Office of the Superintendent of Financial Institutions Canada
Bureau du surintendant des institutions financières Canada

# Guideline

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

**Chapter 2 –** **Definition of Capital**

**Effective Date:** **November 2027 / January 2028**

For institutions with a fiscal year ending October 31 or December 31, respectively.

The Capital Adequacy Requirements (CAR) for banks (including federal credit unions), bank holding companies, federally regulated trust companies, and federally regulated loan companies are set out in nine chapters, each of which has been issued as a separate document. This document should be read in conjunction with the other CAR chapters. The complete list of CAR chapters is as follows:

| | |
|---|---|
| Chapter 1 | Overview of Risk-based Capital Requirements |
| Chapter 2 | Definition of Capital |
| Chapter 3 | Operational Risk |
| Chapter 4 | Credit Risk – Standardized Approach |
| Chapter 5 | Credit Risk - Internal Ratings-Based Approach |
| Chapter 6 | Securitization |
| Chapter 7 | Settlement and Counterparty Risk |
| Chapter 8 | Credit Valuation Adjustment (CVA) Risk |
| Chapter 9 | Market Risk |

Please refer to OSFI's *Corporate Governance Guideline* for OSFI's expectations of institution Boards of Directors in regard to the management of capital and liquidity.

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# Chapter 2 – Definition of Capital

1. This chapter is drawn from the Basel Committee on Banking Supervision's (BCBS) Basel Framework pubished on the Bank for International Settlements (BIS) website.[1] For reference, the Basel paragraph numbers that are associated with the text appearing in this chapter are indicated in square brackets at the end of each paragraph.[2]

## 2.1 Requirements for Inclusion in Regulatory Capital

2. Regulatory capital consists of three categories, each governed by a single set of criteria that instruments are required to meet before inclusion in the relevant category.

a. Common Equity Tier 1 (CET1) capital (going-concern capital) (section 2.1.12.1.1 CET1 Capital)

b. Additional Tier 1 capital (going-concern capital) (section 2.1.22.1.2 Additional Tier 1 Capital)

c. Tier 2 capital (gone-concern capital) (section 2.1.32.1.3 Tier 2 Capital)

Total regulatory capital is the sum of CET1, Additional Tier 1, and Tier 2 capital, net of regulatory adjustments described in section 2.3. Tier 1 capital is the sum of CET1 and Additional Tier 1 capital, net of the regulatory adjustments applied to those categories.

Effective Q1 2028, capital instruments issued by small and medium-sized deposit-taking institutions (SMSBs) are exempt from the non-viability contingent capital (NVCC) requirements specified in section 2.2.[Basel Framework, CAP 10.1 & 10.2]

### 2.1.1 CET1 Capital

3. CET1 capital consists of the sum of the following elements:

a. Common shares issued by the institution that meet the criteria for classification as common shares for regulatory purposes;[3]

b. Stock surplus (share premium) resulting from the issue of instruments included in CET1;[4]

c. Retained earnings;

d. Accumulated other comprehensive income and other disclosed reserves;

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1 The Basel Framework

2 Following the format: [Basel Framework, XXX yy.xx]

3 For an institution that is a federal credit union, references to "common shares" in this guideline encompass "membership shares", as defined in subsection 79.1(1) of the *Bank Act,* and other instruments recognized as CET1 capital under this guideline.

4 Where repayment is subject to Superintendent approval.

e. Contractual Service Margins (CSM) that are reported as liabilities in the financial statements of the institution's insurance subsidiaries, net of CSM that are reported as assets in the financial statements;

f. Common shares issued by consolidated subsidiaries of the institution and held by third parties that meet the criteria for inclusion in CET1 capital (see section 2.1.1.32.1.1.3 Common shares issued by a consolidated subsidiary to third parties (i.e. Minority interest/Non-controlling interests)); and

g. Regulatory adjustments applied in the calculation of CET1 (see section 2.3.12.3.1 Regulatory Adjustments to CET1 Capital).

Retained earnings and other comprehensive income include interim profit or loss. Dividends are removed from CET1 in accordance with applicable accounting standards. The treatment of minority interest and the regulatory adjustments applied in the calculation of CET1 capital are addressed in sections 2.1.1.3 2.1.1.3 Common shares issued by a consolidated subsidiary to third parties (i.e. Minority interest/Non-controlling interests)and 2.3.12.3.1 Regulatory Adjustments to CET1 Capital, respectively.

[Basel Framework, CAP 10.6 & 10.7]

### *2.1.1.1 Common shares issued by the institution directly*

4. For an instrument to be included in CET1 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:

a. Represents the most subordinated claim in liquidation of the institution.

b. 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).

c. 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).

d. 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.

e. 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).

f. There are no circumstances under which the distributions are obligatory. Non-payment is, therefore, not an event of default. This requirement prohibits features that require the institution to make payments in kind.

g. 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.

h. It is the 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.

i. The paid-in amount is recognized as equity capital (i.e. not recognized as a liability) for determining balance sheet solvency.

j. The paid-in amount is classified as equity under the relevant accounting standards.

k. 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.

l. 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.

m. 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.

n. It is clearly and separately disclosed as equity on the institution's balance sheet prepared in accordance with the relevant accounting standards.[7]

[Basel Framework, CAP 10.8]

### *2.1.1.2 CET1 instruments issued by a federal credit union*

5. For an instrument to be included in CET1 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:

a. For instruments other than membership shares, the instrument need not meet CET1 eligibility criteria a, b, e, and h. Investors entitled to claims under such other CET1 instruments must rank *pari passu* with membership shares up to a predetermined amount of gross CET1 capital (i.e. CET1 capital gross of the regulatory adjustments described later in this chapter) which must be reset monthly according to the

[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. [Basel Framework, CAP 10.8 FAQ2]

[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 irrespective of whether it forms part of the consolidated banking group.

[7] The item should be clearly and separately disclosed on the balance sheet published in the institution's annual report. Where an institution publishes results on a semi-annual or quarterly basis, disclosure should also be made at those times.

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.

b. Membership share and other CET1 distributions may be subject to a contractual cap.

c. 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.

d. 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.

#### *2.1.1.3 Common shares issued by a consolidated subsidiary to third parties (i.e. Minority interest/Non-controlling interests)*

6. Common shares issued by a fully consolidated subsidiary of the institution to a third party may receive limited recognition in the consolidated CET1 of the parent institution only if:

a. the instrument, if issued by the institution directly, would meet all of the criteria described in sections 2.1.1.1 and 2.1.1.22.1.1.2 CET1 instruments issued by a federal credit union for classification as common shares for regulatory capital purposes; and

b. the subsidiary that issued the instrument is itself a bank[8] [9]

7. The amount of capital meeting the above criteria that will be recognized in consolidated CET1 is calculated as follows (refer to Appendix 2-1 for an illustrative example):

a. Paid-in capital that meets the criteria set out in paragraph 6 above plus retained earnings that are attributable to third-party investors, gross of deductions, less the amount of surplus CET1 capital of the subsidiary that is attributable to the third-party investors.

b. The surplus CET1 capital of the subsidiary is calculated as the CET1 capital of the subsidiary, net of deductions, minus the lower of: (1) the minimum CET1 capital requirement of the subsidiary plus the capital conservation buffer (i.e. 7.0% of risk-

[8] 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.

