Deemed Retractibles

On February 4, 2011, OSFI released two documents outlining the Canadian implementation of the new international banking standards for non-common equity components of Tier 1 Capital.[1]

The first introduced a new acronym: NVCC, which has the same meaning as the title of the Draft Advisory: *Non-Viability Contingent Capital*.[2] This draft advisory has now been adopted[3] and sets the new requirements for Canadian recognition of Tier 1 Capital such that if a regulated issuer is deemed "Non-Viable" by OSFI, then there must be provisions in the prospectus requiring the immediate conversion of the issue into common shares.

The second, an Advisory titled *Treatment of non-qualifying capital instruments*,[4] described the gradual phase-out of non-qualifying instruments over a ten year period commencing 2013-1-1 as envisaged internationally.[5] The critical detail was: *Capital instruments issued before January 1, 2013 that meet the Basel III criteria for regulatory capital, except that they do not meet the NVCC requirements, will be considered non-qualifying capital instruments and subject to the phase-out described in this Advisory.*

To the surprise of many, there were no exceptions: extant preferred shares that had been included in Tier 1 capital did not meet the NVCC requirement, were not be grandfathered and therefore are subject to the ten year phase-out.

A slight exception to this rule came to light on 2011-5-26, when CIBC announced[6] that OSFI had agreed that its three series of Straight Perpetuals for which the bank had the option to force conversion into common could meet the NVCC requirement given the satisfaction of some conditions, none of which required shareholder consent. This change became official on 2011-8-17.[7]

Although the OSFI announcements are directed only at banks, HIMI considers it highly probable that they will be applied to insurers and insurance holding companies in due course, due to the widely recognized[8] tendency towards harmonization of the capital requirements wherever possible. A broad hint to this effect was included with OSFI's implementation of the NVCC rules[9] that *This Advisory does not apply to regulated life insurance companies, insurance holding companies, federally regulated property and casualty insurance companies or cooperative credit associations. OSFI will, after consultation, determine how and to what extent the Basel III rule changes will be applied to these federally regulated institutions and additional guidance will be released in due course*.

Public Company Reaction

Further support for this analysis came from MFC[12] and SLF[11] in May 2012. Manulife stated: *The Office of the Superintendent of Financial Institutions ("OSFI") continues to consider updates to its regulatory guidance for non-operating insurance companies acting as holding companies, such as MFC, and to its methodology for evaluating stand-alone capital adequacy for Canadian operating life insurance companies, such as MLI. OSFI has indicated that MCCSR and internal target capital ratio guidelines, which have not yet been determined, are expected to become applicable to MFC by 2016.* This warning was repeated in the 2012 Annual Report;[12] in the 2013 Annual Report[13] this became slightly more specific: *The Office of the Superintendent of Financial Institutions ("OSFI") has been considering a number of changes, including establishing methodologies for evaluating standalone capital adequacy for Canadian operating life insurance companies, such as MLI, and updates to its regulatory guidance and disclosures for non-operating insurance companies acting as holding companies, such as MFC. OSFI has indicated that MCCSR and internal target capital ratio guidelines are expected to become applicable to MFC effective January 1, 2016. In addition, OSFI is evaluating a possible overhaul of the regulatory capital framework*

1 Bank for International Settlements, *Final elements of the reforms to raise the quality of regulatory capital issued by the Basel Committee*, Press Release, 2011-1-13, available on-line at http://www.bis.org/press/p110113.htm (accessed 2011-5-15)

2 Office of the Superintendent of Financial Institutions, *Non-Viability Contingent Capital*, Draft Advisory, February 2011, no longer available on-line

3 Office of the Superintendent of Financial Institutions, *Non-Viability Contingent Capital*, Advisory, August 2011, available on-line at http://www.osfi-bsif.gc.ca/app/DocRepository/1/eng/guidelines/capital/advisories/nvcc_e.pdf (accessed 2011-10-14)

4 Office of the Superintendent of Financial Institutions, *Treatment of non-qualifying capital instruments*, Advisory, February 2011, available on-line at http://www.osfi-bsif.gc.ca/app/DocRepository/1/eng/guidelines/capital/advisories/nqcibIII_e.pdf (accessed 2011-3-12)

5 Bank for International Settlements, *Basel Committee issues final elements of the reforms to raise the quality of regulatory capital*, Press Release, 2011-1-13, available on-line at http://www.bis.org/press/p110113.pdf (accessed 2011-3-12)

6 Canadian Imperial Bank of Commerce, *CIBC announces intention to seek non-viability contingent capital treatment for its Class A preferred shares, Series 26, 27 and 29*, Press release, 2011-5-26, available on-line at http://micro.newswire.ca/release.cgi?rkey=1905267134&view=16497-0&Start= (accessed 2011-6-11)

7 Canadian Imperial Bank of Commerce, *CIBC announces it has received confirmation of non-viability contingent capital treatment for its Class A preferred shares, Series 26, 27 and 29*, Press Release, 2011-8-17, available on-line at http://micro.newswire.ca/release.cgi?rkey=1908173569&view=14730-0&Start=0&htm=0 (accessed 2011-11-11)

8 E.g. Sun Life Financial alluded to this in *Management's Discussion and Analysis in the Annual Report for 2010*, available on-line at http://cdn.sunlife.com/static/global/files/Year%20end%20reports/pa_e_Q410_2010_MDA.pdf (accessed 2011-3-13): *In addition, it is expected that OSFI may align some insurance regulations with those that emerge for banks under the proposed new Basel Capital Accord.*

9 Office of the Superintendent of Financial Institutions, *Treatment of non-qualifying capital instruments*, Advisory, February 2011, available on-line at http://www.osfi-bsif.gc.ca/app/DocRepository/1/eng/guidelines/capital/advisories/nqcibIII_e.pdf (accessed 2011-11-11)

10 Manulife Financial Corporation, *Manulife Financial reports 1Q12 income of $1.2 billion and 35 per cent growth in insurance sales, including all-time record in Asia*, Press Release, 2012-5-3, available on-line at http://www.manulife.com/public/files/201/1/MFC_1Q12_PR.pdf (accessed 2012-7-14)

11 Sun Life Financial Corporation, *Sun Life Financial Reports First Quarter 2012 Results*, Press Release, 2012-5-10, available on-line at http://cdn.sunlife.com/static/global/files/News%20Releases%202012%20PDFs/pa_e_Q112_earnings_release.pdf (accessed 2012-7-14)

12 Manulife Financial Corporation, *Annual Report 2012*, available on-line at http://manulife.com/public/files/202/1/mfc_annualreport2012.pdf (accessed 2013-6-22)

13 Manulife Financial Corporation, *Annual Report 2013*, available on-line at http://manulife.com/public/files/202/1/mfc_annualreport2013.pdf (accessed 2014-04-13)

in Canada intended for implementation in 2018. This notice was essentially repeated in the 2014 Annual Report,[14] with the change that the project is *intended to be finalized in 2016 with implementation in 2019*. In 2015, Manulife reported:[15] *The 2016 MCCSR guideline, which took effect on January 1, 2016, does not contain changes that would have material negative implications for our regulatory capital ratio. OSFI will be implementing a revised approach to the regulatory capital framework in Canada, excluding required capital for segregated fund guarantees, in 2018. OSFI has stated they believe, in aggregate, that the Canadian life insurance industry has adequate financial resources (total assets) for its current risks.*

I will also note that GWO commented in their 13Q2 Report[16] (emphasis added): *OSFI has commenced work on a number of initiatives that either will have or may have application to the calculation and reporting of the MCCSR of the Company or certain of its subsidiaries. These initiatives are discussed in the 2012 OSFI Life Insurance Regulatory Framework. Within the Framework, there are three broad categories specific to regulatory capital amounts: the review of methodology used to determine capital requirements in connection with segregated fund guarantees;* ***the review of the qualifying criteria and capital components of Available Capital*** *and the new regime for calculating capital requirements relating to credit, market, insurance and operation risk*. The last, critical, sentence was repeated in the 2013 Annual Report,[17] and the 14Q1,[18] 14Q2,[19] 14Q3,[20] 14Q4,[21] 15Q1,[22] 15Q2,[23] 15Q3[24] and 2014[25] and 2015[26] Annual reports.

More vigorous regulation of insurance holding companies has been foreshadowed by the US Treasury[27] and remarks by Julie Dickson[28] and Mark Carney;[29] and heavy hints have been dropped by the Financial Stability Oversight Council.[30] These hints were given strength by the December, 2013, release of a US Treasury report advocating group capital standards and increased federal involvement in US insurance regulation.[31] There is also a newly important international group, the International Association of Insurance Supervisors, which is seeking to evade public scrutiny by eliminating "Observer Status" for interested parties wishing to attend meetings[32] (see the section *Deliberations of the International Association of Insurance Supervisors (IAIS)*, below).

