Capital Ruling

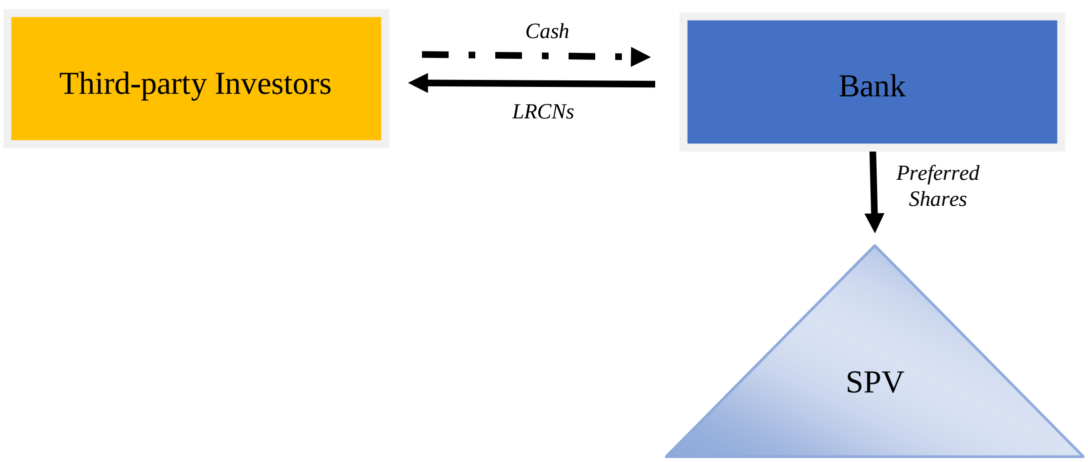
Category: **Definition of Capital**

Subject: **Limited Recourse Capital Notes**

Date: **July 2020**

Issue: The issue is whether to recognize Limited Recourse Capital Notes (LRCNs) issued by federally regulated financial institutions (FRFIs) as Additional Tier 1 capital[1].

Background: A Canadian bank (the Bank) proposed to issue the LRCNs to third-party investors. The structure consists of two instruments: (1) deeply subordinated interest-bearing LRCNs with a term to maturity of 60 years issued by the Bank directly to investors; and (2) perpetual, non- cumulative preferred shares issued by the Bank to a special purpose vehicle (SPV) for the benefit of LRCN holders.



In the event of the non-payment of principal or interest in cash on any interest payment date, upon an event of default[2], or at maturity, the sole recourse against the Bank for the claims of LRCN holders will be the delivery of the preferred shares held by the SPV. Upon a non-viability trigger event as described in Chapter 2 of OSFI's *Capital Adequacy Requirements (CAR) Guideline*, the LRCNs' principal, plus accrued and unpaid interest, will become due and payable and, upon non-payment of such principal and interest, LRCN holders will receive common shares of the Bank issued upon conversion of the preferred shares held by the SPV.

[1] This ruling will also apply to instruments with equivalent terms and conditions that are not characterized as "Limited Recourse Capital Notes". To ensure the inclusion of prospective instruments as regulatory capital, institutions are encouraged to seek rulings, or capital confirmations, from OSFI prior to issuance.

[2] The events of default for regulatory capital instruments issued by FRFIs are limited to liquidation, insolvency, wind-up and bankruptcy.

Redemptions or purchases of the LRCNs or underlying preferred shares by the issuing entity will be subject to prior Superintendent approval.

Considerations: In its evaluation of regulatory capital instruments, OSFI considers structures holistically. OSFI's approach to reviewing the quality of instruments, including the LRCN structure, also emphasizes economic substance over legal form. Finally, OSFI's assessment of instruments considers their potential behaviour and impacts on financial stability, particularly in periods of stress.

Taking into account the foregoing considerations, OSFI assessed the LRCNs and the underlying preferred shares held by the SPV both individually as well as in combination relative to the eligibility criteria set out in Chapter 2 of the CAR Guideline. OSFI's conclusions on key interpretative questions are summarized below.

