~*~~ may be mutually exclusive and should not be viewed as an exhaustive list~~*~~.[17]~~The exercise of discretion by the Superintendent~~ will be informed by OSFI's interaction with the Financial Institutions Supervisory Committee (FISC)[18][16] (and any other relevant agencies the Superintendent determines should be consulted in the circumstances). In particular, the Superintendent will consult with the FISC member agencies~~ and the Minister of Finance~~ prior to making a non-viability determination. It is important to note the conversion of NVCC alone may not be sufficient to restore a DTI to viability; that is, other public sector interventions, including liquidity assistance, would likely be used in tandem with NVCC to maintain a DTI as a going concern. Consequently, while the Superintendent would have the authority to trigger conversion, in practice, the Superintendent's decision to activate the trigger would be conditioned by the legislative provisions and decision frameworks associated with accompanying interventions by other FISC agencies.

In assessing whether a DTI has ceased, or is about to cease, to be viable and that, after the conversion of all contingent capital instruments, it is reasonably likely that the viability of the DTI will be restored or maintained, the Superintendent would consider, in consultation with FISC, all relevant facts and circumstances, including the criteria outlined in relevant legislation and

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[16] ~~See, in particular, OSFI's *Guide to Intervention for Federally Regulated Deposit-Taking Institutions*.~~

[17] ~~The Superintendent retains the flexibility and discretion to deal with unforeseen events or circumstances on a case-by-case basis.~~

[18] [16] Under the *OSFI Act*, FISC comprises OSFI, the Canada Deposit Insurance Corporation, the Bank of Canada, the Department of Finance, and the Financial Consumer Agency of Canada. Under the chairmanship of the Superintendent of Financial Institutions, these federal agencies meet regularly to exchange information relevant to the supervision of regulated financial institutions. This forum also provides for the coordination of strategies when dealing with troubled institutions.

regulatory guidance[17]. Without limiting the generality of the foregoing, this could include a consideration of the following criteria, which* may be mutually exclusive and should not be viewed as an exhaustive list*[18]:

(i) Whether the assets of the DTI are, in the opinion of the Superintendent, sufficient to provide adequate protection to the ~~bank~~DTI's depositors and creditors.

(ii) Whether the DTI has lost the confidence of depositors or other creditors and the public. This may be characterized by ongoing increased difficulty in obtaining or rolling over short-term funding.

(iii) Whether the DTI's regulatory capital has, in the opinion of the Superintendent, reached a level, or is eroding in a manner, that may detrimentally affect its depositors and creditors.

(iv) ~~Has~~Whether the DTI failed to pay any liability that has become due and payable or, in the opinion of the Superintendent, the DTI will not be able to pay its liabilities as they become due and payable~~?~~.

(v) ~~Has~~Whether the DTI failed to comply with an order of the Superintendent ~~under paragraph 485(3)(a) of the *Bank Act*~~ to increase its capital~~?~~.

(vi) ~~In~~Whether, in the opinion of the Superintendent, any other state of affairs exists in respect of the DTI that may be materially prejudicial to the interests of the DTI's depositors or creditors or the owners of any assets under the DTI's administration, including where proceedings under a law relating to bankruptcy or insolvency have been commenced in Canada or elsewhere in respect of the holding body corporate of the ~~bank~~DTI.

(vii) ~~Is~~Whether the DTI is unable to recapitalize on its own through the issuance of common shares or other forms of regulatory capital~~?~~. For example, no suitable ~~private or public~~ investor or group of investors exists that is willing or capable of investing in sufficient quantity and on terms that will restore the ~~bank~~DTI's viability, nor is there any reasonable prospect of such an investor emerging in the near-term in the absence of conversion of NVCC instruments. Further, in the case of a privately-held DTI, including a Schedule II bank, the parent firm or entity is unable or unwilling to provide further support to the subsidiary.

For greater certainty, ~~the Superintendent retains~~Canadian authorities will retain full discretion to choose not to trigger NVCC notwithstanding a determination by the Superintendent that a DTI has ceased, or is about to cease, to be viable. Under such circumstances, the DTI's creditors and

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[17] See, in particular, OSFI's *Guide to Intervention for Federally-Regulated Deposit-Taking Institutions.*

[18] The Superintendent retains the flexibility and discretion to deal with unforeseen events or circumstances on a case-by-case basis.

shareholders could be exposed to losses through the continued operation of the DTI and through the use of liquidation or other resolution tools or in liquidation.

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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.

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