In what I view as the first step towards imposing capital requirements on holding companies, OSFI has decreed that MCCSR disclosures at the holding company level become mandatory (see the section *Revisions to 2016 MCCSR Requirements*, below).

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14 Manulife Financial Corporation, *2014 Annual Report*, available on-line at http://manulife.com/public/files/202/1/mfc_annualreport2014.pdf

15 Manulife Financial Corporation, *2015 Annual Report*, available on-line at http://www.manulife.com/public/files/202/1/mfc_annualreport2015.pdf (accessed 2016-7-10)

16 http://www.greatwestlifeco.com/web5/groups/common/@public/documents/web_content/s7_031108.pdf

17 Great West Lifeco, *Management's Discussion and Analysis for the year 2013*, available on-line at http://www.greatwestlifeco.com/web5/groups/common/@public/documents/web_content/s7_032335.pdf (accessed 2014-2-15)

18 Great West Lifeco, *Quarterly Report to Shareholders, First Quarter Results, For the period ended March 31, 2014*, available on-line at http://www.greatwestlifeco.com/web5/groups/common/@public/documents/web_content/s7_032794.pdf (accessed 2014-7-13)

19 Great West Lifeco, *Quarterly Report to Shareholders, Second Quarter Results, For the period ended June 30, 2014*, available on-line at http://www.greatwestlifeco.com/web5/groups/common/@public/documents/web_content/s7_033494.pdf (accessed 2014-8-10)

20 Great West Lifeco, *Quarterly Report to Shareholders, Third Quarter Results, For the period ended September 30, 2014*, available on-line at http://www.greatwestlifeco.com/web5/groups/common/@public/documents/web_content/s7_034325.pdf (accessed 2014-11-16)

21 Great West Lifeco, *Management's Discussion and Analysis For the year 2014*, available on-line at http://www.greatwestlifeco.com/web5/groups/common/@public/documents/web_content/s7_034851.pdf (accessed 2014-3-15)

22 Great West Lifeco, *Quarterly Report to Shareholders, First Quarter Results, For the period ended March 31, 2015*, available on-line at http://www.greatwestlifeco.com/web5/groups/common/@public/documents/web_content/s7_035083.pdf (accessed 2015-5-10)

23 Great West Lifeco, *Quarterly Report to Shareholders, Second Quarter Results, For the period ended June 30, 2015*, available on-line at http://www.greatwestlifeco.com/web5/groups/common/@public/documents/web_content/s7_035268.pdf

24 Great West Lifeco, *Quarterly Report to Shareholders, Third Quarter Results For the period ended September 30, 2015*, available on-line at http://www.greatwestlifeco.com/web5/groups/common/@public/documents/web_content/s7_035526.pdf (accessed 2015-11-15)

25 Great West Lifeco, *2014 Annual Report*, available on-line at http://www.greatwestlifeco.com/web5/groups/common/@public/documents/web_content/s7_034964.pdf (accessed 2014-4-12)

26 Great West Lifeco, *2015 Annual Report*, available on-line at http://www.greatwestlifeco.com/web5/groups/common/@public/documents/web_content/s7_035776.pdf (accessed 2016-4-11)

27 United States Treasury, *Principles for Reforming the U.S. and International Regulatory Capital Framework for Banking Firms*, Press Release, 2009-9-3, available on-line at http://www.treasury.gov/press-center/press-releases/Documents/capital-statement_090309.pdf (accessed 2012-7-14)

28 Office of the Superintendent of Financial Institutions Canada, *Remarks by Superintendent Julie Dickson, Office of the Superintendent of Financial Institutions Canada (OSFI) to the 2009 Life Insurance Forum*, Prepared Remarks, 2009-11-12, available on-line at http://www.osfi-bsif.gc.ca/app/DocRepository/1/eng/speeches/JDickson_09_Life_e.pdf (accessed 2012-7-14)

29 Eric Reguly and Jeremy Torobin, *Carney to forge ahead without Hildebrand at FSB*, Globe and Mail 2012-1-10, available on-line at http://www.theglobeandmail.com/report-on-business/international-business/european-business/carney-to-forge-ahead-without-hildebrand-at-fsb/article1357916/ (accessed 2012-7-14)

30 MFC Annual Report, 2012, supra

31 Federal Insurance Office, *U.S. Department of the Treasury, How to Modernize and Improve the System of Insurance Regulation in the United States*, December, 2013, available on-line at http://www.treasury.gov/initiatives/fio/reports-and-notices/Documents/How%20to%20Modernize%20and%20Improve%20the%20System%20of%20Insurance%20Regulation%20in%20the%20United%20States.pdf (accessed 2014-4-13)

32 Office of the Superintendent of Financial Institutions, *Remarks by Jeremy Rudin, Superintendent, to the Life Insurance Invitational Forum, Cambridge, Ontario, November 13, 2014*, Speech, available on-line at http://www.osfi-bsif.gc.ca/Eng/osfi-bsif/med/sp-ds/Pages/jr20141113.aspx (accessed 2014-11-16)

OSFI's Life Insurance Regulatory Framework

The public company disclosures were given some added weight in September, 2012, by the OSFI announcement[33] of the Life Insurance Regulatory Framework,[34] which seeks to *help industry stakeholders understand OSFI's perspective, thereby allowing for a deeper and more meaningful discussion and participation in the policy development process*.

There are very few specifics in the paper that can be said to have a direct bearing on the issue of whether the banks' NVCC rules will be applied to insurers. A possible hint is provided by the paragraph *The review of the definition of capital component is necessary to incorporate lessons learned during the recent financial crisis. These relate to the quality of certain capital instruments during periods of stress, the appropriateness of deductions and adjustments made to regulatory capital. The review provides an opportunity to consider each available capital element and assess its contribution to two goals: financial strength and protection of policyholders and creditors*. This could be taken as echoing the rationale for the banks' NVCC rule under Basel 3[35]: *During the financial crisis a number of distressed banks were rescued by the public sector injecting funds in the form of common equity and other forms of Tier 1 capital. While this had the effect of supporting depositors it also meant that Tier 2 capital instruments (mainly subordinated debt), and in some cases Tier 1 instruments, did not absorb losses incurred by certain large internationally-active banks that would have failed had the public sector not provided support.*

OSFI continues its discussion of capital with *OSFI believes going concern capital (tier 1) should be largely comprised of equity (common and perpetual preferred shares)*. These items taken together lead me to believe that my assumption of NVCC harmonization in the future is supported by the document – but there are no guarantees! OSFI stated at the time that they planned *to issue a draft Definition of Capital paper for public consultation in late 2012 or early 2013*, and I had high hopes that this draft would provide some clarity. The timeline provided for Definition of Capital was:

- Project Initiation: 2011Q1
- Quantitative Impact Study (QIS): 2013Q3
- Public Consultation: 2013Q4
- Final Guideline issued: 2014
- Implementation Milestone: 2015

Delays

However, once the first quarter of 2013 had ended with no sign of the Draft Definition of Capital, I sent an inquiry to OSFI: *I am unable to find such a document on your website. If it has been published, can you tell me where it may be found? If it has not been published, can you give me an indication of the currently planned release date?*

A spokesman for OSFI responded: *After reviewing the QIS processes mentioned in the Framework, OSFI determined that some of the information required to accurately refine the definition of capital could potentially be used by stakeholders to engage in premature or erroneous speculation into how the future framework might affect the reported capital position of various insurance companies. Thus, OSFI decided that it would be more prudent to conduct a private, directed consultation with federally-regulated life insurance companies to proceed with this work. Once we have completed our work on designing and calibrating the new framework, there will be a public consultation.*

Well, speculation is the natural state of any financial marketplace. Stakeholders will continue to engage in uninformed premature and erroneous speculation, rather than informed premature and erroneous speculation, but nothing can be done to change the situation at this point.

Even More Delays

In November, 2013, OSFI announced yet another delay, this time for two years:[36] *The timelines set in the September 2012 Life Insurance Regulatory Framework to implement the various regulatory capital initiatives allowed for developing the proposed changes, implementing them, and transitioning to the new regulatory capital regime.*

After further review, the milestone for finalizing the life insurance capital framework has been shifted to 2016 with implementation now targeted for 2018 (see Annex A).

The revised timeline is needed to provide OSFI more time to develop, refine and calibrate the capital framework components, while continuing consultations with industry stakeholders through the Quantitative Impact Studies process. The new dates also give OSFI and insurers more time to prepare and make changes to their information systems, and take account of the impact of the upcoming changes to domestic actuarial and international accounting standards on the regulatory capital framework.