[9] 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.

weighted assets (RWA[10]))[11]; and (2) the portion of the parent's consolidated minimum CET1 capital requirements[12] plus the capital conservation buffer (i.e. 7.0% of RWA[10]) that relates to the subsidiary.

c. The amount of surplus CET1 capital that is attributable to the third-party investors is calculated by multiplying the surplus CET1 capital of the subsidiary (calculated in b. above) by the percentage of CET1 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 CET1 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 2.1.2.2 Additional Tier 1 qualifying capital instruments issued by a subsidiary to third parties and 2.1.3.22.1.3.2 Tier 2-qualifying capital instruments issued by a subsidiary to third parties. [Basel Framework, CAP 10.20 and 10.21]

9. For capital issued by a consolidated subsidiary of a group to third parties to be eligible for inclusion in the consolidated capital of the banking group, the minimum capital requirements and definition of capital must be calculated for the subsidiary irrespective of whether the subsidiary is regulated on a standalone basis. In addition, the contribution of the subsidiary to the consolidated capital requirement of the group (i.e. excluding the impact of intragroup exposures) must be calculated. All calculations must be undertaken in respect of the subsidiary on a sub-consolidated basis (i.e. the subsidiary must also consolidate all of its subsidiaries that are also included in the wider consolidated group). If this is considered too operationally burdensome, institutions may elect to give no recognition in consolidate capital of the group to the capital issued by the subsidiary to third parties. [Basel Framework, CAP 10.21 FAQ2]

### *2.1.1.4 Common shares issued to third parties out of Special Purpose Vehicles (SPVs)*

10. Where capital has been issued to third parties out of an SPV, none of this capital can be included in CET1. 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 eligibility 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 eligibility criteria[13] (as required by criterion 15 under paragraph 13 for Additional Tier 1 and criterion 9 under paragraph 27 for Tier 2 capital).

[10] Category III SMSBs should use [Adjusted Total Assets + RWA $_{\text{Operational Risk}}$] instead of RWA in the calculation of the surplus CET1 capital of the subsidiary.

[11] Calculated using the local regulator's RWA calculation methodology, e.g. 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 (i.e. 7.0% of RWA).

[12] This amount should exclude any intercompany exposures (e.g. loans or debentures) from the subsidiary to the parent that would boost the subsidiary's RWA.

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

11. 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 2.1.2.2 Additional Tier 1 qualifying capital instruments issued by a subsidiary to third parties and 2.1.3.22.1.3.2 Tier 2-qualifying capital instruments issued by a subsidiary to third parties. [Basel Framework, CAP 10.26]

## 2.1.2 Additional Tier 1 Capital

12. Additional Tier 1 capital consists of the sum of the following elements:

a. 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 CET1);

b. Stock surplus (i.e. share premium) resulting from the issue of instruments included in Additional Tier 1 capital. Surplus that is not eligible for inclusion in CET1 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. [Basel Framework, CAP 10.13];

c. 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 CET1 (see sections 2.1.2.2 2.1.2.2 Additional Tier 1 qualifying capital instruments issued by a subsidiary to third parties and 2.1.2.32.1.2.3 Additional Tier 1 instruments issued to third parties out of SPVs); and

d. Regulatory adjustments applied in the calculation of Additional Tier 1 capital (see section 2.3). [Basel Framework, CAP 10.9]

### *2.1.2.1 Additional Tier 1 instruments issued by the institution directly*

13. 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.
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.[14]

4. Is perpetual, i.e. there is no maturity date and there are no step-ups[15] or other incentives to redeem.[16]

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

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

   ii. An institution's actions and the terms of the instrument must not create an expectation that the call will be exercised;[17] and

   iii. 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;[18] or
   - The institution demonstrates that its capital position is well above the minimum capital requirements after the call option is exercised.[19]

   iv. Tax and regulatory event calls are permitted at any time 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.[20]

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.

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[14] 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. [Basel Framework, CAP 10.11 FAQ2]

[15] 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. [Basel Framework, CAP 10.11 FAQ4]

[16] 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. [Basel Framework, CAP 10.11 FAQ4]

[17] An example of an action that would be considered to create an expectation that a call will be exercised is where an institution calls a capital instrument and replaces it with an instrument that is more costly (e.g. a higher credit spread). [Basel Framework, CAP 10.11 FAQ8]

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

[19] The term "minimum" refers to OSFI's target capital requirements described in section 1.10 of Chapter 1 of this guideline which may be higher than the Basel III Pillar 1 minimum requirements.

[20] Where an institution elects to include a regulatory event call in an instrument, the regulatory event call date should be defined as "the date specified in a letter from the Superintendent to the institution on which the instrument will no longer be recognized in full as eligible Additional Tier 1 capital of the institution or included in Total regulatory capital".

7. Any repayment of principal (e.g. through repurchase or redemption) must be subject to the prior approval of the Superintendent and institutions should not assume or create market expectations that such approval will be given.
8. Dividend/coupon discretion:
   i. the institution must have full discretion at all times to cancel distributions/payments[21]
   ii. cancellation of discretionary payments must not be an event of default or credit event
   iii. institutions must have full access to cancelled payments to meet obligations as they fall due
   iv. cancellation of distributions/payments must not impose restrictions on the institution except in relation to distributions to common shareholders.
9. Dividends/coupons must be paid out of distributable items.
10. 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.[22]
11. The instrument cannot contribute to liabilities exceeding assets if such a balance sheet test forms part of national insolvency law.
12. The instrument must be classified as equity for accounting purposes.[23]
13. 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.[24]
14. 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.

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[21] 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. Institutions may not allow investors to convert an Additional Tier 1 instrument to common equity upon non-payment of dividends as this would also impeded the practical ability of the bank to exercise its discretion to cancel payments.

[22] 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. [Basel Framework, CAP 10.11 FAQ12]

[23] OSFI expects Additional Tier 1 instruments to be fully classified as equity at all times where the Superintendent has not declared the institution non-viable.

[24] The intention of this criterion is to prohibit the inclusion of instruments in capital in cases where the institution retains any of the risk of the instruments. The criterion is not contravened if third-party investors bear all of the risks and rewards associated with the instrument. [Basel Framework, CAP 10.11 FAQ14]

15. If the instrument is not issued out of an operating entity or the holding company in the consolidated group (i.e. it is issued out of an SPV), proceeds must be immediately available without limitation to an operating entity[25] 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.[26]
16. 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 NVCC requirements as specified under section 0.[27] Where an instrument is issued by an SPV according to criterion #15 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.

