Guideline

Subject: **Capital Adequacy Requirements (CAR)**

Chapter 2 – Definition of Capital

Effective Date: **April 2018**

The Capital Adequacy Requirements (CAR) for banks, bank holding companies, federally regulated trust companies, federally regulated loan companies and cooperative retail associations are set out in nine chapters, each of which has been issued as a separate document. This document, Chapter 2 – Definition of Capital, should be read in conjunction with the other CAR chapters which include:

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Chapter 2 – Definition of Capital

1. This chapter is drawn from the Basel Committee on Banking Supervision's (BCBS) Basel III framework, *Basel III: A global regulatory framework for more resilient banks and banking systems* (revised version June 2011 - Section I Definition of Capital). For reference, the Basel III text paragraph numbers that are associated with the text appearing in this chapter are indicated in square brackets at the end of each paragraph[1]. This chapter also contains material from the BCBS document, *Basel III definition of capital – frequently asked questions* (December 2011). The Basel FAQ text paragraph numbers are also provided in square paragraphs where appropriate[2].

2.1 Requirements for Inclusion in Regulatory Capital

2. Tier 1 regulatory capital will consist of the sum of the following categories:

- Common Equity Tier 1 capital (section 2.1.1)
- Additional Tier 1 capital (section 2.1.2)

  Total regulatory capital will consist of Tier 1 regulatory capital (Sections 2.1.1 and 2.1.2 above) plus:

- Tier 2 capital (section 2.1.3)

2.1.1 Common Equity Tier 1 Capital

3. Common Equity Tier 1 capital (prior to regulatory adjustments) consists of the sum of the following elements:

- Common shares issued by the institution that meet the criteria for classification as common shares for regulatory purposes[3];
- Surplus (share premium) resulting from the issue of instruments included in Common Equity Tier 1[4];
- Retained earnings;
- Accumulated other comprehensive income and other disclosed reserves;
- Common shares issued by consolidated subsidiaries of the institution and held by third parties that meet the criteria for inclusion in Common Equity Tier 1 capital. See sections 2.1.1.2 and 2.1.1.3 for the relevant criteria; less

1 Following the format: [BCBS June 2011 par x]
2 Following the format: [BCBS FAQs, #x p.x]
3 For an institution that is a federal credit union, references to "common shares" in this Guideline also refer to "membership shares" as defined in 79.1(1) of the *Bank Act* and other instruments recognised as Common Equity Tier 1 capital under this Guideline.
4 Where repayment is subject to Superintendent Approval.

Retained earnings and other comprehensive income include interim profit or loss. Dividends are removed from Common Equity Tier 1 in accordance with applicable accounting standards.
[BCBS June 2011 par 52]

2.1.1.1 Common shares issued by the institution directly

4. For an instrument to be included in Common Equity Tier 1 capital, it must meet all of the following criteria and, in the case of instruments issued by a federal credit union, with the modifications or additional specifications set out in paragraph 5:

1) Represents the most subordinated claim in liquidation of the institution.
2) The investor is entitled to a claim on the residual assets that is proportional with its share of issued capital, after all senior claims have been paid in liquidation (i.e. has an unlimited and variable claim, not a fixed or capped claim).
3) The principal is perpetual and never repaid outside of liquidation (setting aside discretionary repurchases or other means of effectively reducing capital in a discretionary manner that is allowable under relevant law and subject to the prior approval of the Superintendent).
4) The institution does not, in the sale or marketing of the instrument, create an expectation at issuance that the instrument will be bought back, redeemed or cancelled, nor do the statutory or contractual terms provide any feature which might give rise to such expectation.
5) Distributions are paid out of distributable items, including retained earnings. The level of distributions is not in any way tied or linked to the amount paid in at issuance and is not subject to a contractual cap (except to the extent that an institution is unable to pay distributions that exceed the level of distributable items or to the extent that distributions on senior ranking capital must be paid first).
6) There are no circumstances under which the distributions are obligatory. Non-payment is, therefore, not an event of default.
7) Distributions are paid only after all legal and contractual obligations have been met and payments on more senior capital instruments have been made. This means that there are no preferential distributions, including in respect of other elements classified as the highest quality issued capital.
8) It is in the form of issued capital that takes the first and proportionately greatest share of any losses as they occur. Within the highest quality of capital, each instrument absorbs losses on a going concern basis proportionately and *pari passu* with all the others.
9) The paid-in amount is recognized as equity capital (i.e. not recognized as a liability) for determining balance sheet solvency.

10) It is directly issued and paid-in[5] and the institution cannot directly or indirectly fund the purchase of the instrument. Where the consideration for the shares is other than cash, the issuance of the common shares is subject to the prior approval of the Superintendent.

11) The paid-in amount is neither secured nor covered by a guarantee of the issuer or related entity[6] or subject to any other arrangement that legally or economically enhances the seniority of the claim.

12) It is only issued with the approval of the owners of the issuing institution, either given directly by the owners or, if permitted by applicable law, given by the Board of Directors or by other persons duly authorized by the owners.

13) It is clearly and separately disclosed as equity on the institution's balance sheet, prepared in accordance with the relevant accounting standards.

[BCBS June 2011 par 53]

Common Equity Tier 1 instruments issued by a federal credit union

5. For an instrument to be included in Common Equity Tier 1 capital of a federal credit union, it must meet all of the criteria in paragraph 4 with any modifications or additional specifications set out in this paragraph:

- For instruments other than membership shares, the instrument need not meet Common Equity Tier 1 eligibility criteria 1, 2, and 8. Investors entitled to claims under such instruments must rank *pari passu* with membership shares up to a predetermined amount of gross Common Equity Tier 1 capital which must be reset monthly according to the institution's last consolidated balance sheet filed with OSFI. Any assets remaining after the amount is reached would be distributed exclusively to the federal credit union's membership shareholders.
- Distributions may be subject to a contractual cap.
- The purchase or redemption of membership shares may be granted at the sole discretion of the federal credit union, rather than that of its members or other investors. As part of this discretion, the federal credit union must have the unconditional right to refuse, limit or delay redemption of membership shares and such refusal or limitation would not constitute an event of default of the federal credit union.
- A federal credit union may, with the prior consent of the Superintendent, purchase or redeem membership shares provided there are no reasonable grounds to believe that the payment would cause the institution to be in contravention of capital adequacy or liquidity requirements.

5 Paid-in capital generally refers to capital that has been received with finality by the institution, is reliably valued, fully under the institution's control and does not directly or indirectly expose the institution to the credit risk of the investor. [BCBS FAQs # 5 p. 2]

6 A related entity can include a parent company, a sister company, a subsidiary or any other affiliate. A holding company is a related entity.

2.1.1.2 Common shares issued by a consolidated subsidiary to third parties

6. Common shares issued by a fully consolidated subsidiary of the institution to a third party may receive limited recognition in the consolidated Common Equity Tier 1 of the parent institution only if:

- the instrument, if issued by the institution, would meet all of the criteria described in section 2.1.1.1 for classification as common shares for regulatory capital purposes; and
- the subsidiary that issued the instrument is itself a bank[7,8]

7. The amount of capital meeting the above criteria that will be recognized in consolidated Common Equity Tier 1 is calculated as follows (refer to Appendix 2-1 for an illustrative example):

a. Paid-in capital plus retained earnings that are attributable to third-party investors, gross of deductions, less the amount of surplus Common Equity Tier 1 capital of the subsidiary that is attributable to the third-party investors.

b. The surplus Common Equity Tier 1 capital of the subsidiary is calculated as the Common Equity Tier 1 capital of the subsidiary, net of deductions, minus the lower of: (1) the minimum Common Equity Tier 1 capital requirement of the subsidiary plus the capital conservation buffer (ie 7.0% of risk-weighted assets)[9]; and (2) the portion of the parent's consolidated minimum Common Equity Tier 1 capital requirements[10] plus the capital conservation buffer (ie 7.0% of risk-weighted assets) that relates to the subsidiary.

c. The amount of surplus Common Equity Tier 1 capital that is attributable to the third-party investors is calculated by multiplying the surplus Common Equity Tier 1 capital of the subsidiary (calculated in b. above) by the percentage of Common Equity Tier 1 that is attributable to third-party investors.

8. Common shares issued to third-party investors by a consolidated subsidiary that is not a bank cannot be included in the consolidated Common Equity Tier 1 of the parent. However, these amounts may be included in the consolidated Additional Tier 1 and Tier 2 capital of the parent, subject to the conditions in sections 2.1.2.2 and 2.1.3.2. [BCBS June 2011 par 62]

7 Any institution that is subject to the same minimum prudential standards and level of supervision as a bank may be considered to be a bank.

8 Minority interest in a subsidiary that is a bank is strictly excluded from the parent bank's common equity if the parent bank or affiliate has entered into any arrangements to fund directly or indirectly minority investment in the subsidiary whether through an SPV or through another vehicle or arrangement. The treatment outlined above, thus, is strictly available where all minority interests in the bank subsidiary solely represent genuine third party common equity contributions to the subsidiary.

9 Calculated using the local regulator's RWA calculation methodology, i.e. if the local regulator's requirements are based on Basel I rules, this calculation method can be used. The calculation must still be based on the minimum plus the capital conservation buffer (ie 7.0% of risk-weighted assets).

10 This amount should exclude any intercompany exposures (e.g. loans or debentures) from the subsidiary to the parent that would boost the subsidiary's risk-weighted assets.

2.1.1.3 Common shares issued to third-parties out of special purpose vehicles (SPVs)

9. Where capital has been issued to third-parties out of an SPV, none of this capital can be included in Common Equity Tier 1. However, such capital can be included in consolidated Additional Tier 1 or Tier 2 capital and treated as if the institution itself had issued the capital directly to the third-parties only if:

a. it meets all the relevant entry criteria; and

b. the only asset of the SPV is its investment in the capital of the institution in a form that meets or exceeds all the relevant entry criteria[11] (as required by criterion 14 for Additional Tier 1 and criterion 9 for Tier 2 capital).

10. In cases where the capital has been issued to third-parties through an SPV via a fully consolidated subsidiary of the institution, such capital may, subject to the requirements of this paragraph, be treated as if the subsidiary itself had issued it directly to the third parties and may be included in the institution's consolidated Additional Tier 1 or Tier 2 in accordance with the treatment outlined in sections 2.1.2.2 and 2.1.3.2. [BCBS June 2011 par 65]

2.1.2 Additional Tier 1 Capital

11. Additional Tier 1 capital (prior to regulatory adjustments) consists of the sum of the following elements:

- Instruments issued by the institution that meet the criteria for inclusion in Additional Tier 1 capital (and do not meet the criteria for inclusion in Common Equity Tier 1);
- Surplus (share premium) resulting from the issue of instruments included in Additional Tier 1 capital[12];
- Instruments issued by consolidated subsidiaries of the institution and held by third parties that meet the criteria for inclusion in Additional Tier 1 capital and are not included in Common Equity Tier 1 (see sections 2.1.2.2 and 2.1.2.3)
[BCBS June 2011 par 54]

2.1.2.1 Additional Tier 1 instruments issued by the institution directly

12. The following is the minimum set of criteria for an instrument issued by the institution to meet or exceed in order for it to be included in Additional Tier 1 capital:

1) Issued and paid-in in cash or, subject to the prior approval of the Superintendent, in property.

[11] Assets that relate to the operation of the SPV may be excluded from this assessment if they are *de minimus.*

[12] Surplus (i.e. share premium) that is not eligible for inclusion in Common Equity Tier 1 will only be permitted to be included in Additional Tier 1 capital if the shares giving rise to the surplus are permitted to be included in Additional Tier 1 capital. [BCBS June 2011 par 56]

2) Subordinated to depositors, general creditors, and subordinated debt holders of the institution.

3) Is neither secured nor covered by a guarantee of the issuer or related entity or other arrangement that legally or economically enhances the seniority of the claim vis-à-vis the institution's depositors and/or creditors[13].

4) Is perpetual, i.e. there is no maturity date and there are no step-ups[14] or other incentives to redeem[15].

5) May be callable at the initiative of the issuer only after a minimum of five years:

   a. To exercise a call option an institution must receive the prior approval of the Superintendent; and

   b. An institution's actions and the terms of the instrument must not create an expectation that the call will be exercised; and

   c. An institution must not exercise the call unless:

      - It replaces the called instrument with capital of the same or better quality, including through an increase in retained earnings, and the replacement of this capital is done at conditions which are sustainable for the income capacity of the institution[16]; or

      - The institution demonstrates that its capital position is well above the minimum capital requirements after the call option is exercised.

6) Any repayment of principal (e.g. through repurchase or redemption) must require Superintendent approval and institutions should not assume or create market expectations that such approval will be given.

7) Dividend/coupon discretion:

   - the institution must have full discretion at all times to cancel distributions/payments[17]

[13] Further, where an institution uses an SPV to issue capital to investors and provides support, including overcollateralization, to the vehicle, such support would constitute enhancement in breach of Criterion # 3 above. [BCBS FAQs # 1, p.3]

[14] A step-up is defined as a call option combined with a pre-set increase in the initial credit spread of the instrument at a future date over the initial dividend (or distribution) rate after taking into account any swap spread between the original reference index and the new reference index. Conversion from a fixed rate to a floating rate (or vice versa) in combination with a call option without any increase in credit spread would not constitute a step-up.

[15] Other incentives to redeem include a call option combined with a requirement or an investor option to convert the instrument into common shares if the call is not exercised.

[16] Replacement issuances can be concurrent with but not after the instrument is called.

[17] A consequence of full discretion at all times to cancel distributions/payments is that "dividend pushers" are prohibited. An instrument with a dividend pusher obliges the issuing institution to make a dividend/coupon payment on the instrument if it has made a payment on another (typically more junior) capital instrument or share. This obligation is inconsistent with the requirement for full discretion at all times. Furthermore, the term "cancel distributions/payments" means to forever extinguish these payments. It does not permit features that require the institution to make distributions or payments in kind at any time.

- cancellation of discretionary payments must not be an event of default or credit event
- institutions must have full access to cancelled payments to meet obligations as they fall due
- cancellation of distributions/payments must not impose restrictions on the institution except in relation to distributions to common shareholders.