[33] Office of the Superintendent of Financial Institutions, *OSFI releases Life Insurance Regulatory Framework*, Press Release, 2012-9-5, available on-line at http://www.osfi-bsif.gc.ca/app/DocRepository/1/eng/media/LIRF_nr_e.pdf

[34] Office of the Superintendent of Financial Institutions, *Life Insurance Regulatory Framework*, September 2012, available on-line at http://www.osfi-bsif.gc.ca/app/DocRepository/1/eng/guidelines/LIRF_e.pdf

[35] Bank for International Settlements, *Final elements of the reforms to raise the quality of regulatory capital issued by the Basel Committee*, Press Release, 2011-1-13, available on-line at http://www.bis.org/press/p110113.htm (accessed 2011-5-15)

[36] Office of the Superintendent of Financial Institutions, *A Year in Review: Update to the Life Insurance Regulatory Framework*, Notice, 2013-11-12, available on-line at http://www.osfi-bsif.gc.ca/Eng/fi-if/ic-sa/lf-sav/Pages/lirf-updmj.aspx (accessed 2013-12-14)

OSFI is satisfied that the additional time will not pose undue risks to the life insurance industry. The financial crisis demonstrated that the current regulatory capital framework continues to be robust and broadly reflects the financial condition of Canada's life insurers. OSFI continues to believe that, in aggregate, the industry currently has adequate financial resources (total assets) for its current risk. However, the updated framework should result in a better alignment of financial resources to the underlying risks.

On January 5, 2015, OSFI released a paper titled Life Insurance Capital Framework: Standard Approach[37] but *The available capital and segregated fund guarantee components of the new framework were not tested in QIS6 and are not in the scope of this paper.*

Guess What?

As briefly noted above, Manulife stated in the 2014 Annual Report,[38] that the *refresh of the regulatory capital framework in Canada intended to be finalized in 2016 with implementation in 2019*, so we may have to keep waiting for a shred of regulatory certainty.

However, in a recent speech,[39] OSFI Assistant Superintendent Neville Henderson stated *we are still on track to implement OSFI's new life insurance regulatory capital framework in 2018*.

Revisions to 2016 MCCSR Requirements

As noted by MFC in its 15Q2 Shareholders' Report,[40] *OSFI recently issued the 2016 MCCSR guidelines for public comment. The guidelines include the requirement to disclose the MCCSR ratio for MFC and other federally regulated holding companies*. This statement was repeated in the 15Q3 Report.[41]

OSFI's release[42] includes a Draft Guideline,[43] and Impact Statement;[44] the latter document includes the notes *The financial strength of regulated insurance holding companies and non-operating insurance companies (referred to as holding companies), is closely tied to their regulated subsidiaries/ life operating companies. OSFI recognizes the importance of capital requirements for holding companies and is updating its guidance to align them with those of Canadian operating life companies…. As a result, all life insurance companies, including holding companies and non-operating life insurance companies, will be required to prepare and file audited MCCSR returns, to disclose (in the notes to their financial statements) their MCCSR ratios and to establish internal capital targets through their Own Risk and Solvency Assessment*.

The impact analysis statement for the final guideline[45] included the statement: *Effective January 1, 2016, all federally regulated life insurance companies, including holding companies and non-operating life insurance companies, will be required to prepare and file audited MCCSR returns, disclose (in the notes to their financial statements) their MCCSR ratios and establish internal capital targets through their Own Risk and Solvency Assessment*.

I suspect that this requirement for disclosure is the first step towards imposing required levels of the MCCSR at the holding company level.

Finally, A Small Step Forward

On March 31, 2016, OSFI released a draft new life insurance capital adequacy guideline for public consultation.[46]

The bulk of the Draft Guideline[47] deals with risk assessment of various life insurance company assets, such as Credit Risk, Market Risk, Insurance Risk, etc., and there are no changes immediately proposed to the Tier 1 status of preferred shares. However, the heading to section 2.1.1.2, *Qualifying Criteria for Tier 1 Capital Instruments Other than Common Shares*, comes with a footnote: *OSFI continues to explore the applicability of non-viability contingent capital (NVCC) to insurers. In the event insurers become subject to this requirement, the qualifying criteria for Tier 1 capital instruments, other than common shares, and Tier 2 capital instruments will be revised accordingly and further transitioning arrangements may be established for non-qualifying instruments*. This footnote is repeated in its entirety in a footnote to the heading of section 2.2.1.1, *Qualifying Criteria for Tier 2 Capital Instruments*.

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37 OSFI, *Life Insurance Capital Framework: Standard Approach*, OSFI, 2015, available on-line at http://www.osfi-bsif.gc.ca/Eng/Docs/LISFSA.pdf (accessed 2015-1-11)

38 Manulife Financial Corporation, *2014 Annual Report*, available on-line at http://manulife.com/public/files/202/1/mfc_annualreport2014.pdf

39 Neville Henderson, *Remarks by Assistant Superintendent Neville Henderson to the 2015 Life Insurance Invitational Forum, Cambridge, Ontario, December 1, 2015*, Speech, 2015-12-1, OSFI, available on-line at http://www.osfi-bsif.gc.ca/Eng/osfi-bsif/med/sp-ds/Pages/nh20151201.aspx (accessed 2015-12-13)

40 Manulife Financial Corporation, *Second Quarter Report, Six months ended June 30, 2015*, available on-line at http://www.manulife.com/public/files/202/1/MFC_2Q15_SR.pdf (accessed 2015-8-16)

41 Manulife Financial Corporation, *Third Quarter Report, Nine months ended September 30, 2015*, available on-line at http://www.manulife.com/public/files/202/1/MFC_3Q15_SR.pdf (accessed 2015-9-30)

42 Office of the Superintendent of Financial Institutions, *MCCSR Guideline – Proposed Revisions for 2016*, Letter, 2015-7-30, available on-line at http://www.osfi-bsif.gc.ca/eng/fi-if/rg-ro/gdn-ort/gl-ld/Pages/mccsr2016_let.aspx (accessed 2015-8-16)

43 Office of the Superintendent of Financial Institutions, *Draft Guideline, Minimum Continuing Capital and Surplus Requirements*, Issued July 2015, available on-line at http://www.osfi-bsif.gc.ca/Eng/Docs/MCCSR2016.pdf (accessed 2015-8-16)

44 Office of the Superintendent of Financial Institutions, *Guideline Impact Analysis Statement: [Draft] Minimum Continuing Capital and Surplus Requirements*, July 2015, available on-line at http://www.osfi-bsif.gc.ca/Eng/Docs/mccsr2016_gias.pdf (accessed 2015-8-16)

45 Office of the Superintendent of Financial Institutions, *Minimum Continuing Capital and Surplus Requirements, Guideline Impact Analysis Statement*, November, 2015, available on-line at http://www.osfi-bsif.gc.ca/Eng/fi-if/rg-ro/gdn-ort/gl-ld/Pages/MCCSR2016_GIAS.aspx (accessed 2016-2-14)

46 Office of the Superintendent of Financial Institutions, *OSFI releases for public consultation a draft new life insurance capital adequacy guideline*, Press Release, 2016-3-31, available on-line at http://www.osfi-bsif.gc.ca/Eng/Docs/LICAT_nr20160331.pdf (accessed 2016-4-11)

47 Office of the Superintendent of Financial Institutions, *Draft Guideline: Life Insurance Capital Adequacy Test*, March, 2016, available on-line at http://www.osfi-bsif.gc.ca/Eng/Docs/LICAT.pdf (accessed 2016-4-11)

This is, at least, an acknowledgement that a final decision has not yet been made. It is my belief that OSFI will adopt whatever emerges from the deliberations of the International Association of Insurance Supervisors, which are discussed in the next section.

Deliberations of the International Association of Insurance Supervisors (IAIS)

OSFI is a member of the IAIS and is participating in its discussion of a *plan to develop a risk-based global insurance capital standard (ICS) by 2016. This was in response to the FSB's request that the IAIS produce a work plan to create "a comprehensive group-wide supervisory and regulatory framework for Internationally Active Insurance Groups."1 In its statement of 18 July 2013 the FSB stated that "a sound capital and supervisory framework for the insurance sector more broadly is essential for supporting financial stability." The FSB has further reinforced its support for the development of the ICS in its statement of 6 November 2014*.[48]

At present, the IAIS definitions resemble the old bank rules, in that "Core Capital" includes non-cumulative perpetual preferred shares (up to a limit) without requiring a write-down or conversion mechanism,[49] but the intention is to replace this standard with ICS.