Issue # 1: Does the Bank's obligation to settle coupon payments in cash or through the delivery of the SPV's underlying preferred shares comply with the CAR Guideline expectation that institutions must have full discretion to cancel payments and such cancelled payments must not be an event of default or otherwise impose restrictions on the issuer[3]?

OSFI concluded that the Bank has full discretion to trigger the delivery of the preferred shares to the LRCN holders in lieu of making interest payments on the LRCNs. Upon doing so, the LRCNs would be cancelled. Foregone interest payments would be cancelled, are non-cumulative and do not result in events of default or other restrictions.

Issue # 2: Given the fixed maturity date of the LRCNs in year 60, do the LRCNs satisfy the CAR Guideline requirement that Additional Tier 1 instruments be perpetual[4]?

LRCN noteholders' recourse is limited to perpetual Tier 1-qualifying instruments – Bank preferred shares or common shares – in all circumstances, including at maturity of the notes in year 60. OSFI concluded that the LRCN structure is perpetual based on its economic substance and consideration of the structure holistically rather than its component instruments.

Issue # 3: Does the LRCN structure comply with the CAR Guideline requirement that Additional Tier 1 instruments should not embed incentives to redeem[5]?

OSFI concluded the LRCNs do not constitute an incentive to redeem that would be contrary to the CAR Guideline. In addition, the delivery of the preferred shares in exchange for the LRCNs under certain events would not be dilutive to the Bank's shareholders' equity, a key consideration in assessing incentives to redeem for instruments with mandatory or holder-initiated conversions to common shares.

[3] Refer to criterion # 7 of the Additional Tier 1 eligibility criteria set out in section 2.1.2.1 of the CAR Guideline.
[4] Refer to criterion # 4 of the Additional Tier 1 eligibility criteria set out in section 2.1.2.1 of the CAR Guideline.
[5] Refer to criterion # 4 of the Additional Tier 1 eligibility criteria set out in section 2.1.2.1 of the CAR Guideline.

Ruling: OSFI concluded that the LRCN structure meets all of the criteria to be recognized as Additional Tier 1 regulatory capital by the Bank and other FRFIs[6].

Recognition of the LRCNs as Additional Tier 1 capital will be subject to the following limitations. OSFI may add to, amend, or delete these limitations at any time. Limitations may also vary by issuer and/or issuance.

Limitations on Investor Base

1. The LRCNs can only be issued to institutional investors.

Limitations on LRCNs' and Preferred Shares' Terms and Conditions

2. LRCNs and preferred shares must have a minimum par or stated value of $1000 and be traded on institutional desks (i.e. not exchange-listed).
3. The LRCNs must have an initial term to maturity of at least 60 years.
4. Unless the instrument has been replaced with an instrument of higher capital quality (i.e. CET1-qualifying common shares or retained earnings), the issuer will only be permitted to redeem the LRCNs or preferred shares where the carrying cost of the LRCNs or preferred shares exceeds the cost of replacement capital of equivalent quality (i.e. AT1).

Limit on LRCN Issuances

5. LRCN issuances will be subject to a cap of 0.75% of RWA[7] (i.e. 50% of the AT1 bucket) as measured on the date of issuance.
6. In calculating this limit, the issuer should compare the aggregate of its outstanding and proposed issuances of LRCNs on the date of issuance to 0.75% of RWA. The limit should consider the issuer's capital at the last reporting date with adjustments for subsequent transactions including issuances, redemptions, buybacks, and acquisitions.

Disclosure

7. The disclosure and marketing of the LRCNs to investors must clearly disclose how the LRCNs' risks are equivalent to the risks of investing in directly issued Tier 1-qualifying Non-Viability Contingent Capital (NVCC) preferred shares.

[6] If issued, the LRCNs may be recognized as Tier 1 Capital Instruments other than Common Shares in the case of life insurers or Category B capital in the case of property & casualty insurers or mortgage insurers.
[7] OSFI will develop equivalent limitations for insurers in due course.