8) Dividends/coupons must be paid out of distributable items

9) The instrument cannot have a credit sensitive dividend feature, that is a dividend/coupon that is reset periodically based in whole or in part on the institution or organization's credit standing[18]

10) The instrument cannot contribute to liabilities exceeding assets if such a balance sheet test forms part of national insolvency law.

11) Other than preferred shares, instruments included in Additional Tier 1 capital must be classified as equity for accounting purposes.

12) Neither the institution nor a related party over which the institution exercises control or significant influence can have purchased the instrument, nor can the institution directly or indirectly have funded the purchase of the instrument.

13) The instruments cannot have any features that hinder recapitalization, such as provisions that require the issuer to compensate investors if a new instrument is issued at a lower price during a specified time frame.

14) If the instrument is not issued out of an operating entity or the holding company in the consolidated group (e.g. it is issued out of a special purpose vehicle – "SPV"), proceeds must be immediately available without limitation to an operating entity[19] or the holding company in the consolidated group in a form which meets or exceeds all of the other criteria for inclusion in Additional Tier 1 capital. For greater certainty, the only assets the SPV may hold are intercompany instruments issued by the institution or a related entity with terms and conditions that meet or exceed the Additional Tier 1 criteria. Put differently, instruments issued to the SPV have to fully meet or exceed all of the eligibility criteria for Additional Tier 1 capital as if the SPV itself was an end investor – i.e. the institution cannot issue a lower quality capital or senior debt instrument to an SPV and have the SPV issue higher quality capital instruments to third-party investors so as to receive recognition as Additional Tier 1 capital.

15) The contractual terms and conditions of the instrument must include a clause requiring the full and permanent conversion of the instrument into common shares at the point of non-viability as described under OSFI's non-viability contingent capital (NVCC)

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18 Institutions may use a broad index as a reference rate in which the issuing institution is a reference entity, however, the reference rate should not exhibit significant correlation with the institution's credit standing. If an institution plans to issue capital instruments where the margin is linked to a broad index in which the institution is a reference entity, the institution should ensure that the dividend/coupon is not credit-sensitive. [BCBS FAQs #12, p.5].

19 An operating entity is an entity set up to conduct business with clients with the intention of earning a profit in its own right.

requirements as specified under section 2.2. Where an instrument is issued by an SPV according to criterion #14 above, the conversion of instruments issued by the SPV to end investors should mirror the conversion of the capital issued by the institution to the SPV.
[BCBS June 2011 par 55]

13. Purchase for cancellation of Additional Tier 1 capital instruments is permitted at any time with the prior approval of the Superintendent. For further clarity, a purchase for cancellation does not constitute a call option as described in the above Additional Tier 1 criteria.

14. Tax and regulatory event calls are permitted during an instrument's life subject to the prior approval of the Superintendent and provided the institution was not in a position to anticipate such an event at the time of issuance. [BCBS FAQs #15, p.6]

15. Dividend stopper arrangements that stop payments on common shares or other Additional Tier 1 instruments are permissible provided the stopper does not impede the full discretion the institution must have at all times to cancel distributions or dividends on the Additional Tier 1 instrument, nor must it act in a way that could hinder the recapitalization of the institution pursuant to criterion # 13 above. For example, it would not be permitted for a stopper on an Additional Tier 1 instrument to:

- attempt to stop payment on another instrument where the payments on the other instrument were not also fully discretionary;
- prevent distributions to shareholders for a period that extends beyond the point in time that dividends or distributions on the Additional Tier 1 instrument are resumed;
- impede the normal operation of the institution or any restructuring activity, including acquisitions or disposals.

[BCBS FAQs #3, p.3]

16. A dividend stopper may also act to prohibit actions that are equivalent to the payment of a dividend, such as the institution undertaking discretionary share buybacks.

17. Where an amendment or variance of an Additional Tier 1 instrument's terms and conditions affects its recognition as regulatory capital, such amendment or variance will only be permitted with the prior approval of the Superintendent[20].

18. Institutions are permitted to "re-open" offerings of capital instruments to increase the principal amount of the original issuance subject to the following: (1) institutions cannot re-open offerings where the initial issue date was on or before December 31, 2012; and 2) call options will only be exercised, with the prior approval of the Superintendent, on or after the fifth anniversary of the closing date of the latest re-opened tranche of securities.

[20] Any modification of, addition to, or renewal or extension of an instrument issued to a related party is subject to the legislative requirement that transactions with a related party be at terms and conditions that are at least as favourable to the institution as market terms and conditions.

2.1.2.2 Tier 1 qualifying capital instruments issued by a consolidated subsidiary to third parties

19. Tier 1 capital instruments issued by a fully consolidated subsidiary of the institution to third-party investors (including amounts under section 2.1.1.2) may receive recognition in the consolidated Tier 1 capital of the parent institution only if the instrument, if issued by the institution, would meet or exceed all of the criteria for classification as Additional Tier 1 capital.

20. The amount of capital that will be recognized in Tier 1 is calculated as follows (Refer to Appendix 2-1 for an illustrative example):

a. Paid-in capital plus retained earnings that are attributable to third-party investors, gross of deductions, less the amount of surplus Tier 1 capital of the subsidiary that is attributable to the third-party investors.

b. The surplus Tier 1 capital of the subsidiary is calculated as the Tier 1 capital of the subsidiary, net of deductions, minus the lower of: (1) the minimum Tier 1 capital requirement of the subsidiary plus the capital conservation buffer (ie 8.5% of risk-weighted assets)[21]; and (2) the portion of the parent's consolidated minimum Tier 1 capital requirements[22] plus the capital conservation buffer (ie 8.5% of risk-weighted assets) that relates to the subsidiary.

c. The amount of surplus Tier 1 capital that is attributable to the third-party investors is calculated by multiplying the surplus Tier 1 capital of the subsidiary (calculated in (b) above) by the percentage of Tier 1 that is held by third party investors.

The amount of this Tier 1 capital that will be recognized in Additional Tier 1 will exclude amounts recognized in Common Equity Tier 1 under section 2.1.1.2. [BCBS June 2011 par 64]

2.1.2.3 Additional Tier 1 instruments issued to third-parties out of SPVs

21. As stated under paragraph 9, where capital has been issued to third-parties out of an SPV none of this capital can be included in Common Equity Tier 1. However, such capital can be included in consolidated Additional Tier 1 or Tier 2 and treated as if the institution itself had issued the capital directly to the third-parties only if:

- it meets all the relevant entry criteria; and
- the only asset of the SPV is its investment in the capital of the institution in a form that meets or exceeds all the relevant entry criteria[23] (as required by criterion 14 for Additional Tier 1 and criterion 9 for Tier 2).

22. In cases where the capital has been issued to third-parties through an SPV via a fully consolidated subsidiary of the institution, such capital may, subject to the requirements of this

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21 Calculated using the local regulator's RWA calculation methodology, i.e. if the local regulator's requirements are based on Basel I rules, this calculation method can be used. The calculation must still be based on the minimum plus the capital conservation buffer (ie 8.5% of risk-weighted assets).

22 This amount should exclude any intercompany exposures (e.g. loans or debentures) from the subsidiary to the parent that would boost the subsidiary's risk-weighted assets.

23 Assets that relate to the operation of the SPV may be excluded from this assessment if they are *de minimus*.

paragraph, be treated as if the subsidiary itself had issued it directly to the third-parties and may be included in the institution's consolidated Additional Tier 1 or Tier 2 in accordance with the treatment outlined in sections 2.1.2.2 and 2.1.3.2. [BCBS June 2011 par 65]

2.1.2.4 Additional Tier 1 instruments issued to a parent

23. In addition to the qualifying criteria and minimum requirements specified in this Guideline, Additional Tier 1 capital instruments issued by an institution to a parent, either directly or indirectly, can be included in regulatory capital subject to the institution providing notification of the intercompany issuance to OSFI's Capital Division together with the following:

- a copy of the instrument's terms and conditions;
- the intended classification of the instrument for regulatory capital purposes;
- the rationale provided by the parent for not providing common equity in lieu of the subject capital instrument;
- confirmation that the rate and terms of the instrument are at least as favourable to the institution as market terms and conditions;
- confirmation that the failure to make dividend or interest payments, as applicable, on the subject instrument would not result in the parent, now or in the future, being unable to meet its own debt servicing obligations nor would it trigger cross-default clauses or credit events under the terms of any agreements or contracts of either the institution or the parent.

2.1.2.5 Capital instruments issued out of branches and subsidiaries outside Canada

24. In addition to any other requirements prescribed in this Guideline, where an institution wishes to consolidate a capital instrument issued out of a branch or subsidiary outside Canada, it must provide OSFI's Capital Division with the following documentation:

- a copy of the instrument's terms and conditions;
- certification from a senior executive of the institution, together with the institution's supporting analysis, that confirms that the instrument meets or exceeds the Basel III qualifying criteria for the tier of regulatory capital in which the institution intends to include the instrument on a consolidated basis; and
- an undertaking whereby both the institution and the subsidiary confirm that the instrument will not be redeemed, purchased for cancellation, or amended without the prior approval of the Superintendent. Such undertaking will not be required where the prior approval of the Superintendent is incorporated into the terms and conditions of the instrument.

2.1.3 Tier 2 Capital

25. Tier 2 capital (prior to regulatory adjustments) consists of the following elements:

- Instruments issued by the institution that meet the criteria for inclusion in Tier 2 capital (and are not included in Tier 1 capital);
- Surplus (share premium) resulting from the issue of instruments included in Tier 2 capital[24];
- Instruments issued by consolidated subsidiaries of the institution and held by third parties that meet the criteria for inclusion in Tier 2 capital and are not included in Tier 1 capital (see sections 2.1.3.1 to 2.1.3.3); and
- Certain loan loss allowances as specified in section 2.1.3.7.

[BCBS June 2011 par 57]

2.1.3.1 Tier 2 instruments issued by the institution directly

26. The following is the minimum set of criteria for an instrument issued by the institution to meet or exceed in order for it to be included in Tier 2 capital:

1) Issued and paid-in in cash, or with the prior approval of the Superintendent, in property.
2) Subordinated to depositors and general creditors of the institution.
3) Is neither secured nor covered by a guarantee of the issuer or related entity or other arrangement that legally or economically enhances the seniority of the claim vis-à-vis the institution’s depositors and/or general creditors.
4) Maturity:
    - Minimum original maturity of at least five years
    - Recognition in regulatory capital in the remaining five years before maturity will be amortized on a straight-line basis
    - There are no step-ups[25] or other incentives to redeem
5) May be callable at the initiative of the issuer only after a minimum of five years:
    a. To exercise a call option an institution must receive the prior approval of the Superintendent; and

[24] Surplus (share premium) that is not eligible for inclusion in Tier 1 will only be permitted to be included in Tier 2 capital if the shares giving rise to the surplus are permitted to be included in Tier 2 capital. [BCBS June 2011 par 59]

[25] A step-up is defined as a call option combined with a pre-set increase in the initial credit spread of the instrument at a future date over the initial dividend (or distribution) rate after taking into account any swap spread between the original reference index and the new reference index. Conversion from a fixed rate to a floating rate (or vice versa) in combination with a call option without any increase in credit spread would not constitute a step-up.

b. An institution must not do anything which creates an expectation that the call be exercised[26]; and

c. An institution must not exercise the call unless:

  - It replaces the called instrument with capital of the same or better quality, including through an increase in retained earnings, and the replacement of this capital is done at conditions which are sustainable for the income capacity of the institution[27]; or

  - The institution demonstrates that its capital position is well above the minimum capital requirements after the call option is exercised.

6) The investor must have no rights to accelerate the repayment of future scheduled principal or interest payments, except in bankruptcy, insolvency, wind-up, or liquidation.

7) The instrument cannot have a credit sensitive dividend feature; that is, a dividend or coupon that is reset periodically based in whole or in part on the institution or organizations' credit standing[28].

8) Neither the institution nor a related party over which the institution exercises control or significant influence can have purchased the instrument, nor can the institution directly or indirectly have funded the purchase of the instrument.

9) If the instrument is not issued out of an operating entity[29] or the holding company in the consolidated group (e.g. it is issued out of a special purpose vehicle – "SPV"), proceeds must be immediately available without limitation to an operating entity or the holding company in the consolidated group in a form which meets or exceeds all of the other criteria for inclusion in Tier 2 capital. For greater certainty, the only assets the SPV may hold are intercompany instruments issued by the institution or a related entity with terms and conditions that meet or exceed the above Tier 2 criteria. Put differently, instruments issued to the SPV have to fully meet or exceed all of the eligibility criteria for Tier 2 capital as if the SPV itself was an end investor – i.e. the institution cannot issue a senior debt instrument to an SPV and have the SPV issue higher quality capital instruments to third party investors so as to receive recognition as Tier 2 capital.

10) The contractual terms and conditions of the instrument must include a clause requiring the full and permanent conversion of the instrument into common shares at the point of non-viability as described under OSFI's non-viability contingent capital (NVCC) requirements as specified under section 2.2. Where an instrument is issued by an SPV according to criterion #9 above, the conversion of instruments issued by the SPV to end investors should mirror the conversion of the capital issued by the institution to the SPV.

26 An option to call the instrument after five years but prior to the start of the amortisation period will not be viewed as an incentive to redeem as long as the institution does not do anything that creates an expectation that the call will be exercised at this point.

27 Replacement issuances can be concurrent with but not after the instrument is called.

28 Institutions may use a broad index as a reference rate in which the issuing institution is a reference entity, however, the reference rate should not exhibit significant correlation with the institution's credit standing. If an institution plans to issue capital instruments where the margin is linked to a broad index in which the institution is a reference entity, the institution should ensure that the dividend/coupon is not credit-sensitive.

29 An operating entity is an entity set up to conduct business with clients with the intention of earning a profit in its own right.

[BCBS June 2011 par 58]

27. 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.

28. Purchase for cancellation of Tier 2 instruments is permitted at any time with the prior approval of the Superintendent. For further clarity, a purchase for cancellation does not constitute a call option as described in the above Tier 2 criteria.