Debevoise & Plimpton, an internationally active law firm based primarily in New York, notes[50] *the ICS consultation contemplates requiring a principal loss absorbency mechanism that would "provide a means for [Tier 1] instruments to absorb losses on a going-concern basis through reductions in the principal amount in addition to cancellation of distributions." The ICS consultation contemplates limiting the proportion of Tier 1 capital that may be comprised of certain types of Tier 1 capital instruments*.

Other characteristics of potential Tier 1 capital, specified in paragraph 91 of the consultation paper, are familiar from bank definitions, but it is paragraph 92 in which the explicit mention of loss-absorbing capacity beyond mere suspension of distributions is made. Paragraph 92 leads to Question 25 of the consultation: *Should Tier 1 instruments for which there is a limit be required to include a principal loss absorbency mechanism that absorbs losses on a going-concern basis by means of the principal amount in addition to actions with respect to distributions (e.g. coupon cancellation)? If so, how would such a mechanism operate in practice and at what point should such a mechanism be triggered?*

I believe this question relates to an implicit assumption that loss absorbency will be 'high-trigger' rather than the 'low-trigger' threshold defined by the NVCC rules.

The Joint IIF (International Institute of Finance)/Geneva Association (GA) ICS Task Force submitted a response[51] that I admit I found rather cryptic: *The required inclusion of bail-inable instruments in Tier 1 capital should not be an issue with respect to the ICS*.

Other responses of interest regarding the critical Question 25 (regarding loss absorption by principal amounts in addition to that provided by distribution suspension) were received from: Aegon NV *"We can support the requirement for a principal loss absorbency mechanism"*; confusing responses from AIA Group and the American Academy of Actuaries; unequivocal support from the Association of British Insurers, *"Any loss absorbency mechanism should include temporary write down, permanent write down and conversion into ordinary shares"*; opposition from Quebec's Autorite des marches financiers, *"No"*; support from the Bundesanstalt für Finanzdienstleistungsaufsicht, *"we think that Tier 1 instruments for which there is a limit should be required to include a principal loss absorbency mechanism, ensuring that losses are absorbed on a going concern basis."*; a rejection of any global standard by the China Insurance Regulatory Commission; opposition from the Canadian Life and Health Insurance Association, *"We suggest the IAIS clarify the intent of the Question, the principal loss absorbency mechanism, to make it clear there is not the expectation of a requirement in capital instruments to require conversion to common equity"*; a request for clarification of 'going concern' from CNA (I'm not sure who they are); a request for further testing from the European Insurance and Occupational Pensions Authority; a plea for compatibility with Solvency II (see below) from EY (Ernst & Young?); support from the General Insurance Association of Japan and from the Institute of International Finance; a confusing response from Insurance Europe; opposition from Liberty Mutual Insurance Group; opposition from MassMutual Financial Group; support from the Monetary Authority of Singapore; opposition from Canada's OSFI, *"OSFI does not support the inclusion of a principal loss absorbency mechanism on Tier 1 instruments for which there is a limit. Tier 1 instruments must be able to absorb losses on a going concern basis, which these instruments do through coupon cancellation."*; technical quibbles from the Swiss Reinsurance Company, *"Principal loss absorbency mechanism only provides a benefit in terms of accounting and legal solvency. Tier 1 instruments with a limit should include a principal loss absorbency mechanism only if they are accounted as liability."*; and a confusing response that I interpret as opposition from The Life Insurance Association of Japan, *"The clause that allows reductions in the principle amount should not be compulsory because going concern capital without such clause is feasible by designing appropriately so that no refunds are required when loss occurs."*.

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[48] International Association of Insurance Supervisors, *Risk-based Global Insurance Capital Standard*, Public Consultation Document, 2014-12-17, available on-line at https://actuary-pl.s3.amazonaws.com/Risk-based_Global_Insurance_Capital_Standard_Consultation_Document.pdf1.pdf?AWSAccessKeyId=AKIAIOW3KDG2CZARXGMA&Expires=1431248572&Signature=13ZgtkL%2Ber7DN%2B%2Fcav0rJ26N%2BEo%3D (accessed 2015-5-10)

[49] IAIS, *Basic Capital Requirements for Global Systemically Important Insurers*, 2014-10-23, available on-line via http://www.financialstabilityboard.org/2014/10/basic-capital-requirements-for-systemically-important-insurers/ (accessed 2015-10-12)

[50] Debevoise & Plimpton, *IAIS Issues Consultation on Global Insurance Capital*, Client Update, 2015-1-9, available on-line at http://www.debevoise.com/~/media/files/insights/publications/2015/01/iais%20ics%20issues%20consultation%20on%20global%20insurance.pdf (accessed 2015-5-10)

[51] International Institute of Finance, *Joint IIF/GA Response to the IAIS ICS Consultation*, Press Release, 2015-2-16, available on-line at https://www.iif.com/publication/regulatory-comment-letter/joint-iifga-response-iais-ics-consultation (accessed 2015-5-10)

[52] IAIS, *Public Consultation on the Risk-based Global Insurance Capital Standard (ICS) 17 December 2014 to 16 February 2015 Compilation of Responses*, available on-line via http://iaisweb.org/index.cfm?event=getPage&nodeId=56993 (accessed 2015-10-12)

The opposition to principal write-down from OSFI is somewhat alarming, but negotiations continue and they are in a minority among the members – even when Quebec's vote is counted separately!

The comments were summarized[53] by the IAIS as: *BAFIN, MAS and two other Members support the requirement of a principal loss absorbency mechanism. AMF, CIRC* [China Insurance Regulatory Commission] *and OSFI do not support the requirement of a principal loss absorbency mechanism. EIOPA and four other Members commented that the impact should be assessed through field testing before a decision is made. All but one stakeholder commented that a principal loss absorbency mechanism should not be required. One stakeholder suggested that it should only apply to Tier 1 instruments that are classified as a liability on the balance sheet.*

A "Member" is[54] *an insurance industry supervisor who exercises its function within its Jurisdiction, as long as such supervisor or regulator does not actively underwrite, sell, or otherwise provide insurance;* "Stakeholder" is a term used in the by-laws but is not defined therein. According to their "Policy for Consultation of Stakeholders",[55] *stakeholders shall include all groups and individuals who have an interest in insurance supervision and regulation or who are affected by the activities of the IAIS and shall be interpreted as broadly as possible.*

The IAIS response to the comments is: *The IAIS continues to explore the appropriateness of a principal loss absorbency mechanism for Tier 1 instruments for which there is a limit.*

It is the ICS that is important because the ICS is intended to replace the BCR when the ICS becomes effective. The timeframe for production of these standards is:[56]

November 2015	IAIS General Meeting expected to formally adopt HLA G20 Leaders expected to endorse HLA
Mid-2016	Publication of 2nd ICS Consultation Document and ComFrame Consultation
Mid-2017	Approval of ICS Version 1.0 for confidential reporting
Mid-2018	Publication of ICS Version 2.0 and ComFrame Consultation
IAIS 2019 General Meeting	Adoption of ComFrame, including ICS Version 2.0

In light of all the delays, it is worth noting that in a December 2015 speech,[57] Assistant Superintendent Neville Henderson stated *we don't expect ICS 1.0 to be as sophisticated as our current Minimum Continuing Capital and Surplus Requirements (MCCSR) capital test. Consequently, we do not foresee a need to implement any significant changes. The significant changes will likely come as ICS 2.0 is finalized. It may bring sufficient worldwide convergence for OSFI to start thinking about implementation.*

More Deliberations of the International Association of Insurance Supervisors (IAIS)

As noted above, the 2nd ICS Consultation Document was scheduled for publication in mid-2016; the IAIS Newsletter for June 2016 had this to say:[58] *The CSFWG* [Capital, Solvency and Field Testing Working Group] *met in Ottawa the week of 24- 27 May and focussed on the development of the 2016 ICS Consultation Document. This is scheduled for release for public consultation in mid-July following completion of the due governance and approval process, commencing at the June IAIS committee meetings occurring in Budapest. This ICS consultation will have a three-month consultation period reflecting its size and complexity and the likelihood of many stakeholders having some vacation time over the Northern Hemisphere Summer. At the same time, the ICS Consultation Document is published, the IAIS intends to publish the field testing package for all stakeholders.*

On July 19, 2016, the IAIS published the Risk-based Global Insurance Capital Standard Version 1.0 Public Consultation Document[59] which had the following to say about a Principal Loss Absorbency Mechanism:

> *248. Some jurisdictions require certain financial instruments to contain a principal loss absorbency mechanism. Such mechanisms provide a means for such instruments to absorb losses on a going-concern basis through reductions in the principal amount in addition to the cancellation of distributions.*
>
> *249. The IAIS may consider that a principal loss absorbency mechanism is required for Tier 1 Limited financial instruments to qualify as capital resources. Without such mechanisms these instruments could be considered to only provide going concern loss absorbency through cancellation of distributions.*

53 IAIS, *IAIS Responses to ICS Consultation Comments – Section 6 (Capital Resources)*, IAIS, 2015-11-20, available on-line via http://www.iaisweb.org > Consultations > Closed Consultations > Insurance Capital Standard (ICS) (accessed 2015-12-13)

54 IAIS, *By-Laws*, 2015, available via http://iaisweb.org > About the IAIS > By-Laws

55 IAIS, *Policy for Consultation of Stakeholders*, 2015, available via http://iaisweb.org > About the IAIS > Policies and Procedures

56 International Association of Insurance Supervisors, *Capital Requirements for Global Systemically Important Insurers (G-SIIs): Basic Capital Requirements (BCR) and Higher Loss Absorbency (HLA)*, Fact Sheet, 2015-10-5, available on-line via http://iaisweb.org/index.cfm?event=getPage&nodeId=25233 (accessed 2015-11-15)

57 Neville Henderson, *Remarks by Assistant Superintendent Neville Henderson to the 2015 Life Insurance Invitational Forum, Cambridge, Ontario, December 1, 2015*, OSFI, 2015-12-1, available on-line at http://www.osfi-bsif.gc.ca/Eng/osfi-bsif/med/sp-ds/Pages/nh20151201.aspx (accessed 2016-2-14)

58 IAIS, *Newsletter #53*, June 2016, available on-line via http://www.iaisweb.org/page/news/newsletter/file/61139/iais-newsletter-june-2016-final (accessed 2016-7-10)

59 Available via http://www.iaisweb.org/page/consultations/current-consultations/risk-based-global-insurance-capital-standard--second-consultation//file/61557/2016-risk-based-global-insurance-capital-standard-ics-consultation-document (accessed 2016-9-10)

[box] Question 70. Should Tier 1 Limited financial instruments be required to have a principal loss absorbency mechanism?

(1) If "no" to Question 70, should the principal be considered to provide loss absorbency on a going concern basis? Please explain how does the instrument demonstrates loss absorbency on a going concern basis. [sic][close box]

Clearly, the second part of Question 70, asking objectors to specify their claim of going-concern loss absorbency, is directed squarely at OSFI and the AMF, whose disingenuous claim that 'coupon stopper' provisions constitute loss absorbency – so soon after the financial crisis, the gallons of ink spilled over 'burden sharing' in Europe, and their own enactment of loss absorbency requirements for banks' Tier 1 Capital[60] – is a disgrace to Canada.

Responses are due to the IAIS by October 19, 2016. I will report on the responses when they are made available to the public.

Solvency II

Solvency II is the European system of regulation for insurers, set to come into effect in the near future after many years of delay. The European Commission states[61] that *Great care has been taken to ensure that the new EU regime will be in line with the existing international guidelines in this area as agreed by the International Association of Insurance Supervisors (IAIS), as well as with the ongoing work of IAIS on a new international agreement for a solvency regime for insurers and reinsurers.*

Norton Rose Fulbright explains:[62] *Tier 1 'own funds' include ordinary share capital, non-cumulative preference shares and relevant sub-ordinated liabilities. All distributions on tier 1 items must be cancelled in the event of a breach of the SCR and repayment of principal must be suspended. Preference shares and sub-ordinated debt will be subject to a new 'loss absorption' requirement (see 7 below) which could involve writing off all amounts owed by the insurer. Instruments which do not meet the tier 1 requirements on permanence or loss absorbency may still be categorised as tier 2 or tier 3 items. … The new 'tier 1' loss absorption requirement will apply: where the insurer holds less than 75 per cent of its SCR; where it breaches its MCR; or where it breaches its SCR for more than 3 months.*

The requirement is that there be an automatic writing down of the liability (principal and dividend/coupon), a conversion to ordinary shares or use of an 'equivalent mechanism' (i.e. to such writing down or conversion). It is not yet clear what will amount to an 'equivalent mechanism' for these purposes.

Nathan Collins of Global Capital comments:[63] *"Solvency II is at the top of the mind for investors, which wasn't as much the case last year," says Matteo Castelvetri, managing director in the financial institutions group, EMEA, at Morgan Stanley in London. "It goes live on January 12016 hence there has been a lot of focus from issuers on disclosure — they're trying to address investor's questions and concerns." … The structures of Solvency II AT1s will be very similar to Basel III AT1s. Among other things, they occupy the same part of the capital structure, have the same minimum call periods and both have discretionary and non-cumulative coupon payments.*

Both also convert into equity or write down on trigger events, with the difference being that a bank AT1 is triggered at a set core equity tier one ratio while the Solvency II instruments trigger if the issuer's Solvency Ratio — a ratio based on the mark-to-market value of its assets — falls below a certain level.

Alice Gledhill of Reuters points out:[64] *Even the new-style Tier 1 instruments - which from January 1 2016 will start to resemble bank Additional Tier 1 deals and have to include loss absorption features such as write-downs or equity conversion – won't deter investors. "New style insurance Tier 1 bonds are likely to be more investible for mainstream fixed investors than bank AT1," said Neil Williamson, head of EMEA credit research at Aberdeen Asset Management.*

"The main difference is the coupon payments. On the insurance side, coupons would only be turned off if the SCR [Solvency Capital Requirement] was breached, which is a very low probability event. This contrasts to the much higher chance of a bank breaching its combined buffer or TLAC requirement and being forced to turn off AT1 coupons." … "The establishment of the bank AT1 market over the past 18 months is helpful in terms of establishing an institutional investor base," said Nik Dhanani, head of capital solutions at HSBC.

"If the trigger for loss absorbency is based at 100% SCR coverage or less, investors should be sufficiently comfortable that it's remote enough for mainstream insurance companies who are likely to operate significantly above this level."

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60 See, for example, OSFI, *Non-Viability Contingent Capital*, Advisory, August 2011, available on-line at http://www.osfi-bsif.gc.ca/Eng/Docs/nvcc.pdf

61 European Commission, *'Solvency II': Frequently Asked Questions (FAQs)*, Memo, 2007-7-10, available on-line at http://europa.eu/rapid/press-release_MEMO-07-286_en.htm?locale=en (accessed 2015-9-13)

62 Norton Rose Fulbright, *Ten things you need to know about Solvency II: Capital Instruments*, Publication, May 2015, available on-line at http://www.nortonrosefulbright.com/knowledge/publications/74560/ten-things-you-need-to-know-about-solvency-ii-capital-instruments (accessed 2015-9-13)

63 Nathan Collins, *Insurers finally come face to face with Solvency II*, Global Capital, 2015-7-12, available on-line at http://www.globalcapital.com/article/s627tyrw9vbz/insurers-finally-comes-face-to-face-with-solvency-ii (accessed 2015-9-13)

64 Alice Gledhill, *Insurance companies still the darlings of the financial world*, Reuters, 2014-12-11, available on-line at http://www.reuters.com/article/2014/12/11/insurance-capital-idUSL6N0TL2P420141211 (accessed 2015-9-13)

Success of NVCC Compliant Issues

Banks have been highly successful in their offerings of NVCC-compliant FixedResets.[65] This success, which has been referred to as a 'watershed event' indicating the potential for $20-billion in such issues to be issued[66] opens up the possibility that the lucky issuers of lower-coupon issues (both StraightPerpetual and FixedResets) will seek shareholder approval to add NVCC compliance to the issues' terms. I suspect that this could be accomplished relatively cheaply, particularly if stockbrokers are paid a nice proxy solicitation fee if their clients vote in favour; it will be remembered that Bell Canada preferred shareholders agreed to have the guarantor changed to the parent company, BCE, with a derisory extra payment received in compensation for the decline in credit quality;[67] more recently, Dundee Corporation was successful[68] with a term extension on its Operating Retractible issue with the aid of enormous payments to intermediaries.[69] It will be noted that OSFI has specifically encouraged the banks to pursue amendments,[70] but none have been proposed so far.

Royal Bank became the first issuer of an NVCC-compliant Straight Perpetual with RY.PR.N,[71] a $150-million issue with a 4.90% - it is interesting to note that this is the same coupon as RY.PR.W, which is not compliant but which is exchangeable for common, implying that compliance may be achieved without shareholder approval if the company assigns the power to demand an exchange to OSFI. These two issues are trading as closely as one might expect for issues which are, in fact, identical in all respects but the call schedule. The Toronto-Dominion Bank has also issued a NVCC-compliant Straight Perpetual,[72] TD.PF.F, and Bank of Montreal has issued BMO.PR.Z.[73] These issues received uniformly poor market receptions, which I ascribe more to market conditions than to concern regarding their NVCC-compliant status.