14. [Basel Framework, CAP 10.11]

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.

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:

a. attempt to stop payment on another instrument where the payments on the other instrument were not also fully discretionary;
b. 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;
c. impede the normal operation of the institution or any restructuring activity, including acquisitions or disposals.

[25] An operating entity is an entity set up to conduct business with clients with the intention of earning a profit in its own right.
[26] [Basel Framework, CAP 10.11 FAQ16 and FAQ17]
[27] The amount recognized as regulatory capital should be adjusted to account for any actual or foreseeable deferred tax liabilities or tax payments resulting from the conversion or writedown of the instrument. This adjustment should be made from the date of issuance. [Basel Framework, CAP 10.11 FAQ23]

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.[28] [Basel Framework, CAP 10.11 FAQ9]

18. Institutions are permitted to reopen offerings of Additional Tier 1 capital instruments to increase the principal amount of the original issuance subject to the following:

a. institutions cannot reopen offerings where the initial issue date was on or before December 31, 2012;
b. federal credit unions cannot reopen offerings of instruments issued prior to the institution's continuance as a federal credit union; and, in both cases,
c. 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 reopened tranche of securities; and
d. institutions are required to notify OSFI within 30 days of executing a reopening to increase the principal amount of the original issuance.

A "reopening" means the issuance by an institution of additional principal of an existing series of debt securities under an existing indenture whereby the newly issued series are fungible with those of the original issuance.

19. Defeasance or other options that could result in a decrease of the institution's regulatory capital may only be exercised on or after the fifth anniversary of the closing date with the prior approval of the Superintendent.

### *2.1.2.2 Additional Tier 1 qualifying capital instruments issued by a subsidiary to third parties*

20. Additional Tier 1 capital instruments issued by a fully consolidated subsidiary of the institution to third-party investors (including amounts under section 2.1.1.32.1.1.3 Common shares issued by a consolidated subsidiary to third parties (i.e. Minority interest/Non-controlling interests)) 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 Tier 1 capital.

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

[28] 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.

a. Total Tier 1 capital of the subsidiary issued to third parties 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 (i.e. 8.5% of RWA[29])[30]; and (2) the portion of the parent's consolidated minimum Tier 1 capital requirements[31] plus the capital conservation buffer (i.e. 8.5% of RWA[29]) 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 CET1 under section 2.1.1.32.1.1.3 Common shares issued by a consolidated subsidiary to third parties (i.e. Minority interest/Non-controlling interests).

[Basel Framework, CAP 10.22 and 10.23]

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

22. As stated under paragraph 10, where capital has been issued to third parties out of an SPV none of this capital can be included in CET1. 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 eligibility 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 eligibility criteria[32] (as required by criterion 14 of the Additional Tier 1 criteria set out under section 2.1.2.12.1.2.1 Additional Tier 1 instruments issued by the institution directly).

23. 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 2.1.2.2 Additional Tier 1 qualifying capital instruments issued by a subsidiary to third parties and 2.1.3.22.1.3.2 Tier 2-qualifying capital instruments issued by a subsidiary to third parties.

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[29] Category III SMSBs should use [Adjusted Total Assets + RWA $_{\text{Operational Risk}}$], instead of RWA, in the calculation of the surplus Tier 1 capital of the subsidiary.

[30] Calculated using the local regulator's RWA calculation methodology, e.g. 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 (i.e. 8.5% of RWA).

[31] This amount should exclude any intercompany exposures (e.g. loans or debentures) from the subsidiary to the parent that would boost the subsidiary's RWA.

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

#### *2.1.2.4 Additional Tier 1 instruments issued to a parent*

24. 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 together with the following:

a. a copy of the instrument's terms and conditions;

b. the intended classification of the instrument for regulatory capital purposes;

c. the rationale provided by the parent for not providing common equity in lieu of the subject capital instrument;

d. confirmation that the rate and terms of the instrument as at the date of the transaction are at least as favourable to the institution as market terms and conditions; and

e. 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*

25. 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 with the following documentation:

a. a copy of the instrument's terms and conditions;

b. 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

c. 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

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

a. Instruments issued by the institution that meet the criteria for inclusion in Tier 2 capital (and are not included in Tier 1 capital);

b. Stock surplus (i.e. share premium) resulting from the issue of instruments included in Tier 2 capital. Surplus 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. [Basel Framework, CAP 10.17];

c. 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 2.1.3.1 Tier 2 instruments issued by the institution directly and 2.1.3.32.1.3.3 Tier 2 instruments issued to third parties out of SPVs); and

Certain loan loss allowances as specified in section 2.1.3.72.1.3.7 General allowances. [Basel Framework, CAP 10.14]

### *2.1.3.1 Tier 2 instruments issued by the institution directly*

27. 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:

a. Issued and paid-in in cash, or with the prior approval of the Superintendent, in property.

b. Subordinated to depositors and general creditors of the institution.

c. 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.

d. Maturity:

i. Minimum original maturity of at least five years

ii. Recognition in regulatory capital in the remaining five years before maturity will be amortized on a straight-line basis

iii. There are no step-ups[33] or other incentives to redeem

e. May be callable at the initiative of the issuer only after a minimum of five years:

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

[33] 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.

ii. An institution must not do anything which creates an expectation that the call be exercised;[34] and

iii. 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;[35] or
- The institution demonstrates that its capital position is well above the minimum capital requirements after the call option is exercised.[36]

iv. The use of 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.[37]

f. 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.

g. 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.[38]

h. 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.

i. If the instrument is not issued out of an operating entity[39] or the holding company in the consolidated group (i.e. it is issued out of an 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

[34] An option to call the instrument after five years but prior to the start of the amortization 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.

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

[36] The term "minimum" refers to OSFI's target capital requirements as described in section 1.10 of Chapter 1 of this guideline which may be higher than the Basel III Pillar 1 minimum requirements.

[37] Where an institution elects to include a regulatory event call in an instrument, the regulatory event call date should be defined as "the date specified in a letter from the Superintendent to the institution on which the instrument will no longer be recognized in full as eligible Tier 2 capital of the institution or included in Total regulatory capital".

[38] 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.

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

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.[40]

j. 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 NVCC requirements as specified under section 0.[41] 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.

[Basel Framework, CAP 10.14]

28. 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.

29. 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.

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.[42]

31. Defeasance or other options that could result in a decrease of the institution's regulatory capital may only be exercised on or after the fifth anniversary of the closing date with the prior approval of the Superintendent.

32. Institutions are permitted to reopen offerings of capital instruments to increase the principal amount of the original issuance subject to the following:

a. institutions cannot reopen offerings where the initial issue date was on or before December 31, 2012;
b. federal credit unions cannot reopen offerings of instruments issued prior to the institution's continuance as a federal credit union; and, in both cases,
c. 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 reopened tranche of securities; and
d. institutions are required to notify OSFI within 30 days of executing a reopening to increase the principal amount of the original issuance.