29. Tax and regulatory event calls are permitted during an instrument's life subject to the prior approval of the Superintendent and provided the institution was not in a position to anticipate such an event at the time of issuance. [BCBS FAQs #15, p.6]

30. Where an amendment or variance of a Tier 2 instrument's terms and conditions affects its recognition as regulatory capital, such amendment or variance will only be permitted with the prior approval of the Superintendent[30].

31. Institutions are permitted to "re-open" offerings of capital instruments to increase the principal amount of the original issuance subject to the following: (1) institutions cannot re-open offerings where the initial issue date was on or before December 31, 2012; and 2) call options will only be exercised, with the prior approval of the Superintendent, on or after the fifth anniversary of the closing date of the latest re-opened tranche of securities.

2.1.3.2 Tier 2 capital qualifying instruments issued by a consolidated subsidiary to third parties

32. Total capital instruments (i.e. Tier 1 and Tier 2 capital instruments) issued by a fully consolidated subsidiary of the institution to third-party investors (including amounts under sections 2.1.1.2 and 2.1.2.2) may receive recognition in the consolidated Total capital of the parent institution only if the instrument would, if issued by the institution, meet all of the criteria for classification as Tier 1 or Tier 2 capital.

33. The amount of capital that will be recognized in consolidated Total Capital is calculated as follows (refer to Appendix 2-1 for an illustrative example):

a. Paid-in capital plus retained earnings that are attributable to third-party investors, gross of deductions, less the amount of surplus Total Capital of the subsidiary that is attributable to the third-party investors.

b. The surplus Total Capital of the subsidiary is calculated as the Total Capital of the subsidiary, net of deductions, minus the lower of: (1) the minimum Total Capital requirement of the subsidiary plus the capital conservation buffer (ie 10.5% of risk-

[30] Any modification of, addition to, or renewal or extension of an instrument issued to a related party is subject to the legislative requirement that transactions with a related party be at terms and conditions that are at least as favourable to the institution as market terms and conditions.

weighted assets[31]; and (2) the portion of the parent's consolidated minimum Total Capital requirements[32] plus the capital conservation buffer (ie 10.5% of risk-weighted assets) that relates to the subsidiary.

c. The amount of surplus Total capital that is attributable to the third-party investors is calculated by multiplying the surplus Total capital of the subsidiary (calculated in (b)) by the percentage of Total Capital that is attributable to third-party investors.

The amount of this Total capital that will be recognized in Tier 2 will exclude amounts recognized in Common Equity Tier 1 under section 2.1.1.2 and amounts recognized in Tier 1 under section 2.1.2.2. [BCBS June 2011 par 64]

2.1.3.3 Tier 2 instruments issued to third-parties out of SPVs

34. As stated under paragraph 9, where capital has been issued to third-parties out of an SPV none of this capital can be included in Common Equity Tier 1. However, such capital can be included in consolidated Additional Tier 1 or Tier 2 and treated as if the institution itself had issued the capital directly to the third-parties only if:

a. it meets all the relevant entry criteria; and

b. the only asset of the SPV is its investment in the capital of the institution in a form that meets or exceeds all the relevant entry criteria[33] (as required by criterion 14 for Additional Tier 1 and criterion 9 for Tier 2).

In cases where the capital has been issued to third-parties through an SPV via a fully consolidated subsidiary of the institution, such capital may, subject to the requirements of this paragraph, be treated as if the subsidiary itself had issued it directly to the third-parties and may be included in the institution's consolidated Additional Tier 1 or Tier 2 in accordance with the treatment outlined in sections 2.1.2.2 and 2.1.3.2. [BCBS June 2011 par 65]

2.1.3.4 Tier 2 instruments issued to a parent

35. In addition to the qualifying criteria and minimum requirements specified in this Guideline, Tier 2 capital instruments issued by an institution to a parent, either directly or indirectly, can be included in regulatory capital subject to the institution providing notification of the intercompany issuance to OSFI's Capital Division together with the following:

- a copy of the instrument's term and conditions;
- the intended classification of the instrument for regulatory capital purposes;
- the rationale provided by the parent for not providing common equity in lieu of the subject capital instrument;

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31 Calculated using the local regulator's RWA calculation methodology, i.e. if the local regulator's requirements are based on Basel I rules, this calculation method can be used. The calculation must still be based on the minimum requirement plus the capital conservation buffer (ie 10.5% of risk-weighted assets).

32 This amount should exclude any intercompany exposures (e.g. loans or debentures) from the subsidiary to the parent that would boost the subsidiary's risk-weighted assets.

33 Assets that relate to the operation of the SPV may be excluded from this assessment if they are *de minimus*.

- confirmation that the rate and terms of the instrument are at least as favourable to the institution as market terms and conditions;
- confirmation that the failure to make dividend or interest payments, as applicable, on the subject instrument would not result in the parent, now or in the future, being unable to meet its own debt servicing obligations nor would it trigger cross-default clauses or credit events under the terms of any agreements or contracts of either the institution or the parent.

2.1.3.5 Capital instruments issued out of branches and subsidiaries outside Canada

36. Debt instruments issued out of branches or subsidiaries outside Canada must normally be governed by Canadian law. The Superintendent may, however, waive this requirement where the institution can demonstrate that an equivalent degree of subordination can be achieved as under Canadian law. Instruments issued prior to year-end 1994 are not subject to this requirement.

In addition to any other requirements prescribed in this Guideline, where an institution wishes to consolidate a capital instrument issued by a foreign subsidiary, it must provide OSFI's Capital Division with the following documentation:

- a copy of the instrument's term and conditions;
- certification from a senior executive of the institution, together with the institution's supporting analysis, that confirms that the instrument meets or exceeds the Basel III qualifying criteria for the tier of regulatory capital in which the institution intends to include the instrument on a consolidated basis; and
- an undertaking whereby both the institution and the subsidiary confirm that the instrument will not be redeemed, purchased for cancellation, or amended without the prior approval of the Superintendent. Such undertaking will not be required where the prior approval of the Superintendent is incorporated into the terms and conditions of the instrument.

2.1.3.6 Amortization

37. Tier 2 capital instruments are subject to straight-line amortization in the final five years prior to maturity. Hence, as these instruments approach maturity, redemption or retraction, such outstanding balances are to be amortized based on the following criteria:

Years to Maturity	***Included in Capital***
5 years or more	100%
4 years and less than 5 years	80%
3 years and less than 4 years	60%
2 years and less than 3 years	40%
1 year and less than 2 years	20%
Less than 1 year	0%

38. For instruments issued prior to January 1, 2013, where the terms of the instrument include a redemption option that is not subject to prior approval of the Superintendent and/or holders' retraction rights, amortization should begin five years prior to the effective dates governing such options. For example, a 20-year debenture that can be redeemed at the institution's option at any time on or after the first 10 years would be subject to amortization commencing in year 5. Further, where a subordinated debt was redeemable at the institution's option at any time without the prior approval of the Superintendent, the instrument would be subject to amortization from the date of issuance. For greater certainty, this would not apply when redemption requires the Superintendent's approval as is required for all instruments issued after January 1, 2013 pursuant to the above criteria in section 2.1.3.1.

39. Amortization should be computed at the end of each fiscal quarter based on the "years to maturity" schedule in paragraph 37 above. Thus, amortization would begin during the first quarter that ends within five calendar years to maturity. For example, if an instrument matures on October 31, 2020, 20% amortization of the issue would occur November 1, 2015 and be reflected in the January 31, 2016 capital adequacy return. An additional 20% amortization would be reflected in each subsequent January 31 return.

2.1.3.7 General allowances[34]

40. Institutions using the standardized approach for credit risk

- Allowances that are held against future, presently unidentified losses are freely available to meet losses which subsequently materialize and therefore qualify for inclusion within Tier 2. Such allowances are termed 'general allowances' in this guideline, and are defined as Stage 1 and Stage 2 allowances under IFRS 9. Allowances held against identified losses, whether individual or grouped, should be excluded. These allowances are termed 'specific allowances' in this guideline, and are defined as Stage 3 allowances plus partial write-offs under IFRS 9. General allowances eligible for inclusion in Tier 2 capital will be limited to a maximum of 1.25% of credit risk-weighted assets calculated under the Standardized Approach. Deposit-taking Institutions in the business of lending must meet all of the principles and criteria in OSFI's IFRS 9 Guideline[35] in order for general allowances to be included in Tier 2 capital. Inclusion of general allowances in capital does not require prior approval from OSFI. [BCBS June 2011 par 60]

41. Institutions using an IRB approach

- calculate a provisioning excess or shortfall as follows: (1) general allowances, plus (2) all other allowances for credit loss, minus (3) the expected loss amount
- deduct provisioning shortfalls from Common Equity Tier 1 capital
- include provisioning excess in Tier 2 capital up to a limit of the lower of 0.6% of IRB credit risk-weighted assets or the amount of general allowances.

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[34] Eligible allowances or reserves included in Tier 2 capital should be recorded as gross of tax effects.
[35] Available at http://www.osfi-bsif.gc.ca/Eng/fi-if/rg-ro/gdn-ort/gl-ld/Pages/ifrs9.aspx.

[BCBS June 2011 par 61]

42. Institutions that have partially implemented an IRB approach[36]

- split general allowances proportionately based on credit risk-weighted assets calculated under the Standardized Approach and the IRB Approach
- include general allowances allocated to the Standardized Approach in Tier 2 capital up to a limit of 1.25% of credit risk weighted assets calculated using the Standardized Approach
- calculate a provisioning excess or shortfall on the IRB portion of the institution as set out above
- deduct provisioning shortfalls on the IRB portion of the institution from Common Equity Tier 1 capital
- include excess provisions calculated for the IRB portion of the institution in Tier 2 capital up to a limit of the lower of 0.6% of IRB credit risk-weighted assets or the amount of general allowances allocated to the IRB portion of the institution

2.2 Non-Viability Contingent Capital Requirements (NVCC)

43. All regulatory capital must be able to absorb losses in a failed financial institution. The NVCC requirements aim to ensure that investors in non-common regulatory capital instruments bear losses before taxpayers where the government determines it is in the public interest to rescue a non-viable bank[37].

2.2.1 Principles Governing NVCC

44. OSFI has determined that, effective January 1, 2013, all non-common Tier 1 and Tier 2 capital instruments issued by institutions must comply with the following principles to satisfy the NVCC requirement:

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[38] into common shares of the institution upon a trigger event[39]. As such, the terms of non-common capital instruments must not provide for any residual claims that are senior to common equity following a trigger

[36] Institutions that have partially implemented an IRB approach must meet the requirements in paragraph 40 above.

[37] Other resolution options, including the creation of a bridge bank, could be used to resolve a failing institution, either as an alternative to NVCC or, in a manner consistent with Principle 3(a), in conjunction with or following an NVCC conversion, and could also subject capital providers to loss.

[38] 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.

[39] The non-common capital of an institution 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.

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. Institutions that are federal credit unions will be permitted to structure NVCC instruments with contractual clauses that provide for either a full and permanent write-off of the instrument upon a trigger event or a full and permanent conversion into instruments that are eligible for recognition as Common Equity Tier 1 capital under the criteria set out in section 2.1.1.1 of this Guideline.

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: The contractual terms of all Additional Tier 1 and Tier 2 capital instruments must, at a minimum, include the following trigger events:

a. the Superintendent of Financial Institutions (the "Superintendent") publicly announces that the institution has been advised, in writing, that the Superintendent is of the opinion that the institution has ceased, or is about to cease, to be viable and that, after the conversion or write-off, as applicable, of all contingent instruments and taking into account any other factors or circumstances that are considered relevant or appropriate, it is reasonably likely that the viability of the institution will be restored or maintained; or

b. a federal or provincial government in Canada publicly announces that the institution has accepted or agreed to accept a capital injection, or equivalent support, from the federal government or any provincial government or political subdivision or agent or agency thereof without which the institution would have been determined by the Superintendent to be non-viable[40].

The term "equivalent support" in the above second trigger constitutes support for a non-viable institution that enhances the institution'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 institution 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.

[40] 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.

Principle # 4: The conversion terms of new NVCC instruments must reference the market value of common equity on or before the date of the trigger event[41]. 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 should take into account the hierarchy of claims in liquidation 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 that are more favourable than those provided to former preferred shareholders, and that former preferred shareholders receive economic entitlements that are more favourable than those provided to pre-existing common shareholders.

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

a. the institution'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. the institution's by-laws or other relevant constating documents must permit the requisite number of shares to be issued upon conversion;
c. the terms and conditions of any other agreement must not provide for the prior consent of the parties in respect of the conversion or write-off, as applicable;
d. the terms and conditions of capital instruments must not impede conversion or write-off, as applicable; and
e. if applicable, the institution 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 or write-off does not constitute an event of default under that instrument. Further, the issuing institution must take all commercially reasonable efforts to ensure that conversion or write-off is not an event of default or credit event under any other agreement entered into by the institution, directly or indirectly, on or after the date of this Guideline, including senior debt agreements and derivative contracts.

Principle # 8: The terms of the NVCC instrument should include provisions to address NVCC investors that are prohibited, pursuant to the legislation governing the institution, from acquiring common shares in the institution upon a trigger event. Such mechanisms should allow such capital providers to comply with legal prohibitions while continuing to receive the economic results of common share ownership and should allow such persons to transfer their entitlements

[41] As liquidation is the baseline resolution mechanism for a failed institution, it is expected that the market values for capital instruments of a non-viable institution 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.

to a person that is permitted to own shares in the institution and allow such transferee to thereafter receive direct share ownership.

Principle # 9: For institutions, 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 institution must be convertible into common shares of the institution or, subject to the prior consent of OSFI, convertible into common shares of the institution's parent. In addition, the trigger events in an institution'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 an institution's parent).

Principle # 10: For institutions that have subsidiaries in foreign jurisdictions that are subject to the Basel III capital adequacy requirements, the institution may, to the extent permitted by the Basel III rules[42], include the NVCC issued by foreign subsidiaries in the institution's consolidated regulatory capital provided that such foreign subsidiary's NVCC complies with the NVCC requirements according to the rules of its host jurisdiction. 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 institution 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.