Conclusions Regarding Deemed Retractions

Given the lack of clarity on the issue, the HIMIPref™ Deemed Maturity date for insurers and insurance holding companies was changed in April, 2013, to 2025-1-31, an extension from the 2022-1-31 date that was used in the two years prior to April, 2013, and continues to be used for banks. Placing such a date on the assumed final date for inclusion of extant preferreds into Tier 1 capital is, of course, speculation – I can only hope that it's not erroneous or, at least, not as erroneous as the dates other stakeholders use to evaluate their positions (such dates will, of course, include "never").

In the near future the the HIMIPref™ Deemed Maturity date for insurers and insurance holding companies will be extended again.

I justify my choice of date by speculating that OSFI will seek to provide the insurance industry with as much lead time as was given to the banks following their draft NVCC release in February, 2011, (which implies an extension of two years) and that preparation of the memorandum will take an additional year (for a total extension of three years). This choice of Deemed Maturity date for insurers and insurance holding companies will be reviewed periodically as I review OSFI speeches and publications.

In sum, HIMI expects that all preferred shares issued by banks that lack NVCC status will be called at some point on or before 2022-1-31, as the loss of Tier 1 status will, from the point of view of the issuer, change them from "cheap equity" to "expensive debt". In order to account for this, a "Deemed Maturity" entry has been added to the HIMIPref™[74] data for such issues, dated 2022-1-31 at par, which has the same effect on the analysis as an actual maturity with these attributes. In the Straight Perpetual sector, the affected issues are referred to as DeemedRetractibles, with unaffected issues continuing with the names PerpetualDiscount and PerpetualPremium.[75]

In addition, issues from insurers are treated in the same manner, but there has been so much foot-dragging in the regulatory process that the end date, previously set to be the same as that of banks, has been extended by three years to 2025-1-31 and will eventually be extended again.

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65 See issues marked "NVCC" in the table of FixedResets

66 Tim Kiladze, *RBC's preferred-share experiment could open a $20-billion market*, Globe and Mail, 2014-1-22, available on-line at http://www.theglobeandmail.com/report-on-business/streetwise/rbcs-preferred-share-experiment-could-open-a-20-billion-market/article16458059/ (accessed 2014-2-15)

67 BCE Inc., *Announcement of Approval of Bell Plan of Arrangement for Exchange of Bell Canada Preferred Shares*, Press release, 2007-1-23, available on-line at http://www.bce.ca/news-and-media/releases/show/announcement-of-approval-of-bell-plan-of-arrangement-for-exchange-of-bell-canada-preferred-shares (accessed 2014-2-15)

68 Dundee Corporation, *Dundee Corporation Announces Voting Results for the Special Meeting of Series 4 Preferred Shareholders*, Press Release, 2016-1-28, available on-line at http://www.dundeecorp.com/pdf/2016-01-28-Voting-Results.pdf (accessed 2016-2-14)

69 Dundee Corporation, *Dundee Corporation Announces Postponement of Special Meeting and Proposed Amended Terms to its Series 4 Preferred Share Exchange Transaction*, Press Release, 2016-1-6, available on-line at http://dundeecorp.com/pdf/2016-01-06-amended-terms.pdf (accessed 2016-2-14)

70 See the original NVCC draft advisory, no longer available from OSFI but discussed at http://prefblog.com/?p=13995; see also OSFI, *Analysts briefing by Mark White on two Advisories relating to BASEL III: Treatment of non-qualifying capital instruments under Basel III and Non-Viability Contingent Capital*, Transcription, 2011-2-7, available on-line at http://www.osfi-bsif.gc.ca/eng/fi-if/in-ai/pages/2011-02-04b-ntcavs.aspx (accessed 2014-2-15).

71 Royal Bank of Canada, *Royal Bank of Canada announces NVCC Preferred Share Issue*, Press Release, 2015-5-28, available on-line at http://www.rbc.com/newsroom/news/2015/20150528-nvcc-pref-shs.html (accessed 2015-6-14)

72 Toronto-Dominion Bank, *TD Bank Group to Issue Preferred Shares (Non-Viability Contingent Capital (NVCC))*, Press Release, 2015-7-9, available on-line at http://td.mediaroom.com/2015-07-09-TD-Bank-Group-to-Issue-Preferred-Shares-Non-Viability-Contingent-Capital-NVCC (accessed 2015-7-9)

73 Bank of Montreal, *Bank of Montreal Completes $150 Million Preferred Share Issue*, Press Release, 2015-7-29, available on-line at http://newsroom.bmo.com/press-releases/bank-of-montreal-completes-150-million-preferred–tsx-bmo-201507291019120003 (accessed 2015-8-16)

74 See http://www.prefshares.com

75 See http://www.prefletter.com/whatPrefLetter.php and the chart at http://www.prefletter.com/taxonomy.pdf for more detail

Risks to the DeemedMaturity Forecast

As discussed above, it is assumed that removal of Tier 1 eligibility will change the issuers' perception of these issues from "cheap equity" to "expensive debt" and so encourage their redemption.

However, this is by no means assured. Market conditions could change such that extant preferred shares are cheaper than debt; in the case of Straight Perpetuals, for instance, if long term corporate bond rates climb to the double digits, then a 5% dividend will seem quite inexpensive, even if it does have to be paid out of after-tax profits. FixedResets are not immune – it is also possible that the market could require an Issue Reset Spread of 1,000bp, in which case spreads of less than 300 would be considerably better priced (from the issuers' perspective!) than they are now.

I do not consider such changes in market conditions to be likely, but they are risks that should be borne in mind.

The timing of redemption with respect to DeemedMaturities is also problematic. A uniform date of 2022-1-31 has been used for the DeemedMaturity for banks, but given that the cap on eligibility for inclusion in Tier 1 Capital declines by 10% per year from the total amount measured on 2013-1-1,[76] most issuers have the potential for extant issues to exceed the cap prior to this date and thus encourage a redemption of some of the outstanding amount. Thus, we have seen quite a few redemptions of bank DeemedRetractibles in the past few years and will doubtless see more until the full stock has been redeemed in an orderly fashion. No effort has been made to adjust DeemedMaturity dates for individual issues to reflect their likelihood of redemption prior to the 2022-1-31 cut-off date.

More seriously, the DeemedMaturity entries added to the call schedules for FixedResets all have the standardized dates (2022-1-31 for banks; 2025-1-31 for insurers), but none of the FixedResets are actually callable on these days; issuers will have to call the issue on the Exchange Date preceding the DeemedMaturity (and thereby lose the benefit of Tier 1 Capital) or the Exchange Date following the DeemedMaturity (and thereby be carrying 'expensive debt' for some period of time).

While this is a concern, it is not yet a major concern; I will admit that I am crossing my fingers in the hopes that the ambiguities are resolved (by redemptions or changes in terms of the issue by shareholder vote) prior to the time at which the issue has a major effect on analysis.

And, of course, there is the risk that the IAIS and/or OSFI will simply not implement the restrictions I anticipate on insurers' ability to include extant preferred shares in Tier 1 Capital: a requirement for NVCC-compliance may not be enacted; or it may be enacted with a 'grandfathered' eligibility for extant issues; or the time-frame for extant issues to lose their eligibility could be very long.

Credit Rating Effects

Immediately following the announcement that the three convertible CM issues, CM.PR.D, CM.PR.E and CM.PR.G, had been granted NVCC status, DBRS placed them on Review Negative, stating[77] *The rating actions follow the revision of how DBRS views the elevated risk of conversion in an environment where the Office of the Superintendent of Financial Institutions Canada (OSFI) is encouraging Canadian banks to put in place resolution mechanisms, including the release of the OSFI Advisory on Non-Viability Contingent Capital, issued August 16, 2011 (NVCC Advisory), and the regulator's ongoing push toward loss absorption from capital instruments, including convertible preferred securities, to generate common equity prior to the declaration of non-viability by OSFI*.

DBRS completed its review of its applicable rating methodology[78] emphasizing the point that *As preferred shares are equity, various governments during the current crisis have acted to have banks that are under some stress exchange these instruments to bolster their common equity. In some cases, this step has been accomplished through voluntary exchanges. In other cases, banks have engaged in forced exchanges, which DBRS considers tantamount to default. In some cases, preferred shares have been wiped out. This process has helped to bolster these banks' common equity and helped them avoid being put into receivership. Thus, while senior debt and even subordinated debt have continued to pay as agreed, preferred shares have been subject to greater risk of default*.