[40] [Basel Framework, 10.16 FAQ4 and FAQ7]

[41] The amount recognized as regulatory capital should be adjusted to account for any actual or foreseeable deferred tax liabilities or tax payments resulting from the conversion or write-down of the instrument. This adjustment should be made from the date of issuance. [Basel Framework, CAP 10.16 FAQ9]

[42] 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.

### *2.1.3.2 Tier 2-qualifying capital instruments issued by a subsidiary to third parties*

33. 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 2.1.1.3 2.1.1.3 Common shares issued by a consolidated subsidiary to third parties (i.e. Minority interest/Non-controlling interests) and 2.1.2.22.1.2.2 Additional Tier 1 qualifying capital instruments issued by a subsidiary to third parties) may receive recognition in the consolidated Total capital of the parent institution only if the instruments would, if issued by the institution, meet all of the criteria for classification as Tier 1 or Tier 2 capital.

34. 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. Total capital of the subsidiary issued to third parties that is 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 (i.e. 10.5% of RWA[43] [44]) and (2) the portion of the parent's consolidated minimum Total Capital requirements[45] plus the capital conservation buffer (i.e. 10.5% of RWA[43]) 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 CET1 under section 2.1.1.3 2.1.1.3 Common shares issued by a consolidated subsidiary to third parties (i.e. Minority interest/Non-controlling interests)and amounts recognized in Additional Tier 1 under section 2.1.2.22.1.2.2 Additional Tier 1 qualifying capital instruments issued by a subsidiary to third parties.

[Basel Framework, CAP 10.24 and 10.25]

### *2.1.3.3 Tier 2 instruments issued to third parties out of SPVs*

35. As stated under paragraph 10, where capital has been issued to third parties out of an SPV none of this capital can be included in CET1. However, such capital can be included in

[43] Category III SMSBs should use [Adjusted Total Assets + RWA $_{\text{Operational Risk}}$ ], instead of RWA, in the calculation of the surplus Total capital of the subsidiary.

[44] Calculated using the local regulator's RWA calculation methodology, e.g. 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 (i.e. 10.5% of RWA).

[45] This amount should exclude any intercompany exposures (e.g. loans or debentures) from the subsidiary to the parent that would boost the subsidiary's RWA.

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 eligibility 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 eligibility criteria[46] (as required by criterion 9 of the Tier 2 criteria set out under section 2.1.3.12.1.3.1 Tier 2 instruments issued by the institution directly).

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 2.1.2.2 Additional Tier 1 qualifying capital instruments issued by a subsidiary to third parties and 2.1.3.22.1.3.2 Tier 2-qualifying capital instruments issued by a subsidiary to third parties.

[Basel Framework, CAP 10.26]

### *2.1.3.4 Tier 2 instruments issued to a parent*

36. 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 together with the following:

a. a copy of the instrument's term and conditions;

b. the intended classification of the instrument for regulatory capital purposes;

c. the rationale provided by the parent for not providing common equity in lieu of the subject capital instrument;

d. confirmation that the rate and terms of the instrument as at the date of the transaction are at least as favourable to the institution as market terms and conditions;

e. 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*

37. 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

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

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 with the following documentation:

a. a copy of the instrument's term and conditions;

b. 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

c. 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*

38. 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:

**Amortization criteria for outstanding balances**

| *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% |

39. 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 2.1.3.12.1.3.1 Tier 2 instruments issued by the institution directly.

40. Amortization should be computed at the end of each fiscal quarter based on the "years to maturity" schedule in paragraph 38 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*[47]

41. 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 any 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 RWA[48] calculated under the Standardized Approach, and should exclude allowances held against underlying assets treated as a securitization for capital purposes. Deposit-taking institutions in the business of lending must meet all of the principles and criteria in OSFI's IFRS 9 Guideline[49] 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.

[Basel Framework, CAP 10.18]

42. Institutions using an IRB approach for credit risk

a. calculate a provisioning excess or shortfall as follows: (1) general allowances, plus (2) all other allowances for credit loss excluding allowances against securitization exposures or underlying assets treated as a securitization for capital purposes, minus (3) the expected loss amount

b. deduct provisioning shortfalls from CET1 capital

c. include provisioning excess in Tier 2 capital up to a limit of the lower of 0.6% of IRB credit RWA or the amount of general allowances

[Basel Framework, CAP 10.19]

43. Institutions that have partially implemented an IRB approach[50]

[47] Eligible allowances or reserves included in Tier 2 capital should be recorded as gross of tax effects.
[48] Category III SMSBs should use Adjusted Total Assets, instead of credit RWA, when calculating the general allowances eligible for inclusion in Tier 2 capital.
[49] Available at IFRS 9 Financial Instruments and Disclosures
[50] Institutions that have partially implemented an IRB approach must meet the requirements in paragraph 41 above.

a. split general allowances between the Standardized Approach and the IRB Approach in a manner consistent with the institution's internal and external allowance reporting

b. include general allowances allocated to the Standardized Approach in Tier 2 capital up to a limit of 1.25% of credit RWA calculated using the Standardized Approach

c. calculate a provisioning excess or shortfall on the IRB portion of the institution as set out above

d. deduct provisioning shortfalls on the IRB portion of the institution from CET1 capital

e. 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 RWA or the amount of general allowances allocated to the IRB portion of the institution

## 2.2 Non-Viability Contingent Capital Requirements (NVCC)

44. 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.[51]

### 2.2.1 Principles Governing NVCC

45. 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. Effective Q1 2028, capital instruments issued by an SMSB are exempt from the NVCC requirements, and as such, need not comply with the principles set out below.

*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[52] into common shares of the institution upon a trigger event.[53] 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 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 CET1 capital under the criteria set out in section 2.1.1.12.1.1.1 Common shares issued by the institution directly of this guideline.

[51] 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.

[52] 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.

[53] 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.

*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.[54]

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:

a. Emergency Liquidity Assistance provided by the Bank of Canada at or above the Bank Rate;

b. open bank liquidity assistance provided by CDIC at or above its cost of funds; and

c. 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.

[54] 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.[55] 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

[55] 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,[56] 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, also include triggers that are equivalent to the triggers specified in Principle # 3 above.[57] 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

46. 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)[58] (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

[56] For further reference, please refer to sections 2.1.1.3 Common shares issued by a consolidated subsidiary to third parties (i.e. Minority interest/Non-controlling interests), 2.1.2.2 Additional Tier 1 qualifying capital instruments issued by a subsidiary to third parties. and 2.1.3.2 Tier 2-qualifying capital instruments issued by a subsidiary to third parties of this guideline.