2.2.2 Criteria to be considered in triggering conversion or write-off of NVCC

45. The decision to maintain an institution as a going concern where it would otherwise become non-viable will be informed by OSFI's interaction with the Financial Institutions Supervisory Committee (FISC)[43] (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 prior to making a non-viability determination. It is important to note the conversion or write-off of NVCC alone may not be sufficient to restore an institution to viability; that is, other public sector interventions, including liquidity assistance, would likely be used in tandem with NVCC to maintain an institution as a going concern. Consequently, while the Superintendent would have the authority to trigger conversion or write-off, in practice, the Superintendent's decision to activate the trigger would be conditioned by the legislative

[42] For further reference, please refer to sections 2.1.1.2, 2.1.2.2, and 2.1.3.2 of this guideline.

[43] 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.

provisions and decision frameworks associated with accompanying interventions by other FISC agencies.

46. In assessing whether an institution has ceased, or is about to cease, to be viable and that, after the conversion or write-off of all contingent capital instruments, it is reasonably likely that the viability of the institution 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 regulatory guidance[44]. 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[45]:

i. Whether the assets of the institution are, in the opinion of the Superintendent, sufficient to provide adequate protection to the institution's depositors and creditors.

ii. Whether the institution 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 institution'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. Whether the institution failed to pay any liability that has become due and payable or, in the opinion of the Superintendent, the institution will not be able to pay its liabilities as they become due and payable.

v. Whether the institution failed to comply with an order of the Superintendent to increase its capital.

vi. Whether, in the opinion of the Superintendent, any other state of affairs exists in respect of the institution that may be materially prejudicial to the interests of the institution's depositors or creditors or the owners of any assets under the institution'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 institution.

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

47. For greater certainty, Canadian authorities will retain full discretion to choose not to trigger NVCC notwithstanding a determination by the Superintendent that an institution has

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

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

ceased, or is about to cease, to be viable. Under such circumstances, the institution's creditors and shareholders could be exposed to losses through the use of other resolution tools or in liquidation.

48. For information on the capital confirmation process, with specific reference to the NVCC documentation requirements see Appendix 2-2 to this chapter.

2.3 Required Regulatory Adjustments to Capital

49. This section sets out the regulatory adjustments to be applied to regulatory capital. In most cases, these adjustments are applied in the calculation of Common Equity Tier 1. All items that are deducted from capital are risk-weighted at 0% in the risk-based capital adequacy framework. Balance sheet assets that are deducted from Tier 1 capital are excluded from total exposures when calculating the leverage ratio.

50. Except in respect of the items referred to in paragraphs 61 and 64 below, institutions shall not make adjustments to remove from Common Equity Tier 1 capital unrealised gains or losses on assets or liabilities that are measured at fair value for accounting purposes.
[BCBS June 2011 par 52, footnote 10]

51. Global systemically important banks (G-SIBs) are required to meet a minimum Total Loss Absorbing Capacity (TLAC) requirement set in accordance with the Financial Stability Board's (FSB) TLAC principles and term sheet (the FSB TLAC Term Sheet). Similarly, Canadian D-SIBs are subject to minimum TLAC ratios as set out in OSFI's TLAC Guideline. Institutions that invest in TLAC or similar instruments issued by G-SIBs and/or Canadian D-SIBs may be required to deduct such holdings in calculating their own regulatory capital[46].
[BCBS October 2016 par 66a]

52. For the purpose of section 2.3, holdings of TLAC include the following, hereafter collectively referred to as "Other TLAC Instruments":

i. all direct, indirect, and synthetic investments in the instruments of a D-SIB that are eligible to be recognised as TLAC pursuant to OSFI's TLAC Guideline and that do not otherwise qualify as regulatory capital for the issuing D-SIB[47];

ii. all direct, indirect, and synthetic investments in the instruments of a G-SIB resolution entity that are eligible to be recognized as external TLAC and that do not otherwise

[46] Principles on Loss-Absorbing and Recapitalisation Capacity of G-SIBs in Resolution: Total Loss-absorbing Capacity (TLAC) Term Sheet. (FSB: November 2015). The regulatory adjustments for TLAC set out in this section relate to Section 15 of the FSB TLAC Term Sheet.

[47] Tier 2 instruments that no longer count in full as regulatory capital (as a result of having a residual maturity of less than five years or due to Basel III transitioning rules) continue to be recognised in full as a Tier 2 instrument by the investing bank for the regulatory adjustments in this section. Similarly, instruments that no longer count towards TLAC as a result of having a residual maturity of less than 1 year continue to be recognised in full as Other TLAC Instruments by the investing bank for the regulatory adjustments in this section.

qualify as regulatory capital for the issuing G-SIB, with the exception of instruments excluded by paragraph 53; and

iii. all holdings of instruments issued by a G-SIB resolution entity that rank *pari passu* to any instruments included in (ii) with the exception of:

(1) instruments listed as liabilities excluded from TLAC in Section 10 of the FSB TLAC Term Sheet (i.e. "Excluded Liabilities"); and

(2) instruments ranking *pari passu* with instruments eligible to be recognized as TLAC by virtue of the exemptions to the subordination requirements in section 11 of the FSB TLAC Term Sheet.

[BCBS October 2016 par 66b]

53. In certain jurisdictions (excluding Canada), G-SIBs may be able to recognise instruments ranking *pari passu* to Excluded Liabilities as external TLAC, up to a limit, in accordance with the exceptions to the subordination requirements set out in the penultimate paragraph of section 11 of the FSB TLAC Term Sheet. An institution's holdings of such instruments will be subject to a proportionate deduction approach. Under this approach, only a proportion of holdings of instruments that is eligible to be recognized as external TLAC by virtue of the subordination exemptions will be considered a holding of TLAC by the investing institution. The proportion is calculated as: (1) the funding issued by the G-SIB resolution entity that ranks *pari passu* with Excluded Liabilities and that is recognized as external TLAC by the G-SIB resolution entity; divided by (2) the funding issued by the G-SIB resolution entity that ranks *pari passu* with Excluded Liabilities and that would be recognized as external TLAC if the subordination requirement was not applied[48]. Institutions must calculate their holdings of Other TLAC Instruments of the respective issuing G-SIB resolution entities based on the latest available public information provided by the issuing G-SIBs on the proportion to be used. [BCBS October 2016 par 66c]

54. The regulatory adjustments relating to TLAC holdings set out in section 2.3 apply from Q1 2019[49].

[48] For example, if a G-SIB resolution entity has funding that ranks *pari passu* with Excluded Liabilities equal to 5% of RWAs and receives partial recognition of these instruments as external TLAC equivalent to 3.5% RWAs, then an investing institution holding such instruments must include only 70% (i.e. 3.5/5) of such instruments in calculating its TLAC holdings. The same proportion should be applied by the investing institution to any indirect or synthetic investments in instruments ranking *pari passu* with Excluded Liabilities and eligible to be recognized as TLAC by virtue of the subordination exemptions set out in the FSB TLAC Term Sheet.

[49] November 1, 2018 for institutions with an October 31st year-end and January 1, 2019 for institutions with a December 31st year-end.

2.3.1 Regulatory Adjustment to Common Equity Tier 1 Capital

Prudential valuation adjustments

55. Valuation adjustments on less liquid positions as described in paragraph 45 of Chapter 9 of this guideline should be made in the calculation of Common Equity Tier 1.

Goodwill and other intangibles (except mortgage servicing rights)

56. Goodwill related to consolidated subsidiaries, subsidiaries deconsolidated for regulatory capital purposes, and the proportional share of goodwill in joint ventures subject to the equity method accounting should be deducted in the calculation of Common Equity Tier 1. In addition, goodwill included in the valuation of significant investments[50] in the capital of banking, financial, and insurance entities that are outside the scope of regulatory consolidation should also be deducted from Common Equity Tier 1. The full amount is to be deducted net of any associated deferred tax liability which would be extinguished if the goodwill becomes impaired or derecognized under relevant accounting standards. [BCBS June 2011 par 67]

57. All other intangible assets[51] except mortgage servicing rights should be deducted in the calculation of Common Equity Tier 1. This includes intangible assets related to consolidated subsidiaries, subsidiaries deconsolidated for regulatory capital purposes, and the proportional share of intangible assets in joint ventures subject to the equity method accounting. The full amount is to be deducted net of any associated deferred tax liability which would be extinguished if the intangibles assets become impaired or derecognized under relevant accounting standards. Mortgage servicing rights are deducted through the "threshold deductions" set out in paragraphs 84-86. [BCBS June 2011 par 67]

Deferred tax assets

58. Deferred tax assets (DTAs), except for those referenced in paragraph 59 and DTAs associated with the de-recognition of the cash flow hedge reserve, are to be deducted in the calculation of Common Equity Tier 1. Deferred tax assets may be netted with associated deferred tax liabilities (DTLs) only if the DTAs and DTLs relate to taxes levied by the same taxation authority and offsetting is permitted by the relevant taxation authority[52]. Where these DTAs relate to temporary differences (e.g., allowance for credit losses) the amount to be deducted is set out in the "threshold deductions" (paragraphs 84-86). All other such assets, e.g., those relating to operating losses, such as the carry forward of unused tax losses, or unused tax credits, are to be deducted in full net of deferred tax liabilities and net of valuation allowance as described above. The DTLs permitted to be netted against DTAs must exclude amounts that have been netted against the deduction of goodwill, intangibles, defined benefit pension assets, and the de-

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[50] An institution should calculate a goodwill amount as at the acquisition date by separating any excess of the acquisition cost over the investor's share of the net fair value of the identifiable assets and liabilities of the banking, financial or insurance entity. In accordance with applicable accounting standards, this goodwill amount may be adjusted for any subsequent impairment losses and reversal of impairment losses that can be assigned to the initial goodwill amount. [BCBS FAQs #1, p.8]

[51] This includes software intangibles.

[52] Does not permit offsetting of deferred tax assets across provinces.

recognition of the cash flow hedge reserve and must be allocated on a pro rata basis between DTAs subject to the threshold deduction treatment, DTAs that are to be deducted in full and DTAs that are risk-weighted at 100% as per paragraph 59. [BCBS June 2011 par 69]

59. DTAs arising from temporary differences that the institution could realize through loss carrybacks, that is, they do not depend on the future profitability of the institution to be realized, are not subject to deduction, and instead receive a 100 percent risk weight. OSFI's Capital Division requires notification, through the institution's Lead Supervisor, of any DTAs which are assigned the applicable 100% risk weight and institutions may be subject to increased supervisory monitoring in this area.

Current tax assets

60. When an over installment of tax, or current year tax losses carried back to prior years result in the recognition for accounting purposes of a claim or receivable from the government or local tax authority, such a claim or receivable would be assigned the relevant sovereign risk weighting. Such amounts are classified as current tax assets for accounting purposes. Current tax assets are not required to be deducted in the calculation of Common Equity Tier 1. [BCBS June 2011 par 70]

Cash flow hedge reserve

61. The amount of cash flow hedge reserve that relates to the hedging of items that are not fair valued on the balance sheet (including projected cash flows) should be derecognized in the calculation of Common Equity Tier 1. This includes items that are not recognized on the balance sheet but excludes items that are fair valued on the balance sheet. Positive amounts should be deducted from Common Equity Tier 1 and negative amounts should be added back. This treatment specifically identifies the element of the cash flow hedge reserve that is to be derecognised for prudential purposes. It removes the element that gives rise to artificial volatility in common equity, as in this case the reserve only reflects one half of the picture (the fair value of the derivative, but not the changes in fair value of the hedged future cash flow). [BCBS June 2011 par 71-72]

Shortfall in provisions to expected losses

62. Provisioning shortfalls calculated under IRB Approaches to credit risk should be deducted in the calculation of Common Equity Tier 1. The full amount is to be deducted and should not be reduced by any tax effects that could be expected to occur if provisions were to rise to the level of expected losses. [BCBS June 2011 par 73]

Gain on sale related to securitization transactions

63. Increases in equity capital resulting from securitization transactions (e.g., capitalized future margin income, gains on sale) should be derecognized in the calculation of Common Equity Tier 1. [BCBS June 2011 par 74]

Cumulative gains and losses due to changes in own credit risk on fair valued financial liabilities

64. All after-tax unrealized gains and losses that have resulted from changes in the fair value of liabilities that are due to changes in the institution's own credit risk should be derecognized in the calculation of Common Equity Tier 1. In addition, with regard to derivative liabilities, all accounting valuation adjustments arising from the institution's own credit risk should also be derecognized on an after-tax basis. The offsetting between valuation adjustments arising from the institution's own credit risk and those arising from its counterparties' credit risk is not allowed. Institutions that have adopted funding valuation adjustment (funding cost adjustment plus funding benefit adjustment) are expected to derecognize their funding benefit adjustment in full (i.e. gross of any funding cost adjustment). [BCBS June 2011 par 75] [53]

Defined benefit pension fund assets and liabilities

65. Defined benefit pension fund liabilities, as included on the balance sheet, must be fully recognized in the calculation of Common Equity Tier 1 (i.e. Common Equity Tier 1 cannot be increased through derecognizing these liabilities). For each defined benefit pension fund that is an asset on the institution's balance sheet, the amounts reported as an asset on the balance sheet[54] should be deducted in the calculation of Common Equity Tier 1 net of any associated deferred tax liability that would be extinguished if the asset should become impaired or derecognized under the relevant accounting standards.

66. Assets in the fund to which the institution has unrestricted and unfettered access can, with prior OSFI approval, be used to offset the deduction. In addition, where a Canadian institution has a foreign subsidiary which is insured by a deposit insurance corporation and the regulatory authority in that jurisdiction permits the subsidiary to offset its deduction from CET1 related to defined benefit pension assets on the basis that the insurer has unrestricted and unfettered access to the excess assets of the subsidiary's pension plan in the event of receivership, OSFI will allow the offset to be reflected in the Canadian institution's consolidated regulatory capital, subject to prior OSFI approval. Such offsetting assets should be given the risk weight they would receive if they were owned directly by the institution. [BCBS June 2011 par 76-77]

Investments in own shares (treasury stock)[55]

67. All of an institution's investments in its own common shares[56], whether held directly or indirectly, will be deducted in the calculation of Common Equity Tier 1 (unless already derecognized under IFRS). In addition, any own stock which the institution could be contractually obliged to purchase should be deducted in the calculation of Common Equity

53 Refer to the BCBS July 25, 2012 press release *Regulatory treatment of valuation adjustments to derivative liabilities: final rule issued by the Basel Committee*

54 Generally, institutions currently report this amount in Other Assets on the balance sheet.

55 Where an institution acts as a market maker in its own capital instruments, the contractual obligation requiring deduction is deemed to commence upon the institution agreeing to purchase the security at an agreed price and either this offer has been accepted or cannot be withdrawn. [BCBS FAQs, #12 p.11]

56 Institutions may also be subject to restrictions or prohibitions on the holdings of their own securities under their governing statutes.