This has resulted in a downgrade[79] of these issues by two notches to Pfd-2 on December 9, 2013, whereas other issues were downgraded by only a single notch. This one-notch penalty for NVCC-compliance has been extended to NVCC-compliant new issues.

In addition, the new methodology appears to have led DBRS to downgrade each of the Big-5 banks by one notch (to Pfd-2(high)), although this seems to have been done without a press release, which is unusual to say the least,[80] while discontinuing the rating of RY.PR.W[81] on the grounds that *the trigger for conversion into common equity is inadequately defined*. However, DBRS has provided ratings for the NVCC-compliant FixedReset new issues, one notch below the non-compliant issues.[82]

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76 See http://www.osfi-bsif.gc.ca/Eng/Docs/CAR_chpt2.pdf

77 DBRS, *DBRS Places CIBC's Non-Cum. Class A Preferred Shares, Series 26, 27 and 29*, Under Review-Negative, 2011-8-17, available on-line at http://www.dbrs.com/research/241665/dbrs-places-cibc-s-non-cum-class-a-preferred-shares-series-26-27-and-29-under-review-negative.html (accessed 2013-12-14)

78 DBRS, *DBRS Criteria: Rating Bank Capital Securities – Subordinated, Hybrid, Preferred & Contingent Capital Securities*, available on-line at http://www.dbrs.com/research/263418/rating-bank-capital-securities-subordinated-hybrid-preferred-contingent-capital-securities.pdf (accessed 2013-12-14)

79 DBRS, *DBRS Rates CIBC Convertible Preferred Shares with OSFI NVCC Declaration Trigger Pfd-2*, 2013-12-9, available on-line at http://www.dbrs.com/research/263426/dbrs-rates-cibc-convertible-preferred-shares-with-osfi-nvcc-declaration-trigger-pfd-2.html (accessed 2013-12-14)

80 See http://prefblog.com/?p=24032

81 DBRS, *DBRS Discontinues Rating on Royal Bank of Canada Series W Preferred Shares*, Press Release, 2013-12-9, available on-line at http://www.dbrs.com/research/263427/dbrs-discontinues-rating-on-royal-bank-of-canada-series-w-preferred-shares.html (accessed 2013-12-15)

82 DBRS, *DBRS Provisionally Rates RBC's Non-Viability Contingent Capital Preferred Shares at Pfd-2, Stable*, Press Release, 2014-1-21, available on-line at http://dbrs.com/research/264518/dbrs-provisionally-rates-rbc-s-non-viability-contingent-capital-preferred-shares-at-pfd-2-stable.html?v=1390367775082 (accessed 2014-2-15)

The DBRS actions have made a mockery of my efforts to minimize credit differences in the universe used for the charts in this section; therefore, all the issuers affected by these changes have been grandfathered as 'High Quality' issues for the purpose of charting.

S&P at first took less drastic action to date, downgrading CM.PR.D and CM.PR.E (oddly, they did not rate CM.PR.G) by one notch on the global scale (to BBB+ from A-) when their NVCC status was confirmed.[83] They have also rated NVCC-compliant FixedReset new issues one notch below their non-compliant comparators[84], due to *The deduction of an additional notch to reflect that the preferred shares feature a contingent conversion trigger provision*. They have now reduced ratings further due to concerns about the 'bail-in' regime (see below).

Neither agency has made any public pronouncements regarding the potential for the NVCC rules to be extended to the insurance sector, or what the effect of such an extension might be.

DBRS recently updated their insurance industry methodology,[85] which resulted in the downgrading of SLF,[86] PWF,[87] GWO,[88] POW,[89] MFC,[90] confirmation of FFH[91] and upgrades of CCS[92] and IFC,[93] but these changes did not reflect any view on the application of NVCC rules to these companies.

Potential Change: Bail-In Debt

The Canadian federal government's Ministry of Finance has announced (long prior to the recent change in government):[94] *a public consultation on a key element of the Government's comprehensive risk management framework for Canada's domestic systemically important banks*. The fact that it is the federal government directly, and not OSFI, that is conducting this consultation must be considered a slap in the face for the latter institution and makes even more of a mockery of the naïve claims of OSFI independence that are sometimes heard.

The consultation[95] requested comments by September 12, 2014. Essentially, the proposal would require the large banks to hold between 17 and 23 percent of risk-weighted assets (RWA) as equity, NVCC-instruments and convertible senior debt. This convertible senior debt would convert in much the same manner as extant NVCC instruments, but conversion would be triggered separately and after full NVCC conversion. Additionally, the proportion of eligible senior debt converted would be set by the authorities.

In addition, the previous government proposed that it have the power "to cancel, in whole or in part, the pre-existing common shares of the bank in the context of exercising the conversion power", however, shares issued as part of an NVCC conversion would not be affected. This implies that senior debt conversion would occur effectively simultaneously with NVCC conversion, since otherwise comingling of "old common shares" and "new common shares" would occur with the first market trade following conversion.

This in turn implies that valuation of NVCC instruments and convertible senior debt during a crisis will be even more of a nightmare than it might otherwise be. Investors will have to guess whether conversion will happen at all, what proportion of eligible debt might be converted and then guess whether some proportion of extant equity will be cancelled. This uncertainty will make it very difficult for a bank in dire straits to sell new issues.

83 Standard & Poor's, *Two Preferred Issues of Canadian Imperial Bank of Commerce Downgraded to 'BBB+'; All Other Ratings Confirmed*, Press Release, 2011-9-16, available on-line at http://www.standardandpoors.com/prot/ratings/articles/en/us/?articleType=HTML&assetID=1245320617503 (accessed 2013-12-15)

84 Standard & Poor's, *Royal Bank of Canada's Tier 1 Noncumulative Perpetual Rate Reset First Preferred Shares Series AZ Rated BBB+éP-2(High)*, Press Release, 2014-1-21, available on-line at http://www.standardandpoors.com/prot/ratings/articles/en/us/?articleType=HTML&assetID=1245363187361 (accessed 2014-2-15)

85 DBRS, *DBRS Releases New Global Insurance Methodology*, Press Release, 2015-12-17, available on-line at http://dbrs.com/research/288280/dbrs-releases-new-global-insurance-methodology.html (accessed 2016-1-10)

86 DBRS, *DBRS Confirms Sun Life Assurance at AA (low), Downgrades Sun Life Financial Inc.'s Senior Unsecured Debentures to "A" from A(high)*, Press Release, 2015-12-17, available on-line at http://dbrs.com/research/288339/dbrs-confirms-sun-life-assurance-at-aa-low-downgrades-sun-life-financial-inc-s-senior-unsecured-debentures-to-a-from-a-high.html (accessed 2016-1-10)

87 DBRS, *DBRS Downgrades Power Financial Corporation's Issuer Rating to A(high) from AA(low); Confirms Great West Life Assurance Co at AA*, Press Release, 2015-12-17, available on-line at http://dbrs.com/research/288335/dbrs-downgrades-power-financial-corporation-s-issuer-rating-to-a-high-from-aa-low-confirms-great-west-life-assurance-co-at-aa.html (accessed 2016-1-10)

88 DBRS, *DBRS Confirms The Great-West Life Assurance Company Ratings at AA; Downgrades Great-West Lifeco's Debentures to A(high) from AA(low)*, Press Release, 2015-12-17, available on-line at http://dbrs.com/research/288335/dbrs-downgrades-power-financial-corporation-s-issuer-rating-to-a-high-from-aa-low-confirms-great-west-life-assurance-co-at-aa.html (accessed 2016-1-10)

89 DBRS, *DBRS Downgrades Power Corporation of Canada's Senior Debt to "A" from A(high); Confirms Great West Life Assurance Co at AA*, Press Release, 2015-12-17, available on-line at http://dbrs.com/research/288333/dbrs-downgrades-power-corporation-of-canada-s-senior-debt-to-a-from-a-high-confirms-great-west-life-assurance-co-at-aa.html (accessed 2016-1-10)

90 DBRS, *DBRS Confirms The Manufacturers Life Insurance Company Ratings at AA(low); Downgrades Manulife Financial Corporation's MTNs to "A" from A(high)*, Press Release, 2015-12-17, available on-line at http://dbrs.com/research/288332/dbrs-confirms-the-manufacturers-life-insurance-company-ratings-at-aa-low-downgrades-manulife-financial-corporation-s-mtns-to-a-from-a-high.html (accessed 2016-1-10)

91 DBRS, *DBRS Confirms Ratings of Fairfax Financial Holdings at BBB; Assigns Financial Strength Rating of A(low) to Canadian Subsidiaries; Trends Now Positive*, Press Release, 2015-12-17, available on-line at http://dbrs.com/research/288331/dbrs-confirms-ratings-of-fairfax-financial-holdings-at-bbb-assigns-financial-strength-rating-of-a-low-to-canadian-subsidiaries-trends-now-positive.html (accessed 2015-12-17)

