Office of the Superintendent of Financial Institutions Canada
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VIA FAX: (613) 990-5591
Original to follow

June 26, 2008

Sirs,

Re: Draft Advisory; Innovative Tier 1 Instruments; June 2008

I write to urge a halt to any planned implementation of the captioned Draft Advisory.

No rationale has been advanced for the change: In order for investors – at all levels of Canadian banks' capital structures, not just those subscribing to the planned instruments – to understand the implications of changes to supervisory guidance, it is necessary that reasons for such changes be made public. This is particularly the case with respect to current investors in paper that is junior to these securities – preferred and common shares – whose rights are being affected without any indication at present of a clear and necessary public policy purpose behind their increased subordination.

No commentary has been sought: Public policy achieves clarity through discussion; there will be greater confidence by investors and the general public in the supervision of banks if there is some assurance that opposing views, which may represent opposing forces in the capital markets, have been solicited. When OSFI disagrees with the views expressed, the underlying philosophical or factual basis of such disagreement should be made plain, to ensure that expectations of capital market participants are well aligned with OSFI's intent.

As a model for a confidence-building process, I suggest the "Public Statement of Consultation Procedures" of the Committee of European Banking Supervisors ("C-EBS"), available on-line at http://www.c-ebs.org/Consultation_papers/CP01_final.htm.

At the opposite end of the spectrum, it is clear that a lack of understanding of OFSI's role in Canadian capital markets has led to some confusion as to whether any blame should be attached to the Office with respect to the collapse of the non-bank Asset Backed Commercial Paper market. It has even been suggested (Derek DeCloet, Globe and Mail, April 26, 2008) that this market debacle was, at least in part, due to a lack of understanding of capital markets by OSFI personnel. Communication of OSFI's goals and thorough explanation of the means by which it seeks to achieve those goals, is clearly lacking.

More specifically, with respect to the Draft Advisory at issue:

Cumulative Coupons are, at best, deprecated internationally for Tier 1 Capital: The "Sydney Press Release" of the Bank for International Settlements (online at http://www.bis.org/press/p981027.htm) specifically demands that Tier 1 instruments be non-cumulative. According to the C-EBS "Proposal for a common EU definition of Tier 1 hybrids" (online at http://www.c-ebs.org/Advice/documents/hybrids.pdf) 89% of Europe's innovative instruments are non-cumulative, while "The small percentage of cumulative instruments with payment in cash includes grandfathered issues of silent partnerships in Germany and a few non-innovative and innovative grandfathered instruments in Ireland and Denmark. The small percentage of cumulative instruments with payment in kind includes mostly innovative and non-innovative instruments in the United Kingdom."

Canada is a small nation and events of the past year have shown most emphatically that in times of trouble it is very helpful for banks to have access to foreign capital. While I certainly do not advocate blind adoption of regulatory standards from other countries, it is prudent to ensure that, in the case where Canada deviates from international best practices, these deviations – and the rationales supporting such deviations - are clearly communicated.

The proposal is procyclical: The cumulation of unpaid coupons as preferred shares in times of stress will create an overhang of Tier 1 instruments that may be expected to be dumped on the market at the first opportunity. If we assume that, eventually, 15% of a given bank's Tier 1 capital is comprised of instruments such as are envisaged in the Draft Advisory, and make the assumption that unpaid coupons on these instruments accrue at the rate of 6.67% p.a., we arrive at an overhang that will accumulate at the rate of 1% of Tier 1 Capital p.a. This approximates the size of a new issue of preferred shares; many new holders – particularly non-taxable holders, without an investment management mandate to hold preferred shares – will simply sell at whatever price they can get at the first opportunity. This effect and, more insidiously, fear of this effect will make it more difficult for the bank experiencing difficulties to issue preferred stock – and events of the past year have shown that preferred stock can be a very efficient medium for raising capital in times of stress. Thus the Draft Advisory can be viewed as being somewhat pro-cyclical, a tendency in bank regulation that has attracted critical comment in the past year (for example: Willem Buiter, *Lessons from the North Atlantic financial crisis*, online at http://www.nber.org/~wbuiter/NAcrisis.pdf).

The proposal is unnecessary: It appears that the Draft Advisory has the intent of re-starting the new issue market for Loan-Based Innovative Tier 1 Capital Instruments, which was brought to a halt by the October 31, 2006, announcement and subsequent enactment of legislation targeted at the Canadian market for "Specified Investment Flow-Throughs" – although, in the absence of a rationale formally stated by OSFI, assessment of intent is mere speculation. It is not necessary to make changes to the regulation to allow the issuance of Innovative Tier 1 Capital, since the Asset-Backed avenue for such issuance is still viable, as has been shown by the recent issuance of “RBC TruCS - Series 2008-1” and announcement of “NBC CapS II – Series 2”.

There is no discouragement of “Step-Ups”: Step-ups represent a grossly pro-cyclical element of international bank regulation and issuers should be discouraged from exposing themselves to the risks therein. If the step-up date should occur in a time of stress, the issuing bank, if unable to issue replacement instruments (or to obtain supervisory permission for the recapitalization) will be exposed simultaneously to disparagement by investors (who trade these instruments with the assumption that they will be called) and to costs that will presumably increase. And yet instruments with step-ups are regarded as 100% tier 1 capital, regardless of how close the step-up date is. Any proposal to alter the investment characteristics of Innovative Tier 1 Capital should address this issue by amortizing the qualification of these instruments to a maximum 50% inclusion in Tier 1 at the time of the step up.

Thus, it may be seen that the draft advisory represents the promulgation of flawed regulation through a flawed process. I strongly urge OSFI to

- prepare a formalized consultative process, with specific input sought from large buy-side investment management firms.
- Commence this process with a clear statement of both the draft advisory itself and discussion of why OSFI believes such instruments to be a prudent addition to the regulation of banks in Canada
- Draw clear comparisons between the elements of the Draft Advisory and international practice, on a “comply or explain” basis
- Make public the statements received via publication on the OSFI website in a convenient, searchable, linkable manner
- Make changes to the draft advisory in response to valid criticism of the proposal
- Respond to criticism of the proposal deemed invalid with the objective of assisting market participants to understand the factual and philosophical elements of the decision, again publicly.

In such a manner OSFI will be able to retain the confidence of both buy-side investment professionals and the general public, in addition to strengthening the regulatory process through adversarial discussion that reflects the adversarial nature of the capital markets.

Sincerely,
HYMAS INVESTMENT MANAGEMENT INC.

James Hymas
President