Tier 1. The treatment described will apply irrespective of the location of the exposure in the banking book or the trading book. In addition:

- Gross long positions may be deducted net of short positions in the same underlying exposure only if the short positions involve no counterparty risk.
- Institutions should look though holdings of index securities to deduct exposures to own shares. However, gross long positions in own shares resulting from holdings of index securities may be netted against short positions in own shares resulting from short positions in the same underlying index provided the maturity of the short position matches the maturity of the long position or has a residual maturity of at least one year. In such cases, the short positions may involve counterparty credit risk (which will be subject to the relevant counterparty credit risk charge).

  [BCBS June 2011 par 78]

Reciprocal cross holdings in the common shares of banking, financial and insurance entities

68. Reciprocal cross holdings in common shares (e.g. Bank A holds shares of Bank B and Bank B in return holds shares of Bank A) that are designed to artificially inflate the capital position of institutions will be fully deducted in the calculation of Common Equity Tier 1. [BCBS June 2011 par 79]

Decision tree to determine the capital treatment of equity investments

69. When an equity investment (including an equity investment in a fund) is made, the following decision tree should be used to determine how the capital requirements for that equity investment should be calculated:

(a) The first decision point is to consider whether the entity in which the equity investment is made is a banking, financial or insurance entity. If it is, then either paragraphs 77-86 below (significant investments) or paragraphs 70-76 (non-significant investments) should be used to calculate capital requirements for the equity investment.

(b) If the entity is not a financial entity, then the next question to ask is whether the entity is a fund. If it is, then either section 3.1.18 of Chapter 3 of the CAR Guideline (Standardized Approach) or section 6.5.3 of Chapter 6 of the CAR Guideline (IRB approach) should be used to calculate capital requirements for the equity investment.

(c) Finally, if the equity investment is made in an entity that is not captured in (a) or (b) above, then either paragraph 101 of this chapter (significant investment in a commercial entity) or the de-facto treatment for equity investments (non-significant investments) of either Chapter 3 (Standardized Approach) or Chapter 6 (IRB Approach) should be used to calculate capital requirements for the equity investment.

Non-significant investments in the capital and/or Other TLAC Instruments of banking, financial[57] and insurance entities[58],[59]

70. The regulatory adjustment described in this section applies to investments in the capital and/or Other TLAC Instruments of banking, financial and insurance entities where the investment is not considered a significant investment[60]. These investments are deducted from regulatory capital, subject to a threshold. For the purpose of this regulatory adjustment:

- Investments include direct, indirect[61], and synthetic holdings of capital instruments[62] and/or Other TLAC Instruments. Institutions should look through holdings of index securities to determine their underlying holdings of capital or Other TLAC Instruments. If institutions find it operationally burdensome to look through and monitor their exact exposures to other financial institutions as a result of their holdings of index securities, OSFI will permit institutions, subject to prior supervisory approval, to use a conservative estimate.
- A written put option will not be considered a synthetic holding for purposes of this paragraph where <u>all</u> of the following conditions have been met:
    i. The purchase price for the subject capital or Other TLAC instrument will be based on the future market value, or fair value to be determined in the future via a third party or through an arms-length negotiation between institutions.
    ii. The contractual terms of the option/agreement provide that the institution has the legal right, without consent from the counterparty/counterparties, to issue an equivalent notional amount of its own capital or, for G-SIBs and D-SIBs, its own TLAC in an equivalent (or higher quality) tier as consideration for the subject capital.
    iii. The institution publicly discloses the material terms of the put option that permit the bank to settle the option through the issuance of an equivalent notional

[57] Examples of the types of activities that financial entities might be involved in include financial leasing, issuing credit cards, portfolio management, investment advisory, custodial and safekeeping services and other similar activities that are ancillary to the business of banking. [BCBS FAQs #7 p.10]

[58] The scope of this regulatory adjustment should be considered comprehensive. Institutions are encouraged to contact OSFI for further guidance in this area, relating to specific investments, where necessary. Institutions should also note that hedge funds should be considered within the scope of the required regulatory adjustment.

[59] For the purpose of this Guideline, investments in the capital of banking, financial and insurance entities include investments in the capital of cooperative credit associations (i.e. Centrals), credit unions, and other cooperative financial institutions.

[60] See paragraph 77 (and footnote 66) for the definition of significant investment.

[61] Indirect holdings are exposures or parts of exposures that, if a direct holding loses its value, will result in a loss to the institution substantially equivalent to the loss in the value of the direct holding. Where an institution holds an investment in a mutual fund that is a pass-through security, it should be treated as an indirect holding in the pool of assets in the fund.

[62] Examples of indirect and synthetic holdings include: (i) the institution invests in the capital of an entity that is not consolidated for regulatory purposes and is aware that this entity has an investment in the capital of a financial institution. (ii) The institution enters into a total return swap on capital instruments of another financial institution. (iii) The institution provides a guarantee or credit protection to a third party in respect of the third party's investments in the capital of another financial institution. (iv) The institution owns a call option or has written a put option on the capital instruments of another financial institution. (vi) The institution has entered into a forward purchase agreement on the capital of another financial institution. [BCBS FAQs #15 p.12]

amount of its own capital or, for G-SIBs and D-SIBs, its own TLAC in an equivalent (or higher quality) tier.

iv. The institution has obtained the prior approval of the Superintendent to exclude the written put option from its investment in financials.

- Holdings in both the banking book and trading book are to be included. Capital includes common stock and all other types of cash and synthetic capital instruments (e.g. subordinated debt). Other TLAC Instruments are defined in paragraphs 52 and 53.
- For capital instruments, it is the net long position that is to be included (i.e. the gross long position net of short positions in the same underlying exposure where the maturity of the short position either matches the maturity of the long position or has a residual maturity of at least one year). For Other TLAC Instruments, it is the gross long position that is to be included in paragraphs 96-98 and the net long position that is to be included in paragraph 74.
- Underwriting positions in capital instruments and/or Other TLAC Instruments held for five working days or less can be excluded. Underwriting positions held for more than five working days must be included.

If the capital instrument of the entity in which the institution has invested does not meet the criteria for Common Equity Tier 1, Additional Tier 1 or Tier 2 capital of the institution, the capital is to be considered common shares for the purposes of this capital deduction[63] [64]. [BCBS October 2016 par 80]

71. Guarantees or other capital enhancements provided by an institution to such entities will be treated as capital invested in other financial institutions based on the maximum amount that the institution could be required to pay out under such arrangements.[65][BCBS FAQs #3, p.10]

72. Exposures should be valued according to their valuation on the institution's balance sheet. Subject to prior supervisory approval, institutions may temporarily exclude certain

63 If the investment is issued out of a regulated financial entity and not included in regulatory capital in the relevant sector of the financial entity, it is not required to be deducted.

64 For investments in financial and insurance entities, not subject to Basel III entry criteria for capital instruments (as outlined in this Guideline), the deduction should be applied from the higher tier of capital (CET1 being the highest) identified by the following two methods:

a. The tier of capital (if any) the instrument qualifies for under the Basel III criteria.
b. The tier of capital the instrument qualifies for under the most recent Minimum Continuing Capital and Surplus requirements (MCCSR) Guideline.

If the capital instrument of the entity in which the institution has invested does not meet the criteria for inclusion in regulatory capital under either the Basel III criteria, or the MCCSR Guideline, it is to be considered common shares for the purposes of this deduction.

65 For an institution that is a federal credit union, when applicable, guarantees or other capital enhancements must include potential capital calls from a provincial Central. Capital calls subject to a cap should be valued at the maximum amount of a potential capital call. Capital calls not subject to a cap should be valued at the maximum amount of a potential capital call the federal credit union could be subject to in severe but plausible scenarios. A federal credit union will be required to demonstrate that it has sufficient capital to absorb the maximum amount of a potential capital call in these scenarios.

investments where these have been made in the context of resolving or providing financial assistance to reorganize a distressed institution. [BCBS FAQs #9, p.11]

73. Synthetic exposures should be valued as follows:

a. for call options, the current carrying value;

b. for put options, the number of shares times the strike price;

c. for any other synthetic holdings, the nominal or notional amount.

For options or forward purchase agreements with a variable price, institutions are required to estimate, on a periodic basis, the market value, strike price or nominal amount of the underlying holding (as the case may be). This estimation may be subject to periodic review by OSFI and may be required to be substantiated through an external third party valuation in the case of material uncertainty.

74. To determine the amount to be deducted from capital:

a. Institutions should compare the total of all holdings of capital instruments (after applicable netting) and Other TLAC Instruments to 10% of the institution's Common Equity Tier 1 after all regulatory adjustments listed in paragraphs 55-68. The Other TLAC Instruments included herein should not reflect those items covered by the 5% threshold described in paragraphs 97 and 98 (for D-SIBs and G-SIBs) or paragraph 96 (for all other institutions).

b. The amount by which the total of all holdings of capital instruments and Other TLAC Instruments listed above exceeds the 10% threshold described in (a) should be deducted from capital in aggregate and on a net long basis in the manner set out below. In the case of capital instruments, deduction should be made applying a corresponding deduction approach. This means the deduction should be applied to the same component of capital for which the capital would qualify if it was issued by the institution itself. In the case of holdings of Other TLAC Instruments, the deduction should be applied to Tier 2 capital. Deductions should be applied in the following manner:

    i. The amount to be deducted from Common Equity Tier 1 capital is equal to the deduction amount multiplied by the total holdings in Common Equity Tier 1 of other institutions divided by the total holdings of capital instruments and Other TLAC Instruments determined in (a).

    ii. The amount to be deducted from Additional Tier 1 capital is equal to the deduction amount multiplied by the total holdings in Additional Tier 1 capital of other institutions divided by the total holdings of capital instruments and Other TLAC Instruments determined in (a).

iii. The amount to be deducted from Tier 2 capital is equal to the deduction amount multiplied by the total holdings in Tier 2 capital and Other TLAC Instruments of other institutions that are not covered by paragraphs 96-98 divided by the institution's total holdings of capital instruments and holdings of Other TLAC Instruments determined in (a).

[BCBS October 2016 par 81]

75. The amount of all holdings which falls below the 10% threshold described in paragraph 74(a) will not be deducted from capital. Instead, these investments will be subject to the applicable risk weighting as specified in the approach to credit risk (banking book exposures) or market risk (trading book exposures) used by the institution. For the application of risk weighting, the amount of holdings must be allocated on a pro rata basis between those below and those above the threshold. [BCBS June 2011 par 83]

76. If an institution is required to make a deduction from a particular tier of capital and it does not have sufficient capital to make that deduction, the shortfall will be deducted from the next highest tier of capital (e.g. if an institution does not have sufficient Additional Tier 1 capital to satisfy the deduction, the shortfall will be deducted from Common Equity Tier 1). [BCBS June 2011 par 82]

Significant investments[66] in the capital and/or Other TLAC Instruments of banking, financial and insurance entities[67] that are outside the scope[68] of regulatory consolidation[69,70]

77. The regulatory adjustments described in this section apply to investments in the capital and/or Other TLAC Instruments of banking, financial, and insurance entities that are outside the scope of regulatory consolidation where the institution has a significant investment or where the entity is an affiliate of the bank.

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66 The term "significant investment" refers to investments that are defined to be a substantial investment under section 10 of the *Bank Act* or the *Trust and Loan Companies Act*.

67 See paragraph 77, bullet 6, for a notification requirement where the deduction is made at the insurance operating company level.

68 The scope of this regulatory adjustment should be considered comprehensive. Institutions are encouraged to contact OSFI for further guidance in this area, relating to specific investments, where necessary. Institutions should also note that hedge funds should be considered within the scope of the required regulatory adjustment.

69 Investments in entities that are outside the scope of regulatory consolidation refers to investments in entities that have not been consolidated at all or have not been consolidated in such a way as to result in their assets being included in the calculation of consolidated risk-weighted assets of the group. This includes (i) investments in unconsolidated entities, including joint ventures carried on the equity method of accounting, (ii) investments in subsidiaries deconsolidated for regulatory capital purposes (including insurance subsidiaries), (iii) other facilities that are treated as capital by unconsolidated subsidiaries and by unconsolidated entities in which the institution has a significant investment. Further, the treatment for securitization exposures or vehicles that are deconsolidated for risk-based regulatory capital purposes pursuant to Chapter 7 – Structured Credit Products of the CAR Guideline will be as outlined in that chapter.

70 For the purposes of this Guideline, investments in the capital of banking, financial and insurance entities include investments in the capital of cooperative credit associations (Centrals), credit unions, and other cooperative financial institutions.

- Investments include direct, indirect[71], and synthetic holdings of capital instruments[72] or Other TLAC Instruments. Institutions should look through holdings of index securities to determine their underlying holdings in capital[73] and/or Other TLAC Instruments. If institutions find it operationally burdensome to look through and monitor their exact exposures to other financial institutions as a result of their holdings of index securities, OSFI will permit institutions, subject to prior supervisory approval, to use a conservative estimate.

- A written put option will not be considered a synthetic holding for purposes of this paragraph where all of the following conditions have been met:

    i. The purchase price for the subject capital or Other TLAC instrument will be based on the future market value, or fair value to be determined in the future via a third party or through an arms-length negotiation between institutions.

    ii. The contractual terms of the option/agreement provide that the institution has the legal right, without consent from the counterparty/counterparties, to issue an equivalent notional amount of its own capital, or in the case of G-SIBs and D-SIBs, its own TLAC in an equivalent (or higher quality) tier as consideration for the subject capital.

    iii. The institution publicly discloses the material terms of the put option that permit the bank to settle the option through the issuance of an equivalent notional amount of its own capital, or in the case of a G-SIB or D-SIB, its own TLAC in an equivalent (or higher quality) tier.

    iv. The institution has obtained the prior approval of the Superintendent to exclude the written put option from its investment in financials.