[57] For greater certainty, instruments issued by foreign subsidiaries of institutions must include triggers that can be activated by both OSFI and the host authority in order to be recognized as capital on a group consolidated basis. [Basel Framework, CAP 10.11 FAQ18]

[58] Under the OSFI Act, FISC comprises OSFI, the Canada Deposit Insurance Corporation, the Bank of Canada, the Department of Finance, the Financial Consumer Agency of Canada, and the Financial Transactions and Reports Analysis Centre 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.

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

47. 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.[59] 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:[60]

a. 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.

b. 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.

c. 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.

d. 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.

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

f. 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.

g. 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.

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

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

48. 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 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.

49. For information on the capital confirmation process, see Appendix 2-2 of this chapter.

## 2.3 Required Regulatory Adjustments to Capital

50. This section sets out the regulatory adjustments to be applied to regulatory capital. In most cases these adjustments are applied in the calculation of CET1. 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.

51. Except in respect of the items referred to in paragraphs 63 and 69 below, institutions shall not make adjustments to remove from CET1 capital unrealized gains or losses on assets or liabilities that are measured at fair value for accounting purposes.

52. 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.[61] [Basel Framework, CAP 30.2]

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

a. all direct, indirect, and synthetic investments in the instruments of a D-SIB that are eligible to be recognized as TLAC pursuant to OSFI's TLAC Guideline and that do not otherwise qualify as regulatory capital for the issuing D-SIB;[62]

b. 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

[61] 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.

[62] 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 recognized 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 recognized 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 54; and

c. 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:

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

   ii. 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.

[Basel Framework, CAP 30.3]

54. In certain jurisdictions (excluding Canada), G-SIBs may be able to recognize 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.[63] 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. [Basel Framework, CAP 30.4 & 30.5]

55. The regulatory adjustments relating to TLAC holdings set out in section 2.3 apply from Q1 2019.[64]

## 2.3.1 Regulatory Adjustments to CET1 Capital

### Prudential valuation adjustments

56. Valuation adjustments on less liquid positions as described in section 9.4.5 of Chapter 9 of this guideline should be made in the calculation of CET1. [Basel Framework, CAP 50.14]

[63] 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.

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

**Goodwill and other intangibles (except mortgage servicing rights)**

57. 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 CET1. In addition, goodwill included in the valuation of significant investments[65] in the capital of banking, financial, and insurance entities that are outside the scope of regulatory consolidation should also be deducted from CET1. 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. [Basel Framework, CAP 30.7]

58. All other intangible assets[66] except mortgage servicing rights and right-of-use (ROU) assets where the underlying asset being leased is a tangible asset[67] should be deducted in the calculation of CET1. 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 92 to 94. [Basel Framework, CAP 30.7]

**Prepaid portfolio insurance assets**

59. Premiums paid for mortgage portfolio insurance (bulk insurance) and capitalized on the balance sheet are to be deducted in the calculation of CET1 where the premiums are not amortized in accordance with the expectations set out in section 4.1.24 of Chapter 4 of this guideline. The amount deducted is net of any associated deferred tax liability that would be extinguished if the asset were to become impaired or derecognized under the relevant accounting standards.

**Deferred tax assets**

60. Deferred tax assets (DTAs), except for those referenced in paragraph 61 and DTAs associated with the de-recognition of the cash flow hedge reserve, are to be deducted in the calculation of CET1. 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

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[65] 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. [Basel Framework, CAP 30.7 FAQ1]

[66] This includes software intangibles.

[67] For regulatory capital purposes, a ROU should not be deducted from regulatory capital so long as the underlying asset being leased is a tangible asset. Where the underlying asset being leased is a tangible asset, the ROU asset asset should be included in the risk-based capital and leverage ratio denominators and should be risk-weighted at 100%, consistent with the risk weight applied to owned tangible assets. [Basel Framework, CAP 30.7 FAQ2]

offsetting is permitted by the relevant taxation authority.[68] 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 92 to 94). All other DTAs 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, the de-recognition of the cash flow hedge reserve, and prepaid portfolio insurance assets 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 61. [Basel Framework, CAP 30.9]

61. 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% risk weight.[69] OSFI 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**

62. 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 CET1. [Basel Framework, CAP 30.10]

**Cash flow hedge reserve**

63. 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 CET1. 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 CET1 and negative amounts should be added back. This treatment specifically identifies the element of the cash flow hedge reserve that is to be derecognized 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). [Basel Framework, CAP 30.11 & 30.12]

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

[69] The 100% risk weight is not applicable to Category III SMSBs as these assets are included in Adjusted Total Assets in the Simplified Risk-Based Capital Ratio.

**Shortfall in provisions to expected losses**

64. Provisioning shortfalls calculated under IRB Approaches to credit risk should be deducted in the calculation of CET1. 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. [Basel Framework, CAP 30.13]

**Non-payment and non-delivery on non-Delivery versus Payment (DvP) transactions**

65. For non-DvP (including non-PvP) transactions where five business days have elapsed since the second contractual payment/delivery date and where the second leg has not effectively taken place, institutions that have made the first payment leg should deduct from CET1 capital the full amount of the value transferred plus replacement cost, if any.[70]

**Materiality thresholds on credit protection**

66. Materiality thresholds on payments below which the protection provider is exempt from payment in the event of loss are equivalent to retained first-loss positions. The portion of the exposure that is below a materiality threshold for credit protection must be deducted from CET1 by the institution purchasing the credit protection. [71] [Basel Framework, CRE 22.79]

**Gain on sale related to securitization transactions**

67. Increases in equity capital resulting from securitization transactions (e.g. capitalized future margin income, gains on sale) should be deducted in the calculation of CET1. [Basel Framework, CAP 30.14]

**Assets risk-weighted at 1250% that can be deducted**

68. Institutions may choose to deduct from CET1 the exposure amounts of the following items as an alternative to applying a riskweight of 1250%:

a. the nominal amount of protection provided by first-to-default credit derivatives, in accordance with section 4.1.21 of Chapter 4 of this guideline;

b. equity investments in funds, in accordance with section 4.1.23 of Chapter 4 of this guideline;

c. securitization positions, in accordance with section 6.5.1 of Chapter 6 of this guideline.

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

[70] Refer to section 7.2.2. of Chapter 7.

[71] Refer to section 4.3.5(v) of Chapter 4. All forms of credit protection, including credit derivatives, are part of this scope of application apart from mortgage insurance purchased from a private mortgage insurer in Canada, which is subject to the rules in section 4.3.5 (vi) of Chapter 4 or section 5.4.2(i) of Chapter 5.

69. 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 CET1. 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). [72] [Basel Framework, CAP 30.15]

**Defined benefit pension fund assets and liabilities**

70. Defined benefit pension fund liabilities, as included on the balance sheet, must be fully recognized in the calculation of CET1 (i.e. CET1 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[73] should be deducted in the calculation of CET1 net of any associated deferred tax liability that would be extinguished if the asset should become impaired or derecognized under the relevant accounting standards.

