Heenan Blaikie LLP

Financial Services & Banking

MARCH 28, 2011

OSFI Enhances Quality of Capital for Deposit Taking Institutions

In February, 2011, Canada's Office of the Superintendant of Financial Institutions ("OSFI") released concurrent draft advisories (the "Advisories") regarding capital requirements for banks, bank holding companies, and federally regulated trust and loan companies (each, a deposit-taking institution or "DTI"). The Advisories are part of OSFI's ongoing transition to meet the Basel III rules text published December 16, 2010[1] and supplemented January 13, 2011.[2]

The Advisories set out OSFI's expectations with respect to phasing out some $70 billion of bank capital that will no longer qualify as the strongest form of capital (Tier 1 capital) under new international rules.[3] Both Tier 1 and Tier 2 capital are used to determine whether a DTI meets its required capital adequacy standards under OSFI guidelines. Starting in 2013, instruments such as preferred shares, subordinated debt and hybrid bonds will be phased out of Tier 1 capital, losing 10% of their value as bank capital each year until 2023.[4]

CONTACT

Michael Davies
Partner
416 643.6807
mdavies@heenan.ca

Ilia Danef
Partner
416 643.6904
idanef@heenan.ca

Ken Kraft
Partner
416 643.6822
kkraft@heenan.ca

ENHANCING THE QUALITY OF REGULATORY CAPITAL

Following the financial crisis of 2008, many types of non-common Tier 1 and Tier 2 capital (i.e. capital other than common equity) were criticized for failing to adequately absorb losses in many foreign banks that would have failed in the absence of government support. Consistent with the Basel III rules, OSFI has now set out its expectations with respect to non-viability contingent capital ("NVCC"); this form of capital is designed to absorb losses before taxpayers where the government determines that it is in the public interest to rescue a non-viable financial institution.[5]

In order to satisfy the NVCC requirements, all non-common Tier 1 and Tier 2 capital instruments must, among other things, contain in their contractual terms and conditions, a clause requiring a full and permanent conversion into common shares upon a "trigger event." Such a trigger event must, at minimum, include the following:

- notification by OSFI that the DTI has ceased to be viable and that, after conversion of all contingent capital instruments, its viability is likely to be restored; and
- a federal or provincial government in Canada publicly announces that the DTI has accepted or agreed to accept a capital injection, or equivalent support, without which the DTI would have been determined by OSFI to be non-viable.

In addition, the conversion into common shares must be automatic and immediate. NVCC investors must also receive voting rights consistent with their resulting common equity position.[6]

The Advisories are a part of OSFI's ongoing transition to meet Basel III guidelines. OSFI is expected to provide further guidance with respect to the amount of Tier 1 and Tier 2 capital DTIs are required to keep on-hand, as well as new leverage constraints designed to supplement capital requirements. ■

---

[1] Basel III: A global regulatory framework for more resilient banks and banking system, Basel Committee on Banking Supervision ("BCBS"), December 16, 2010.
[2] BCBS press release, *Basel Committee issues final elements of the reforms to raise the quality of regulatory capital*. January 13, 2011.
[3] John Greenwood and Barbara Shecter, "Hybrid capital to be phased out gradually; OSFI decision" *The Financial Post*, February 5, 2011.
[4] OSFI Capital Advisory, "Treatment of non-qualifying capital instruments" February 5, 2011.
[5] OSFI Capital Advisory, "Non-viability contingent capital" February 5, 2011.
[6] *Ibid*.

The *Financial Services & Banking E-News Bulletin* is published by Heenan Blaikie LLP. The articles and comments contained herewith provide general information only. They should not be regarded or relied upon as legal advice or opinions. Heenan Blaikie LLP would be pleased to provide more information on matters of interest to our readers. © 2011, Heenan Blaikie LLP