- Holdings in both the banking book and trading book are to be included. Capital includes common stock and all other types of cash and synthetic capital instruments (e.g. subordinated debt). Other TLAC Instruments are defined in paragraphs 52 and 53. The net long position is to be included (i.e. the gross long position net of short positions in the same underlying exposure where the maturity of the short position either matches the maturity of the long position or has a residual maturity of at least one year).

- Underwriting positions in capital instruments or Other TLAC Instruments held for five working days or less can be excluded. Underwriting positions held for more than five working days must be included.

- If the capital instrument of the entity in which the institution has invested does not meet the criteria for Common Equity Tier 1, Additional Tier 1 or Tier 2 capital of the

[71] Indirect holdings are exposures or parts of exposures that, if a direct holding loses its value, will result in a loss to the institution substantially equivalent to the loss in the value of the direct holding. Where an institution holds an investment in a mutual fund that is a pass-through security, it should be treated as an indirect holding in the pool of assets in the fund.

[72] For some examples of indirect and synthetic holdings see footnote 62.

[73] If institutions find it operationally burdensome to look through and monitor their exact exposures to the capital of other financial institutions as a result of their holding index securities, OSFI will permit institutions, subject to prior supervisory approval, to use a conservative estimate.

institution, the capital is to be considered common shares for the purposes of this capital deduction[74] [75]. [BCBS October 2016 par 84]

- Institutions are required to notify OSFI's Capital Division, through their Lead Supervisor, if the required deduction is made at the insurance operating company level, rather than the insurance holding company level, where a holding company exists directly above the insurance entity and greater than 50% of the holding company's holdings are invested in insurance subsidiaries. Initial notifications should be made beginning January 2013 and subsequent updates should be provided to OSFI upon material changes. Further, institutions may be subject to increased supervisory overview in this area.

78. Guarantees or other capital enhancements provided by an institution to such entities will be treated as capital invested in other financial institutions based on the maximum amount that the institution could be required to pay out under such arrangements.[76] [BCBS FAQs #3, p.10]

79. Exposures should be valued according to their valuation on the institution's balance sheet. Subject to prior supervisory approval, institutions may temporarily exclude certain investments where these have been made in the context of resolving or providing financial assistance to reorganize a distressed institution. [BCBS FAQs #9, p.11]

80. Synthetic exposures should be valued as follows:

a. for call options, the current carrying value;

b. for put options, the number of shares times the strike price;

c. for any other synthetic holdings, the nominal or notional amount.

For options or forward purchase agreements with a variable price, institutions are required to estimate, on a periodic basis, the market value, strike price or nominal amount of the underlying holding (as the case may be). This estimation may be subject to periodic review by OSFI and may be required to be substantiated through an external third party valuation in the case of material uncertainty.

81. All investments in capital instruments included above that are not common shares must be fully deducted from the corresponding tier of capital. This means the deduction should be applied to the same tier of capital for which the capital would qualify if it were issued by the institution itself (e.g. investments in the Additional Tier 1 capital of other entities must be

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74 An exception to this requirement is if the investment is issued out of a regulated financial entity and not included in regulatory capital in the relevant sector of the financial entity, it is not required to be deducted.

75 See footnote 64 for further information on the treatment of investments in financial and insurance entities not subject to Basel III entry criteria for capital instruments.

76 For an institution that is a federal credit union, when applicable, guarantees or other capital enhancements must include potential capital calls from a provincial Central. Capital calls subject to a cap should be valued at the maximum amount of a potential capital call. Capital calls not subject to a cap should be valued at the maximum amount of a potential capital call the federal credit union could be subject to in severe but plausible scenarios. A federal credit union will be required to demonstrate that it has sufficient capital to absorb the maximum amount of a potential capital call in these scenarios.

deducted from the institution's Additional Tier 1 capital).[77] All holdings of Other TLAC Instruments included above (and as defined in paragraphs 52 and 53, i.e. applying the proportionate deduction approach for holdings of instruments eligible for TLAC by virtue of the penultimate paragraph of Section 11 of the FSB Term Sheet) must be fully deducted from Tier 2 capital. [BCBS October 2016 par 85]

82. Investments included above that are common shares will be subject to the threshold deductions as described in paragraphs 84-86. [BCBS June 2011 par 86]

83. If an institution is required to make a deduction from a particular tier of capital and it does not have sufficient capital to make that deduction, the shortfall will be deducted from the next highest tier of capital (e.g. if an institution does not have sufficient Additional Tier 1 capital to satisfy the deduction, the shortfall will be deducted from Common Equity Tier 1). [BCBS October 2016 par 85]

Threshold deductions (basket)

84. The following items will be subject to the capital deductions described in this section:

- Significant investments in the common shares of banking, financial and insurance entities that are outside the scope of regulatory consolidation (as defined in paragraphs 77-82);
- Mortgage servicing rights (MSRs), including those related to consolidated subsidiaries, subsidiaries deconsolidated for regulatory capital purposes, and the proportional share of MSRs in joint ventures subject to proportional consolidation or equity method accounting.; and
- Deferred tax assets arising from temporary differences (see paragraph 58).

[BCBS June 2011 par 87]

85. To determine the amount to be deducted from capital,

a) Institutions should compare each of the above items to 10% of the institution's common equity Tier 1 after all deductions listed in paragraphs 55-83 but before the threshold deductions listed in this section.

b) The amount by which each of the above items exceeds the 10% threshold described in (a) should be deducted from Common Equity Tier 1 capital.

During the interim period, from January 1, 2013 to January 1, 2018, the treatment in (c) and (d) below will apply:

c) The amount of each of the above items not deducted in (b) above should be taken in aggregate and compared to 15% of the institution's Common Equity Tier 1 after all deductions listed in paragraphs 55-83.

[77] Institutions are required to notify OSFI's Capital Division, through their Lead Supervisors, if they intend to use the corresponding deduction approach outlined in this paragraph with relation to investments in insurance entities.

d) The amount by which the aggregate amount of these three items not deducted in (b) exceeds the 15% threshold described in (c) should be deducted from Common Equity Tier 1 capital.

Beginning January 1, 2018, the final treatment in (e) and (f) below will apply (see Appendix 2-3 for an example of the final calculation):

e) If the amount of the aggregate of the above items not deducted from Common Equity Tier 1 capital after the application of all regulatory adjustments exceeds 15% of the institution's Common Equity Tier 1 after all regulatory adjustments, then a deduction of such excess from Common Equity Tier 1 is required, subject to (f) below.

f) To determine the amount of the aggregate of the above items that is not required to be deducted from Common Equity Tier 1, institutions should multiply the amount of Common Equity Tier 1 (after all deductions including the deduction of the three items in full) by 17.65% (this number is derived from the proportion of 15% to 85%). Only the excess above this amount must be deducted from Common Equity Tier 1. [BCBS June 2011 par 88]

86. The amount of the above three items not deducted from Common Equity Tier 1 capital will be risk-weighted at 250%. [BCBS June 2011 par 89]

2.3.2 Regulatory Adjustments to Additional Tier 1 capital

Net Tier 1 capital is defined as gross Tier 1 capital adjusted to include all Tier 1 regulatory adjustments.

Investments in own Additional Tier 1 capital instruments

87. Institutions are required to make deductions from Additional Tier 1 capital for investments in their own Additional Tier 1 capital instruments (unless already derecognized under IFRS). In addition, any Additional Tier 1 capital instrument in which the institution could be contractually obliged to purchase should be deducted in the calculation of Tier 1 capital. [BCBS June 2011 par 78]

Reciprocal cross holdings in Additional Tier 1 capital of banking, financial and insurance entities

88. Reciprocal cross holdings (e.g. Bank A holds investments in Additional Tier 1 capital instruments of Bank B and Bank B in return holds investments in Additional Tier 1 capital instruments of Bank A) that are designed to artificially inflate the capital position of institutions will be fully deducted from Additional Tier 1 capital. [BCBS June 2011 par 79]

Non-significant investments in the capital of banking, financial and insurance entities

89. Institutions are required to make deductions from Additional Tier 1 capital for investments in the capital of banking, financial, and insurance entities which are not considered

to be significant investments as described in paragraphs 70-76 above. [BCBS June 2011 par 80-83]

Significant investments in the capital of banking, financial and insurance entities that are outside the scope of regulatory consolidation[78]

90. Institutions are required to make deductions from Additional Tier 1 capital for significant investments in the capital of banking, financial, and insurance entities that are outside the scope of regulatory consolidation as described in paragraphs 77-83 above. [BCBS June 2011 par 84-86]

Reverse Mortgages

91. Reverse mortgages: where a reverse mortgage exposure has a current loan-to-value greater than 85%, the exposure amount that exceeds 85% LTV is deducted from tier 1capital. The remaining amount is risk weighted at 100%.

Deductions related to insufficient Tier 2 capital

92. If an institution does not have sufficient Tier 2 capital needed to make required deductions from Tier 2 capital, the shortfall must be deducted from Additional Tier 1 capital.

2.3.3 Regulatory Adjustments to Tier 2 capital

Net Tier 2 capital is defined to be Tier 2 capital including all Tier 2 regulatory adjustments, but may not be lower than zero. If the total of all Tier 2 deductions exceeds Tier 2 capital available, the excess must be deducted from Tier 1.

Investments in own Tier 2 capital instruments and/or own Other TLAC Instruments

93. Institutions are required to make deductions from Tier 2 capital for investments in their own Tier 2 capital instruments (unless already derecognized under IFRS). In addition, any Tier 2 capital instrument in which the institution could be contractually obliged to purchase should be deducted in the calculation of Total capital. G-SIBs and D-SIBs must also deduct holdings of their own Other TLAC Instruments in the calculation of their TLAC ratios[79]. [BCBS October 2016 par 78]

Reciprocal cross holdings in Tier 2 capital and/or Other TLAC Instruments of banking, financial and insurance entities

94. Reciprocal cross holdings (e.g. Bank A holds investments in Tier 2 capital instruments of Bank B and Bank B in return holds investments in Tier 2 capital instruments of Bank A) that

[78] See footnote 69.

[79] For greater certainty, the application of the 10% and 5% thresholds, including the market-making exemption, described in section 2.3 of this guideline are not available in respect of holdings of an institution's own capital instruments and/or own Other TLAC Instruments.

are designed to artificially inflate the capital position of institutions will be fully deducted from Tier 2 capital. Reciprocal cross holdings of Other TLAC Instruments that are designed to artificially inflate the TLAC position of G-SIBs and/or D-SIBs must also be deducted in full from Tier 2 capital. [BCBS October 2016 par 79]

Non-significant investments in the capital of banking, financial and insurance entities and/or Other TLAC Instruments issued by G-SIBs and D-SIBs (which are not considered significant investments)

95. Institutions are required to make deductions from Tier 2 capital for investments in the capital of banking, financial, and insurance entities and/or investments in Other TLAC Instruments issued by D-SIBs and/or G-SIBs which are not considered significant investments as described in paragraphs 70-76 above. [BCBS October 2016 par 80-83]

96. If an institution is not a D-SIB or a G-SIB, its holdings of Other TLAC Instruments must be deducted from Tier 2 capital per subparagraph 74(b)(iii) unless: (1) such holdings are, in aggregate and on a gross long basis, less than 5% of the institution's Common Equity Tier 1 (after applying the regulatory adjustments listed in paragraphs 55-68); or (2) the holding falls within the 10% threshold provided for in paragraph 74. [BCBS October 2016 par 80c]

97. A D-SIB or G-SIB's holdings of Other TLAC Instruments must be deducted from Tier 2 capital per subparagraph 74(b)(iii) unless (1) the following market-making exemption conditions are met; or (2) the holding falls within the 10% threshold provided for in paragraph 74:

- the holding has been designated by the D-SIB or G-SIB to be treated as market-making activities in accordance with this paragraph;
- the holding is in the bank's trading book; and
- the holding has not been held for more than 30 business days from the date of its acquisition.

This market-making exemption is available for holdings that are, in aggregate and on a gross long basis, up to 5% of the D-SIB or G-SIB's Common Equity Tier 1 (after applying the regulatory adjustments listed in paragraphs 55-68). Holdings in excess of 5% of the D-SIB or G-SIB's Common Equity must be deducted from Tier 2 capital.

[BCBS October 2016 par 80a]

98. If a holding designated under paragraph 97 no longer meets any of the market-making exemption conditions set out in that paragraph, it must be deducted in full from Tier 2 capital. Once a holding has been designated under paragraph 97, it may not subsequently be included within the 10% threshold referred to in paragraph 74. This approach is designed to limit the use of the 5% allowance in paragraph 97 to holdings of Other TLAC Instruments needed to be held within the banking system to ensure deep and liquid markets. [BCBS October 2016 par 80b]

99. The amount of all holdings which falls below the 5% thresholds described in paragraphs 96 and 97 will not be deducted from capital. Instead, these investments will be subject to the

applicable risk weighting as specified in the approach to credit risk (banking book exposures) or market risk (trading book exposures) used by the institution. For the application of risk weighting, the amount of holdings must be allocated on a pro rata basis between those below and those above the threshold.

Significant investments in the capital of banking, financial and insurance entities and/or Other TLAC Instruments issued by G-SIBs and D-SIBs that are outside the scope of regulatory consolidation[80]

100. Institutions are required to make deductions from Tier 2 capital for significant investments in the capital of banking, financial, and insurance entities and/ or investments in Other TLAC Instruments issued by D-SIBs and/or G-SIBs that are outside the scope of regulatory consolidation as described in paragraphs 77-83 above. [BCBS October 2016 par 80-83]

2.3.4 Items subject to 1250% risk weight

101. The following items will receive a risk weight of 1250%:

- The following securitization exposures (refer to Chapter 7 – Structured Credit Products):
    a. For all institutions:
        - Credit-enhancing interest-only strips, net of any increases in equity capital resulting from securitization transactions

    b. Institutions using the Standardized Approach:
        - For third party investors, investments in securitization exposures with long-term credit ratings B+ and below, and in unrated exposures
        - For third party investors, investments in securitization exposures with short-term credit ratings below A-3/P-3/R-3 and in unrated exposures
            i. For originating banks, retained securitization exposures that are rated below investment grade (below BBB-), or that are unrated
            ii. Exceptions to the requirement to deduct unrated securitization exposures are made for the most senior exposure in a securitization, exposures that are in a second loss position or better in asset-backed commercial paper (ABCP) programmes, and eligible liquidity facilities. Refer to Chapter 7 – Structured Credit Products, paragraphs 60 to 65 for requirements.

    c. Institutions using the IRB approach:
        - Investments in securitization exposures with long-term credit ratings below BB- and in unrated exposures

[80] See footnote 69.