71. 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. [Basel Framework, CAP 30.16]

**Reverse mortgages**

72. Where a reverse mortgage exposure has a current loan-to-value (LTV) greater than 80%, the exposure amount that exceeds 80% LTV is deducted from CET1 capital. The remaining amount is risk weighted at 100%.

**Exposures to non-qualifying central counterparties (CCP)**

73. Institutions must fully deduct their default fund contributions (including default fund exposures to QCCP subject to the cap in section 7.1.8.1 of Chapter 7) to a non-qualifying CCP from CET1 capital. For the purposes of this paragraph, the default fund contributions of such institutions will include both the funded and the unfunded contributions which are liable to be paid should the CCP so require. Where there is a liability for unfunded contributions (i.e.

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

[73] Generally, institutions currently report this amount in Other Assets on the balance sheet.

unlimited binding commitments), OSFI will determine in its Pillar 2 assessments the amount of unfunded commitments to which a CET1 deduction should apply.

**Investments in own common shares - treasury stock[74]**

74. All of an institution's investments in its own common shares[75] [76] and/or other CET1 capital instruments, whether held directly or indirectly, will be deducted in the calculation of CET1 (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 CET1. The treatment described will apply irrespective of the location of the exposure i.e. if the exposure is in the banking book or the trading book. In addition:

a. Gross long positions may be deducted net of short positions in the same underlying exposure only if the short positions involve no counterparty risk.

b. 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).

c. Subject to supervisory approval, a bank may use a conservative estimate of investments in its own shares where the exposure results from holdings of index securities and the banks finds it operationally burdensome to look through and monitor its exact exposure.

[Basel Framework, CAP 30.18]

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

75. 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 CET1.
[Basel Framework, CAP 30.21]

**Decision tree to determine the capital treatment of equity investments in funds**

[74] 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. [Basel Framework, CAP 30.18 FAQ1]

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

[76] All regulatory adjustments that are applicable to common shares also apply to membership shares and/or other CET1 instruments issued by federal credit unions.

76. 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 85 to 94 below (significant investments) or paragraphs 78 to 84 (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 4.1.23 of Chapter 4 or section 5.2.2 of Chapter 5 of the CAR Guideline should be used to calculate capital requirements for the equity investment. As noted in section 4.1.23 of Chapter 4, if an equity investment is subject to the fall-back approach, the insitution's equity investment in the fund is to be deducted from CET1 capital. [Basel Framework, CRE 60.8]

c. Finally, if the equity investment is made in an entity that is not captured in (a) or (b) above, then either paragraph 77 of this chapter (significant investment in a commercial entity) or the de-facto treatment for equity investments (non-significant investments) of either Chapter 4 or Chapter 5 should be used to calculate capital requirements for the equity investment.

**Significant investments in commercial entities**

77. Significant investments[77] in commercial entities that, in aggregate, exceed 10% of CET1 capital should be fully deducted in the calculation of CET1 capital. Amounts less than this threshold are subject to a 250% risk-weight[78] as set out in Chapter 4.

**Non-significant investments in the capital and/or Other TLAC Instruments of banking, financial[79] and insurance entities[80] [81]**

78. 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.[82] These investments are deducted from regulatory capital, subject to a threshold. For the purpose of this regulatory adjustment:

[77] See footnote 90 for the definition of significant investment.

[78] The 250% risk-weight is not applicable to Category III SMSBs as the amounts less than the 10% threshold are included in Adjusted Total Assets in the Simplified Risk-Based Capital Ratio.

[79] 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. [Basel Framework, CAP 30.22 FAQ2]

[80] 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.

[81] 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.

[82] See footnote 90 for the definition of significant investment.

a. Investments include direct, indirect, and synthetic holdings of capital instruments 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.

b. An indirect holding arises when an institution invests in an unconsolidated intermediate entity that has an exposure to the capital of an unconsolidated bank, financial or insurance entity and thus gains an exposure to the capital of that entity.[83] [84] [Basel Framework, CAP 99.9]

a. A synthetic holding arises when an institution invests in an instrument where the value of the instrument is directly linked to the value of the capital of an unconsolidated bank, financial or insurance entity. [Basel Framework, CAP 99.10]

b. 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, for G-SIBs and D-SIBs, its own TLAC in an equivalent (or higher quality) tier as consideration for the subject capital or TLAC.

   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, 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.

[83] 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 [Basel Framework, CAP 30.22].

[84] 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. [Basel Framework, CAP 99.11]

c. 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 53 and 54.

d. 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).[85] For Other TLAC Instruments, it is the gross long position that is to be included in paragraphs 103 to 105 and the net long position that is to be included in paragraph 82.

e. 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 CET1, 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.[86] [87]
[Basel Framework, CAP 30.22]

79. 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.[88] [Basel Framework, CAP 30.22 FAQ1]

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[85] In the case of a cash equity position and a short position on the same underlying exposure, where both positions are in the trading book, if the institution has a contractual right/obligation to sell a long position at a specific point in time and the counterparty in the contract has an obligation to purchase the long position if the bank exercises its right to sell, this point in time may be treated as the maturity of the long position. Therefore if these conditions are met, the maturity of the long position and the short position are deemed to be matched even if the maturity of the short position is within one year. [Basel Framework, CAP 30.22 FAQ6].

[86] 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.

[87] For investments in financial and insurance entities, not subject to the Basel Framework eligibility 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 Framework criteria.
b. The tier of capital the instrument qualifies for under the most recent capital adequacy guidelines applicable to insurance entities regulated by OSFI.

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 most recent capital adequacy guidelines applicable to insurance entities regulated by OSFI, it is to be considered common shares for the purposes of this deduction.

[88] 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. A federal credit union must notify OSFI in a timely manner of any changes that could impact its exposure to future capital calls as well as any decisions to participate in a capital call. Additionally, a federal credit union should obtain the prior approval of the Superintendent, as applicable, where the capital call would result in the federal credit union acquiring or increasing a substantial investment pursuant to the *Bank Act*.

80. 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. [Basel Framework, CAP 30.22 FAQ4]

81. 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.

82. 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 CET1 after all regulatory adjustments listed in paragraphs 56 to 75. The Other TLAC Instruments included herein should not reflect those items covered by the 5% threshold described in paragraphs 104 and 105 (for D-SIBs and G-SIBs) or paragraph 103 (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 CET1 capital is equal to the deduction amount multiplied by the total holdings in CET1 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 103 to 105 divided by the institution's total holdings of capital instruments and holdings of Other TLAC Instruments determined in (a).

[Basel Framework, CAP 30.26]

83. The amount of all holdings which falls below the 10% threshold described in paragraph 82(a) will not be deducted from capital. Instead, these investments will be subject to the applicable risk weighting[89] 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. [Basel Framework, CAP 30.28]

84. 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 CET1). [Basel Framework, CAP 30.27]

**Significant investments[90] in the capital and/or Other TLAC Instruments of banking, financial and insurance entities[91] that are outside the scope[92] of regulatory consolidation[93] [94]**

85. 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.