- Investments in securitization exposures with short-term ratings below A-3/P-3/R-3 and in unrated short-term exposures
- Securitization exposures with risk-weights of 1250% derived using the Supervisory Formula
- Retained securitizations, or parts thereof, that absorb losses at or below the level of KIRB[81]

- Certain equity exposures under the PD/LGD approach (refer to Chapter 6 – Credit Risk - Internal Ratings Based Approach)
- Non-payment/delivery on non-DvP and non-PvP transactions (refer to Section 4.2 of Chapter 4 – Settlement and Counterparty Risk); and
- Significant investments in commercial entities.

[BCBS June 2011 par 90]

2.4 Transitional Arrangements

2.4.1 Treatment for Non-qualifying capital instruments

2.4.1.1 For institutions that are not federal credit unions

102. Capital instruments that do not meet the criteria for inclusion in Common Equity Tier 1 will be excluded from Common Equity Tier 1 as of January 1, 2013. However, instruments meeting the following three conditions will be phased out over the same horizon as specified in paragraph 105: (1) they are issued by a non-joint stock company other than a federal credit union; (2) they are treated as equity under the prevailing accounting standards; and (3) they receive unlimited recognition as part of Tier 1 capital under current national banking law. [BCBS June 2011 par 95]

103. Existing public sector capital injections will be grandfathered until January 1, 2018. [BCBS June 2011 par 94 (f)]

104. The following transition will apply to non-qualifying capital instruments. [Note: This treatment applies to non-qualifying capital instruments issued by the parent institution or a subsidiary[82].]

105. As outlined below, capital instruments that no longer qualify as Common Equity Tier 1, Additional Tier 1 capital or Tier 2 capital (according to the criteria for inclusion outlined in Section 2.1) and which are eligible for transitioning as outlined in this Guideline will be phased

[81] K_{IRB} is the ratio of the IRB capital requirement including the EL portion for the underlying exposure in the pool to the exposure amount of the pool (e.g., the sum of the drawn amounts related to securitized exposures plus the EAD associated with undrawn commitments related to securitized exposures). Refer to paragraph 119 of Chapter 7 – Structured Credit Products.

[82] The amount of capital issued out of a subsidiary subject to the treatment outlined is limited to the amount which was previously permitted to be included in regulatory capital (under OSFI's 2012 CAR Guideline).

out beginning on January 1, 2013. Fixing the base at the nominal amount of such instruments outstanding on January 1, 2013, their recognition will be capped at 90% from January 1, 2013, with the cap reducing by 10 percentage points in each subsequent year[83].

Fiscal reporting period	Applicable cap
Q1 2013	90%
Q1 2014	80%
Q1 2015	70%
Q1 2016	60%
Q1 2017	50%
Q1 2018	40%
Q1 2019	30%
Q1 2020	20%
Q1 2021	10%
Q1 2022	0%

106. This cap will be applied to Additional Tier 1 and Tier 2 separately and refers to the aggregate amount of instruments outstanding in each category that no longer meet the relevant entry criteria and are eligible for transitioning[84]. To the extent an instrument is redeemed, or its recognition in capital is amortized, after January 1, 2013, the nominal amount serving as the base is not reduced. In addition, instruments may only be included under a particular cap to the extent that they are recognized in that tier of capital under OSFI's former Guideline[85].

107. For example, where an innovative Tier 1 instrument is recognized in tier 2B capital as innovative overflow, the instrument may only be used to contribute to the Tier 2 base and should not contribute to the Tier 1 notional base.

108. Where an instrument's recognition in capital is subject to amortization on or before January 1, 2013, only the amortised amount recognized in capital on January 1, 2013 should be taken into account in the amount fixed for transitioning rather than the full nominal amount. <u>The instrument will continue to amortize on a straight-line basis at a rate of 20% per annum during the transition period</u>, while the aggregate cap will be reduced at a rate of 10% per year. [BCBS FAQs #7, p.15]

109. Surplus (share premium) may be included in the base provided that it relates to an instrument that is eligible to be included in the base for the transitional arrangements.

110. Non-qualifying instruments that are denominated in a foreign currency should be included in the base using their value in the reporting currency of the institution as at January 1, 2013. The base will therefore be fixed in the reporting currency of the institution throughout the

[83] The level of the base is fixed on January 1, 2013 and does not change thereafter. [BCBS FAQs # 19, p. 18]
[84] Where an instrument is derecognised at January 1, 2013, it will not be eligible for grandfathering and does not count towards the base fixed on January 1, 2013. [BCBS FAQS # 2, p.14]
[85] OSFI's 2012 CAR Guideline A or A-1

transition period. During the transition period, instruments denominated in a foreign currency should be valued as they are reported on the balance sheet of the institution at the relevant reporting date (adjusting for any amortization in the case of Tier 2 instruments).

111. Where an instrument is fully derecognized on January 1, 2013 or otherwise ineligible for these transitioning arrangements, the instrument must not be included in the base fixed on January 1, 2013.

2.4.1.2 For institutions that continue as federal credit unions

112. The following transition will apply to non-qualifying capital instruments issued by a federal credit union or a subsidiary of a federal credit union.

113. Beginning in the year that an institution continues as a federal credit union, outstanding capital instruments that do not qualify as Common Equity Tier 1, Additional Tier 1 or Tier 2 capital according to the criteria for inclusion outlined in Section 2.1 will be subject to a phase-out. To be eligible for a phase-out, the instrument must have been recognized under provincial capital requirements as regulatory capital prior to the institution's continuance as a federal credit union. Non-qualifying instruments that were not recognized as regulatory capital under provincial capital requirements prior to continuance will not be eligible for transitioning.

114. The phase-out period will begin upon the institution's continuance as a federal credit union[86]. Fixing the base at the nominal amount of the capital instruments outstanding on the continuance date, recognition of non-qualifying instruments will be capped at 90% in Year 1, with the cap reducing by 10 percentage points in each subsequent year[87].

Reporting period	Applicable cap
Year 1	90%
Year 2	80%
Year 3	70%
Year 4	60%
Year 5	50%
Year 6	40%
Year 7	30%
Year 8	20%
Year 9	10%
Year 10	0%

[86] Year 1 refers to the four fiscal quarters commencing in the quarter in which the institution continued as a federal credit union.

[87] The level of the base is fixed on the date of continuance and does not change thereafter.

115. This cap will be applied to non-qualifying Common Equity Tier 1, Additional Tier 1 and Tier 2 capital separately[88]. As the cap refers to the total amount of instruments outstanding within each tier of capital, some instruments in a tier may continue to fully qualify as capital while others may need to be excluded to comply with the cap. To the extent an instrument is redeemed, or its recognition in capital is amortized during the transitioning period, the nominal amount serving as the base is not reduced.

116. Where an instrument is fully derecognized upon the institution's continuance as a federal credit union or otherwise ineligible for these transitioning arrangements, the instrument must not be included in the fixed base.

117. Where an instrument's recognition in capital is subject to amortization on or before the institution's continuance, only the amortized amount recognized in capital as at that date should be taken into account in the amount fixed for transitioning rather than the full nominal amount. In addition, limited life instruments subject to transition will be subject to amortization on a straight-line basis at a rate of 20% per annum in their final five years to maturity, while the aggregate cap will be reduced at a rate of 10% per year.

118. Where a non-qualifying instrument includes a step-up or other incentive to redeem, it must be fully excluded from regulatory capital on the effective date of that incentive to redeem.

119. Surplus (i.e. share premium) may be included in the base provided that it relates to an instrument that is eligible to be included in the base for the transitional arrangements.

120. Non-qualifying instruments that are denominated in a foreign currency should be included in the base using their value in the reporting currency of the institution as at the date of continuance. The base will therefore be fixed in the reporting currency of the institution throughout the transition period. During the transition period, instruments denominated in a foreign currency should be valued as they are reported on the balance sheet of the institution at the relevant reporting date (adjusting for any amortization in the case of Tier 2 instruments).

2.4.2 Phase-Out of Non-Qualifying Capital for institutions that are not federal credit unions

121. The rules to be applied to govern the phase-out of non-qualifying capital, issued by the institution directly or through a subsidiary, are as follows:

1) Capital instruments issued prior to September 12, 2010 that previously qualified as regulatory capital but do not meet the Basel III criteria for regulatory capital (on a forward looking basis[89]) will be considered non-qualifying capital instruments and subject to the phase-out described in this Guideline. [BCBS June 2011 par 96]

[88] Federal credit unions should consult with OSFI's Capital Division to determine the appropriate tier of capital in which to assign non-qualifying instruments.

[89] For greater certainty, an instrument is deemed to not meet the Basel III criteria on a forward-looking basis where the terms of the instrument permitted redemption within the first five years after issuance irrespective of whether

2) Capital instruments issued before January 1, 2013 that meet the Basel III criteria for regulatory capital, except that they do not meet the NVCC requirements[90], will be considered non-qualifying capital instruments and subject to the phase-out described in this Guideline. [BCBS Press Release Jan 2011]

3) Capital instruments issued between September 12, 2010 and January 1, 2013 that do not meet one or more of the Basel III criteria for regulatory capital (other than the NVCC requirements) will be excluded from regulatory capital as of January 1, 2013 (i.e. they will not be subject to the phase-out described in this Guideline).

4) Capital instruments issued after January 1, 2013 must meet all of the Basel III criteria for regulatory capital (including the NVCC requirements) to qualify as regulatory capital. Instruments that do not meet all of these requirements will be excluded from regulatory capital.

5) The cap will apply separately to Additional Tier 1 and Tier 2 capital. As the Basel III cap refers to the total amount of non-qualifying instruments outstanding within each tier of capital, some instruments in a tier may continue to fully qualify as capital while others may need to be excluded to comply with the cap.

6) OSFI expects institutions to comply with the Basel III requirements concerning the phase-out of non-qualifying capital instruments, while maximizing the amount of available regulatory capital and, to the maximum extent practicable, giving effect to the legitimate expectations of the parties to such capital instruments (as evidenced by the terms of such instruments). Accordingly, an institution should prioritize redeeming capital in a way that will give effect to the following priorities:

   (a) Maximize the amount of non-qualifying capital instruments outstanding during the Basel III transition period (based on the assumption that all capital will be redeemed at the earliest regular[91] par redemption date); and

   (b) Minimize the amount of capital that would be subject to a regulatory event.

7) To achieve this, institutions should act as follows:

   (a) Institutions should, to the maximum extent possible, manage their capital within the applicable Basel III cap by redeeming instruments at their regular par redemption date (or otherwise using rights granted under the instrument or generally available, such as a small amount of open market purchases), rather than by relying on redemption due to a regulatory event.

   (b) Institutions are not required to redeem capital instruments that cannot be included within the cap. The cap may be met by an institution excluding an amount of non-qualifying instruments from its available regulatory capital such that its reported available regulatory capital is within the cap (a "voluntary exclusion").

such redemption was subject to the prior approval of the Superintendent and whether the instrument has been outstanding for more than five years.

90 Minimum requirements to ensure loss absorbency at the point of non-viability, Annex 1 of BCBS Press Release *Basel Committee issues final elements of the reforms to raise the quality of regulatory capital*, January 13, 2011.

91 A redemption not due to a regulatory event.

(c) If an institution forecasts that it would not be able to manage its Basel III capital transition without the use of a regulatory event redemption, OSFI expects the institution to:

- Develop a regulatory event redemption schedule specifying the expected redemption date for each non-qualifying instrument;
- Disclose this schedule to the public as soon as practicable considering applicable disclosure rules and other legal requirements and subject to such conditions as may be appropriate;
- Subsequently update this schedule and public disclosure should circumstances change such that a different regulatory event redemption schedule is expected[92]; and
- Adhere to this schedule when seeking OSFI approval to redeem such capital instruments.

(d) If an institution has non-common regulatory capital and forecasts that it will not redeem any instruments through the use of a regulatory event redemption, it should disclose to the public that it expects no regulatory event redemptions and will not be disclosing a regulatory event redemption schedule.

8) OSFI will, to assist an institution in gaining assurance that its expected regulatory event redemption schedule complies with this Guideline, review such schedules in advance along with supporting representations as to the appropriateness of such schedule.

9) OSFI will follow the normal process for redemption requests but will not consider approving redemption requests except in accordance with any information related to regulatory event redemptions disclosed to the public and which OSFI agrees conforms to the priorities and methodology stated above. After an institution requests approval to redeem an instrument under a regulatory event redemption, OSFI will, as part of its capital redemption approval process, provide notice to the institution that such redemption is in accordance with OSFI guidance.

[92] An updated regulatory event redemption schedule may be required due to a variety of circumstances within an institution's control (e.g. open market purchases; a decision to exclude non-qualifying capital from its available regulatory capital; a decision to redeem non-qualifying capital which it previously intended to retain as outstanding but treat with a voluntary exclusion; an action by an institution to amend the terms of existing non-qualifying instruments to thereby bring them into compliance so that they cease to be non-qualifying, etc.) or beyond an institution's control (e.g. further rule changes related to qualifying regulatory capital or its transition; generally applicable legal changes that have the effect of causing non-qualifying regulatory capital to become compliant, etc.). No assurance is provided that an institution's regulatory event redemption schedule will not change from time to time.

10) Instruments with an incentive to redeem will be treated as follows:

- For an instrument that has a call and a step-up (or other incentive to redeem) prior to January 1, 2013, if the instrument is not called at its effective maturity date[93] and on a forward-looking basis (i.e. from the effective maturity date) <u>will</u> meet the new criteria for inclusion in Additional Tier 1 or Tier 2 capital, it will continue to be recognized in that tier of capital.
- For an instrument that has a call and a step-up (or other incentive to redeem) between September 12, 2010 and January 1, 2013, if the instrument is not called at its effective maturity date and on a forward-looking basis (i.e. from the effective maturity date) <u>will not</u> meet the new criteria for inclusion in Additional Tier 1 or Tier 2 capital, it will be fully derecognized in that tier of capital from January 1, 2013.
- For an instrument that has a call and a step-up (or other incentive to redeem) on or after January 1, 2013, if the instrument is not called at its effective maturity date and on a forward-looking basis (i.e. from the effective maturity date) <u>will not</u> meet the new criteria for inclusion in Additional Tier 1 or Tier 2 capital, it will be fully derecognized in that tier of capital from the effective maturity date. Prior to the effective maturity date, the instrument will be considered an "instrument that no longer qualifies as Additional Tier 1 or Tier 2" and will therefore be phased out from January 1, 2013.
- For an instrument that has a call and a step-up (or other incentive to redeem) on or prior to September 12, 2010, if the instrument was not called at its effective maturity date and on a forward-looking basis (i.e. from the effective maturity date) <u>does not</u> meet the new criteria for inclusion in Additional Tier 1 or Tier 2 capital, it will be considered an "instrument that no longer qualifies as Additional Tier 1 or Tier 2" and will therefore be phased out from January 1, 2013.

[BCBS June 2011 par 94 (g)]

122. During the phase-out period, SPVs associated with Tier 1 and Tier 2B innovative instruments should continue to not, at any time, hold assets that materially exceed the amount of the innovative instrument. For Asset-Based Structures, OSFI will consider the excess to be material if it exceeds 25% of the innovative instrument(s) and, for Loan-Based Structures; the excess will be considered to be material if it exceeds 3% of the innovative instrument(s). Amounts in excess of these thresholds require the Superintendent's approval.

[93] Effective maturity date refers to the incentive to redeem date. Instruments without an incentive to redeem would not have an effective maturity date other than their scheduled maturity (if any).

Appendix 2-1 - Illustrative example of the inclusion of capital issued out of a subsidiary to third parties in consolidated capital of the parent

The following is an illustrative example of the calculation for determining the amount of capital issued out of subsidiaries to third parties that can be included in the parent's consolidated capital, as described in sections 2.1.1.2, 2.1.2.2, and 2.1.3.2 of this Guideline.

Assume the subsidiary has issued qualifying common shares to third parties which, together with retained earnings attributable to third parties, equal $400. The amount of common shares issued to and retained earnings attributable to the parent equal $1600. The required regulatory adjustments to Common Equity Tier 1 are $500. There are no regulatory adjustments to Additional Tier 1 or Tier 2 capital.

The subsidiary has also issued $200 in qualifying Additional Tier 1 instruments and $300 in qualifying Tier 2 instruments to third parties. (No Additional Tier 1 or Tier 2 instruments have been issued by the subsidiary to the parent).

Paid in capital of the subsidiary	
Paid in common shares plus retained earnings owned by third parties, gross of all deductions	400
Paid in common shares plus retained earnings owned by the group, gross of all deductions	1,600
Total Common Equity Tier 1 of the subsidiary, net of deductions	1,500
Paid in Tier 1 capital plus retained earnings owned by third parties, gross of all deductions	600
Paid in Tier 1 capital plus retained earnings owned by the group, gross of all deductions	1,600
Total Tier 1 capital (CET1 + Additional Tier 1) of the subsidiary, net of deductions	1,700
Paid in Total capital plus retained earnings owned by third parties, gross of all deductions	900
Paid in Total capital plus retained earnings owned by the group, gross of all deductions	1,600
Total capital (CET1 + Additional Tier 1 + Tier 2) of the subsidiary, net of deductions	2,000

To determine how much of the above capital issued to third parties can be included in the consolidated capital of the parent, the surplus capital of the subsidiary needs to be calculated using the minimum capital requirements plus capital conservation buffer are 7% Common Equity Tier 1 (CET1), 8.5% Tier 1 capital and 10.5% Total capital.

Step 1: Calculate the minimum capital requirements (plus capital conservation buffer) of the subsidiary. This is based on the lower of (i) the risk-weighted assets of the subsidiary and (ii) the portion of the consolidated risk-weighted assets that relate to the subsidiary multiplied by 7%, 8.5%, and 10.5% for CET1, Tier 1 capital and Total capital, respectively.

Minimum plus capital conservation buffer (CCB) requirements of the subsidiary		
Total risk-weighted assets of the subsidiary	10,000	
Risk-weighted assets of the consolidated group that relate to the subsidiary	11,000	
Minimum Common Equity Tier 1 requirement of the subsidiary plus CCB	700	= 10,000*7%
Portion of the consolidated minimum CET1 requirement plus CCB that relates to the subsidiary	770	= 11,000*7%
Minimum Tier 1 requirement of the subsidiary plus the CCB	850	= 10,000*8.5%
Portion of the consolidated minimum Tier 1 requirement plus CCB that relates to the subsidiary	935	= 11,000*8.5%
Minimum Total capital requirements of the subsidiary plus CCB	1,050	= 10,000*10.5%
Portion of the consolidated minimum Total capital requirement plus CCB that relates to the subsidiary	1,155	= 11,000*10.5%

Step 2: Calculate the surplus capital of the subsidiary. This is the difference between the eligible capital of the subsidiary held (net of deductions) less the minimum capital (plus capital conservation buffer) required.

Capital of the subsidiary, net of deductions		
Total Common Equity Tier 1 of the subsidiary, net of deductions	1,500	
Total Tier 1 (CET1 + Additional Tier 1) of the subsidiary, net of deductions	1,700	
Total Capital (CET1 + Additional Tier 1 + Tier 2) of the subsidiary, net of deductions	2,000	
Surplus capital of the subsidiary		
Surplus Common Equity Tier 1 of the subsidiary	800	= 1,500 - 700
Surplus Tier 1 of the subsidiary	850	= 1,700 - 850
Surplus Total Capital of the subsidiary	950	= 2,000 - 1,050

Step 3: Calculate the amount of surplus capital that is attributable to third party investors. This is equal to the amount of surplus capital of the subsidiary multiplied by the percentage of the subsidiary owned by third parties (based on the paid in capital plus related retained earnings owned by third parties).

Surplus capital of the subsidiary attributable to third party investors		
Surplus CET1 of the subsidiary that is attributable to third party investors	160	= 800 * (400/2,000)
Surplus Tier 1 of the subsidiary that is attributable to third party investors	232	= 850 * (600/2,200)
Surplus Total capital of the subsidiary that is attributable to third party investors	342	= 950 * (900/2,500)

Step 4: Calculate the amount of capital issued to third parties that can be included in the consolidated capital of the parent. This is equal to the amount of capital issued to third parties (plus attributable retained earnings) less the surplus capital attributable to third parties.

Amount recognized in consolidated capital		
Amount of capital issued to third parties recognized in Common Equity Tier 1	240	= 400 - 160
Amount of capital issued to third parties recognized in Tier 1	368	= 600 - 232
Amount of capital issued to third parties recognized in Total capital	558	= 900 - 342
Amount of capital issued to third parties recognized in Additional Tier 1	128	= 368 - 240
Amount of capital issued to third parties recognized in Tier 2	190	= 558 - 240 - 128

Appendix 2-2 - Information Requirements to Confirm Quality of NVCC Instruments

While not mandatory, institutions are strongly encouraged to seek confirmations of capital quality from OSFI's Capital Division prior to issuing NVCC instruments[94]. In conjunction with such requests, the institution 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 institution'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 or write-off, as applicable is enforceable, that the issuance has been duly authorized and is in compliance with applicable law[95] and that there are no impediments to the automatic conversion of the NVCC instrument into common shares of the institution or to the write-off, as applicable upon a trigger event.
6. Where the terms of the instrument include a redemption or similar feature upon a tax event, an external tax opinion confirming the availability of such deduction in respect of interest or distributions payable on the instrument for income tax purposes[96].
7. An accounting opinion describing the proposed treatment and disclosure of the NVCC instrument on the institution's financial statements[97].
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[98] 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

[94] If an institution 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 an institution's available regulatory capital.

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

[96] 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.

[97] 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.

[98] The swap-spread methodology is described in Appendix 2-I of the 2012 CAR Guideline.

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 indicative level of dilution of the institution's common shares that would occur upon a trigger event, the 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 would enhance the viability of an otherwise non-viable institution.
11. Capital projections that demonstrate that the institution will be in compliance with the institution's internal target capital ratios, the institution's authorized leverage ratio, 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 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 2.2.1 of this Guideline. 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.
13. A written attestation from a senior officer of the institution confirming that the institution has not provided financing to any person for the express purpose of investing in the proposed capital instrument.

Appendix 2-3 - Example of the 15% of common equity limit on specified items (threshold deductions)

1. This Appendix is meant to clarify the calculation of the 15% limit on significant investments in the common shares of unconsolidated financial institutions (banks, insurance and other financial entities); mortgage servicing rights, and deferred tax assets arising from temporary differences (collectively referred to as specified items).

2. The recognition of these specified items will be limited to 15% of Common Equity Tier 1 (CET1) capital, after the application of all deductions. To determine the maximum amount of the specified items that can be recognised*, banks and supervisors should multiply the amount of CET1** (after all deductions, including after the deduction of the specified items in full) by 17.65%. This number is derived from the proportion of 15% to 85% (ie 15%/85% = 17.65%).

3. As an example, take a bank with $85 of common equity (calculated net of all deductions, including after the deduction of the specified items in full).

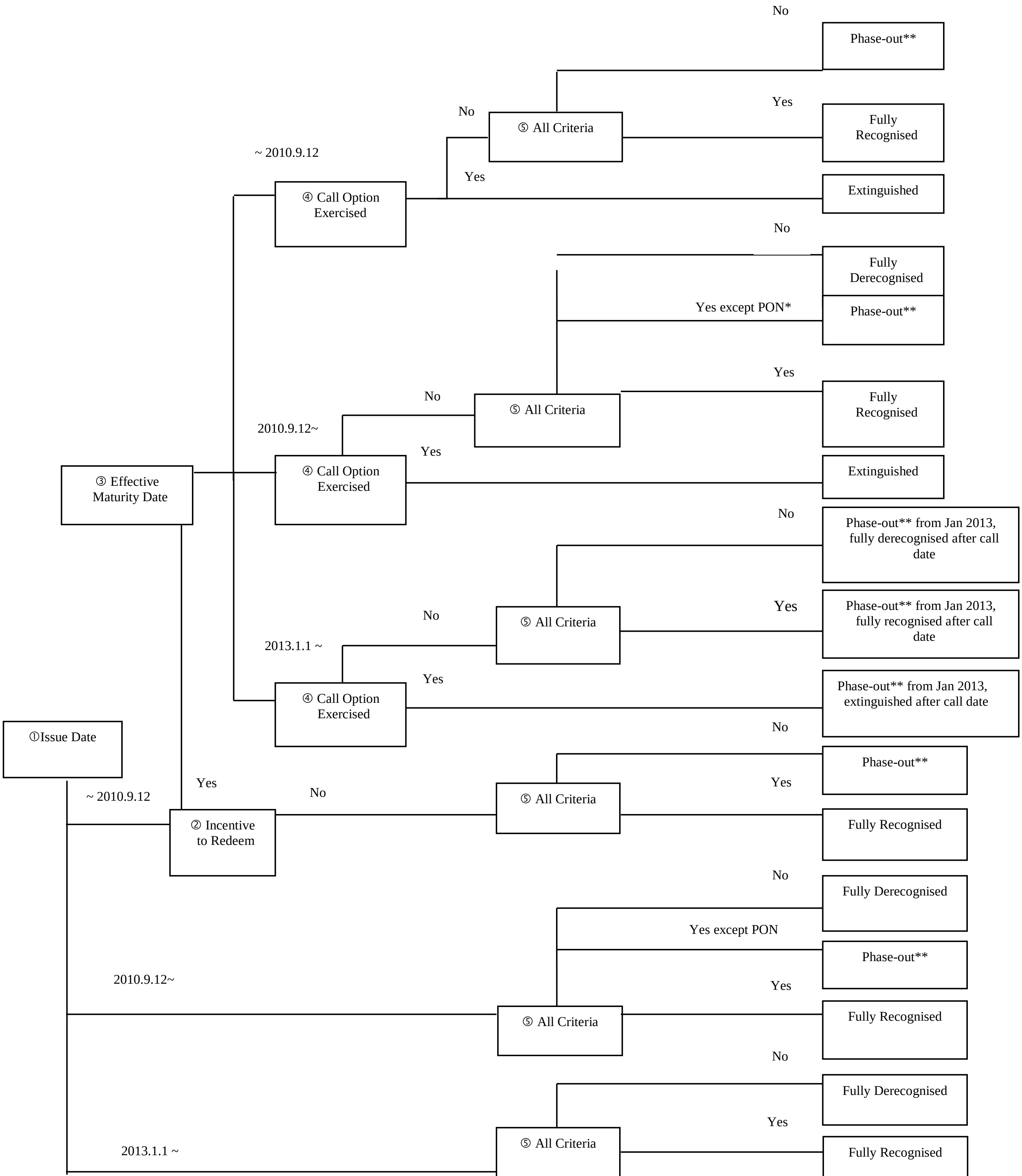
4. The maximum amount of specified items that can be recognised by this bank in its calculation of CET1 capital is $85 x 17.65% = $15. Any excess above $15 must be deducted from CET1. If the bank has specified items (excluding amounts deducted after applying the individual 10% limits) that in aggregate sum up to the 15% limit, CET1 after inclusion of the specified items, will amount to $85 + $15 = $100. The percentage of specified items to total CET1 would equal 15%.

* The actual amount that will be recognised may be lower than this maximum, either because the sum of the three specified items are below the 15% limit set out in this appendix, or due to the application of the 10% limit applied to each item.

** At this point this is a "hypothetical" amount of CET1 in that it is used only for the purposes of determining the deduction of the specified items.

[BCBS June 2011 Annex 1, p.64]

Appendix 2-4 - Flowchart to illustrate the application of transitional arrangements for non-qualifying instruments



* “PON” refers to the point of non-viability requirements that are set out in section 2.2.

** “Phase-out” refers to the transitional arrangements for non-qualifying capital set out in section 2.4.3.