[89] For Category III SMSBs, investments below the 10% threshold are included in Adjusted Total Assets in the Simplified Risk-Based Capital Ratio.

[90] 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*.

[91] See paragraph 85, bullet 8, for a notification requirement where the deduction is made at the insurance operating company level.

[92] 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.

[93] 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 RWA 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 6 of the CAR Guideline will be as outlined in that chapter.

[94] 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.

a. Investments include direct, indirect, and synthetic holdings of capital instruments or Other TLAC Instruments. Institutions should look through holdings of index securities to determine their underlying holdings in capital[95] 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.

b. An indirect holding arises when an institution invests in an unconsolidated intermediate entity that has an exposure to the capital of an unconsolidated bank, financial or insurance entity and thus gains an exposure to the capital of that entity. [Basel Framework, CAP 99.9]

c. A synthetic holding arises when an institution invests in an instrument where the value of the instrument is directly linked to the value of the capital of an unconsolidated bank, financial or insurance entity.[84] [Basel Framework, CAP 99.10]

d. 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 arm's-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.

e. 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 53 and 54. 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).[96]

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[95] 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.

[96] In the case of a cash equity position and a short position on the same underlying exposure, where both positions are in the trading book, if the institution has a contractual right/obligation to sell a long position at a specific

f. 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.

g. If the capital instrument of the entity in which the institution has invested does not meet the criteria for CET1, 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.[97] [98] [Basel Framework, CAP 30.29]

h. Institutions are required to notify OSFI, 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.

86. 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.[99] [Basel Framework, CAP 30.29 FAQ1]

87. Exposures should be valued using the equity method of accounting as defined under IFRS (i.e. initial cost of the subsidiary + retained earnings net of dividends + AOCI)[100]. 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. [Basel Framework, CAP 30.22 FAQ4]

88. Synthetic exposures should be valued as follows:

point in time and the counterparty in the contract has an obligation to purchase the long position if the bank exercises its right to sell, this point in time may be treated as the maturity of the long position. Therefore if these conditions are met, the maturity of the long position and the short position are deemed to be matched even if the maturity of the short position is within one year [Basel Framework, CAP 30.29 FAQ6].

97 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.

98 See footnote 877 for further information on the treatment of investments in financial and insurance entities not subject to Basel III eligibility criteria for capital instruments.

99 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. A federal credit union must notify OSFI in a timely manner of any changes that could impact its exposure to future capital calls as well as any decisions to participate in a capital call. Additionally, a federal credit union should obtain the prior approval of the Superintendent, as applicable, where the capital call would result in the federal credit union acquiring or increasing a substantial investment pursuant to the *Bank Act*.

100 For investments in insurance subsidiaries, CSM that have been included in the group's consolidated CET1 capital pursuant to paragraph 3 should be added to this exposure.

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.

89. 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 (i.e. investments in the Additional Tier 1 capital of other entities must be deducted from the institution's Additional Tier 1 capital).[101] All holdings of Other TLAC Instruments included above (and as defined in paragraphs 53 and 54, 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. [Basel Framework, CAP 30.30]

90. Investments included above that are common shares will be subject to the threshold deductions as described in paragraphs 92 to 94. [Basel Framework, CAP 30.31]

91. 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 CET1). [Basel Framework, CAP 30.30]

**Threshold deductions (basket)**

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

a. Significant investments in the common shares of banking, financial and insurance entities that are outside the scope of regulatory consolidation (as defined in paragraphs 85 to 90);

b. 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

c. Deferred tax assets arising from temporary differences (see paragraph 60).

a. [Basel Framework, CAP 30.32]

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

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

a. Institutions should compare each of the above items to 10% of the institution's CET1 after all deductions listed in paragraphs 56 to 91 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 CET1 capital.

c. If the amount of the aggregate of the above items not deducted from CET1 capital after the application of all regulatory adjustments exceeds 15% of the institution's CET1 after all regulatory adjustments, then a deduction of such excess from CET1 is required, subject to (d) below.

d. To determine the amount of the aggregate of the above items that is not required to be deducted from CET1, institutions should multiply the amount of CET1 (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 CET1. See Appendix 2-3 for an example of the final calculation.

e. [Basel Framework CAP, 30.33 FAQ1]

94. The amount of the above three items not deducted from CET1 capital will be risk-weighted at 250%.[102] [Basel Framework, CAP 30.34]

## 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**

95. 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. [Basel Framework, CAP 30.20]

[102] For Category III SMSBs, any amounts not deducted from CET1 capital will be included in Adjusted Total Assets under the Simplified Risk-Based Capital Ratio.

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

96. 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. [Basel Framework, CAP 30.21]

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

97. 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 78 to 84 above.[103] [Basel Framework, CAP 30.26]

**Significant investments in the capital of banking, financial and insurance entities that are outside the scope of regulatory consolidation[104] [105]**

98. 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 85 to 91 above. [Basel Framework 30.29]

**Deductions related to insufficient Tier 2 capital**

99. 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 capital.

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

100. 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

[103] See footnote 87 for further information on the treatment of investments in financial and insurance entities not subject to Basel III eligibility criteria for capital instruments.
[104] See footnote 93.
[105] See footnote 87 for further information on the treatment of investments in financial and insurance entities not subject to Basel III eligibility criteria for capital instruments.

their own Other TLAC Instruments in the calculation of their TLAC ratios.[106] [Basel Framework, CAP 30.20) ]

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

101. Reciprocal cross holdings of Tier 2 capital instruments (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 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. [Basel Framework, CAP 30.21]

**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)[107]**

102. 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 78 to 84 above. [Basel Framework, CAP 30.26]

103. 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 82(b)(iii) unless: (1) such holdings are, in aggregate and on a gross long basis, less than 5% of the institution's CET1 (after applying the regulatory adjustments listed in paragraphs 56 to 75); or (2) the holding falls within the 10% threshold provided for in paragraph 82. [Basel Framework, CAP 30.25]

104. A D-SIB or G-SIB's holdings of Other TLAC Instruments must be deducted from Tier 2 capital per subparagraph 82(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 82:

a. the holding has been designated by the D-SIB or G-SIB to be treated as market-making activities in accordance with this paragraph;

b. the holding is in the bank's trading book; and

c. 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 CET1 (after applying the regulatory adjustments

[106] 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.

[107] See footnote 87 for further information on the treatment of investments in financial and insurance entities not subject to Basel III eligibility criteria for capital instruments.

listed in paragraphs 56 to 75). Holdings in excess of 5% of the D-SIB or G-SIB's CET1 must be deducted from Tier 2 capital. [Basel Framework, CAP 30.23]

105. If a holding designated under paragraph 104 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 104, it may not subsequently be included within the 10% threshold referred to in paragraph 82. This approach is designed to limit the use of the 5% allowance in paragraph 104 to holdings of Other TLAC Instruments needed to be held within the banking system to ensure deep and liquid markets. [Basel Framework, CAP 30.24]

106. The amount of all holdings which falls below the 5% thresholds described in paragraphs 103 and 104 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. [Basel Framework, CAP 30.28]

**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[108] [109]**

107. 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 85 to 91 above. [Basel Framework, CAP 30.29]

## 2.4 Transitional arrangements for Federal Credit Unions

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

109. Beginning in the year that an institution continues as a federal credit union, outstanding capital instruments that do not qualify as CET1, 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.

[108] See footnote 90.
[109] See footnote 87 for further information on the treatment of investments in financial and insurance entities not subject to Basel III eligibility criteria for capital instruments.

110. The phase-out period will begin upon the institution's continuance as a federal credit union.[110] 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.[111]

**Transitional phase-out of outstanding non-qualifying federal credit union instruments**

| 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% |

111. This cap will be applied to non-qualifying CET1, Additional Tier 1 and Tier 2 capital separately.[112] 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.

112. 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.

113. 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.

114. 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.

[110] Year 1 refers to the four fiscal quarters commencing in the quarter in which the institution continued as a federal credit union.
[111] The level of the base is fixed on the date of continuance and does not change thereafter.
[112] Federal credit unions should consult with OSFI to determine the appropriate tier of capital in which to assign non-qualifying instruments.

115. 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.

116. 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).

## Appendix 2-1 – Illustrative example of the inclusion of capital issued by a subsidiary to third parties in consolidated regulatory capital

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 2.1.1.32.1.1.3 Common shares issued by a consolidated subsidiary to third parties (i.e. Minority interest/Non-controlling interests), 2.1.2.22.1.2.2 Additional Tier 1 qualifying capital instruments issued by a subsidiary to third parties, and 2.1.3.22.1.3.2 Tier 2-qualifying capital instruments issued by a subsidiary to third parties.

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 CET1 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**

| | **Value** |
|---|---|
| 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 CET1 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% CET1, 8.5% Tier 1 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 RWA of the subsidiary and (ii) the portion of the consolidated RWA that relates to the subsidiary multiplied by 7%, 8.5%, and 10.5% for CET1, Tier 1 and Total capital, respectively.

**Minimum plus capital conservation buffer (CCB) requirements of the subsidiary**

| | Value | Calculation |
|---|---|---|
| Total RWA of the subsidiary | 10,000 | |
| RWA of the consolidated group that relate to the subsidiary | 11,000 | |
| | | |
| Minimum CET1 requirement of the subsidiary plus CCB | 700 | = 10,000 x 7% |
| Portion of the consolidated minimum CET1 requirement plus CCB that relates to the subsidiary | 770 | = 11,000 x 7% |
| | | |
| Minimum Tier 1 requirement of the subsidiary plus the CCB | 850 | = 10,000 x 8.5% |
| Portion of the consolidated minimum Tier 1 requirement plus CCB that relates to the subsidiary | 935 | = 11,000 x 8.5% |
| | | |
| Minimum Total capital requirements of the subsidiary plus CCB | 1,050 | = 10,000 x 10.5% |
| Portion of the consolidated minimum Total capital requirement plus CCB that relates to the subsidiary | 1,155 | = 11,000 x 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**

| | Value | Calculation |
|---|---|---|
| Total CET1 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 CET1 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**

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

| | Value | Calculation |
|---|---|---|
| Amount of capital issued to third parties recognized in CET1 | 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 Capital Instruments

While not mandatory, institutions are strongly encouraged to seek confirmations of capital quality prior to issuing capital instruments.[113] Confirmation requests should be sent electronically to OSFI at confirmations@osfi-bsif.gc.ca. In conjunction with such requests, the institution is expected to provide, at a minimum, 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 capital instrument supported by relevant documents (e.g. 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. Where the instrument has NVCC features, 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[114] 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. For precedent-setting confirmations of quality of capital 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.[115] For all confirmations of quality of capital where the terms of the instrument include a tax event redemption or similar feature, an attestation from a senior officer of the institution confirming that the institution is not aware of any circumstances that would constitute grounds for a tax event at the date of issuance, including, but not limited to, any recent or proposed changes to the income tax legislation.
7. For Additional Tier 1 instruments other than preferred shares, institutions should submit an analysis which confirms that the instrument will be treated as equity under IFRS until the point of non-viability. Institutions should consult and obtain the concurrence of their external auditors in respect of their conclusions regarding the proposed treatment and disclosure of the instrument.[116]

[113] 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.

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

[115] 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.

[116] 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.

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[117] calculation should be provided, which confirms there is no step-up upon the change in interest rate. The step-up calculation should be supported by the following:
    a. Screenshots of the relevant benchmarks used for the step-up calculation should be provided.
    b. The interpolated benchmark yield should be calculated with the two closest maturities to the reset date, unless a written explanation is provided to OSFI explaining the deviation.
    c. The interpolated benchmark yield should be rounded up to the nearest hundredth for the purpose of calculating the reset spread.
9. Where the terms of the instrument provide for triggers in addition to the baseline triggers specified in *Principle # 2*, the rationale for such additional triggers and a detailed analysis of the possible market implications that might arise from the inclusion of such additional triggers or upon a breach of such triggers.
10. 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. In the case of an NVCC instrument, this assessment should take into account the principles for NVCC instruments set out in section 0 of this guideline. For greater 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 instrument are not materially altered.
11. 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.
12. In the case of an NVCC instrument, a written attestation from a senior officer of the institution confirming that the institution has taken 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 January 1, 2013, including senior debt agreements and derivative contracts. An institution issuing capital instruments to a parent is not required to submit an attestation.

**Information requirements for capital instruments issued to a parent**

13. The rationale provided by the parent for not providing common equity in lieu of the subject capital instrument.
14. A written attestation from a senior officer confirming that the rate and terms of the instrument as at the date of transaction are at least as favourable to the institution as market terms and conditions.

[117] Institutions seeking further guidance on step-up calculations should contact OSFI.

15. A written attestation confirming 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.

**Service Fees related to Capital Confirmation Requests**

Each capital confirmation request (i.e., preliminary or final) is subject to service fees. Amounts due to OSFI are based on the service fees in effect for precedent and/or non-precedent setting capital confirmation requests on the date of the request plus HST. Institutions should remit payments to OSFI promptly when they receive a capital confirmation.

## 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 CET1 capital, after the application of all deductions. To determine the maximum amount of the specified items that can be recognized,* 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% (i.e. 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 recognized 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 recognized may be lower than this maximum, either because the sum of the three specified items isbelow 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.

[Basel Framework, CAP 30.33 FAQ1]