92 DBRS, *DBRS Upgrades Co-operators General Insurance Company to Pfd-2(low); Assigns Financial Strength Rating of A(low); Stable Trend*, Press Release, 2015-12-17, available on-line at http://dbrs.com/research/288329/dbrs-upgrades-co-operators-general-insurance-company-to-pfd-2-low-assigns-financial-strength-rating-of-a-low-stable-trend.html (accessed 2016-1-10)

93 DBRS, *DBRS Upgrades Intact Financial Corporation Issuer Rating to "A" from A(low) and Assigns Financial Strength Rating of AA(low) to Intact Insurance Company*, Press Release, 2015-12-17, available on-line at http://dbrs.com/research/288328/dbrs-upgrades-intact-financial-corporation-issuer-rating-to-a-from-a-low-and-assigns-financial-strength-rating-of-aa-low-to-intact-insurance-company.html (accessed 2016-1-10)

94 Department of Finance Canada, *Government Launches Public Consultation on a Taxpayer Protection and Bank Recapitalization Regime*, Press Release, 2014-8-1, available on-line at http://www.fin.gc.ca/n14/14-099-eng.asp (accessed 2014-8-10)

95 Department of Finance Canada, *Taxpayer Protection and Bank Recapitalization Regime: Consultation Paper*, 2014-8-1, available on-line at http://www.fin.gc.ca/activty/consult/tpbrr-rpcrb-eng.asp (accessed 2014-8-10)

As usual, there are two fundamental objections to the proposed scheme: firstly, these are all low-trigger conversions, which might be good enough to resolve a crisis, but do not even attempt to avert a crisis; secondly, it gives powers formerly held by a bankruptcy court to a handful of highly politicized, unscrutinized bureaucrats in the CDIC.

I see the whole thing as a lot of flim-flam; a fig-leaf over the ravaging of the rule of law.

On September 29, 2014, S&P announced[96] that *We believe that banking regulators are adopting a tougher "bail-in" stance (where investors share in the cost of a government's rescue of a failing bank) toward hybrid capital instruments compared with our expectations in late 2011. … This increases the possibility that banks might have to use hybrid capital instruments to a greater extent to absorb losses, and that regulators would be prepared to see such instruments absorb losses as a response to a bank stress. … We have lowered the ratings one notch on Tier 1 preferred shares issued by Bank of Montreal, The Bank of Nova Scotia, Canadian Imperial Bank of Commerce, Laurentian Bank of Canada, National Bank of Canada, Royal Bank of Canada, and The Toronto-Dominion Bank. We have affirmed the ratings on subordinated debt issues of the same issuers that had been placed under criteria observation. We have lowered the ratings on HSBC Bank Canada's preferred shares and subordinated debt by two and one notches, respectively, based on our group rating methodology and the parent-level ratings on HSBC*.

It does not appear that any comments have been published by our secretive masters in Ottawa.[97] I have found a comment letter from the Canadian Bond Investors' Association[98] (frequently mocked on PrefBlog[99]), providing an unsupported plea for a higher conversion ratio – i.e., proposing that conversion terms be more favourable for senior debt-holders than is currently proposed. There is another from the Credit Union Central of Canada[100] which also suggests a higher conversion ratio (or alternatively, that bank shareholders suffer losses before senior debt is bailed in); requests clarification on the status of deposits; clarification of the plan's relationship to Ottawa's other powers; and a comprehensive review of banking-related legislation in 2017.

The 2015 federal budget[101], introduced in March 2015, stated that: *The Government intends to introduce legislative amendments to enhance the resolution toolkit for Canada's systemically important banks, including implementation of the framework for the Taxpayer Protection and Bank Recapitalization regime, with associated regulations and guidelines to follow*. It is not clear just what the new government will do with this plan.

On December 11, 2015, S&P announced[102] that the Negative Outlook it had assigned to the larger Canadian banks in August, 2014, had been revised to Stable Outlook, due to uncertainty regarding the timing of government action, if any: *We now expect that the timeframe could be substantially longer than we had previously assumed. We see the absence of the topic from the new government's Dec. 4 Speech from the Throne as recent, incremental evidence in this regard. …. Moreover, with Canada experiencing no government bank bail-outs, nor large bank failures, for decades, we believe the political incentive to rapidly end "too-big-to-fail" is less in Canada than in the U.S. and several EU countries, which are jurisdictions under which we have already removed uplift for our expectation of the likelihood of extraordinary government support from our ratings … We will take this factor into consideration as we continue to evaluate our view on the likelihood of extraordinary government support in Canada relative to not only the U.S. and Europe, but also other jurisdictions where we maintain a government support assessment of "supportive" or "highly supportive" under our criteria (such as for many countries in Latin America and Asia-Pacific …*

Unsurprisingly, it appears that the proposal for 'bail-in' debt has cross-party support. The 2016 federal budget contained a section[103] titled "Introducing a Bank Recapitalization "Bail-in" Regime", which stated: *To protect Canadian taxpayers in the unlikely event of a large bank failure, the Government is proposing to implement a bail-in regime that would reinforce that bank shareholders and creditors are responsible for the bank's risks – not taxpayers. This would allow authorities to convert eligible long-term debt of a failing systemically important bank into common shares to recapitalize the bank and allow it to remain open and operating. Such a measure is in line with international efforts to address the potential risks to the financial system and broader economy of institutions perceived as "too-big-to-fail".*

The Government is proposing to introduce framework legislation for the regime along with accompanying enhancements to Canada's bank resolution toolkit. Regulations and guidelines setting out further features of the regime will follow. This will provide stakeholders with an additional opportunity to comment on elements of the proposed regime.

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96 Standard & Poor's, *Various Rating Actions Taken On Canadian Bank Hybrid Capital Instruments On Release Of Revised Bank Hybrid Criteria*, Press Release, 2014-9-29, available on-line at http://www.standardandpoors.com/prot/ratings/articles/en/us?articleType=HTML&assetID=1245374936853 (accessed 2014-10-12)

97 I have sent an inquiry by eMail, but have no expectations of a satisfactory result.

98 Canadian Bond Investors' Association, *Re: Non Viable Contingent Capital (NVCC) and Bail-in Debt*, Comment Letter, 2014-9-29, available on-line at http://bondinvestors.ca/wp-content/uploads/14-09-29-CBIA-to-Finance-re-NVCC-and-Bail-In.pdf (accessed 2014-11-16)

99 E.g. http://prefblog.com/?p=25836

100 Credit Union Central of Canada, *Submission to the Department of Finance On The Taxpayer Protection and Bank Recapitalization Regime: Consultation Paper*, 2014-9-12, available on-line at http://www.cucentral.ca/GovernmentRelations/140912%20Submission%20to%20Finance%20on%20The%20Taxpaper%20Protection%20and%20Bank%20Recapitalization%20Regime%20Consultation%20Paper.pdf (accessed 2015-2-15)

101 Government of Canada, *Budget 2015, Chapter 4.1*, available on-line at http://www.budget.gc.ca/2015/docs/plan/ch4-1-eng.html (accessed 2015-11-15)

102 S&P, *Outlooks On Systemically Important Canadian Banks Revised To Stable From Negative On Extended Bail-In Implementation*, 2015-12-11, available on-line at http://www.standardandpoors.com/en_US/web/guest/article/-/view/type/HTML/id/1548627 (accessed 2015-12-13)

103 Government of Canada, *Growing the Middle Class – Budget 2016; Chapter 8 – Tax Fairness and a Strong Financial Sector*, 2016-3-22, available on-line at http://www.budget.gc.ca/2016/docs/plan/ch8-en.html#_Toc446106866 (accessed 2016-4-11)

The government has, in fact, passed this legislation as Bill C-15, but the weighty issues – critically, what debt may be issued and on what terms – has been left to regulations and to CDIC by-laws, sheltered from scrutiny by Parliament and the public:[104] *Under Bill C-15, the federal government will be able to direct the CDIC to convert a DSIB's prescribed liabilities and shares into common shares of either the DSIB or one of its affiliates. The categories of liabilities and shares eligible for such conversion, as well as the mechanics of the conversion, will be specified in regulations and CDIC by-laws, which have yet to be published. The federal government will only be able to order a conversion if the CDIC has already been appointed a receiver of the DSIB or all or part of its shares and subordinated debt have already been vested in the CDIC. New regulations and guidelines under the* Bank Act *will also specify a loss-absorbing capacity requirement for DSIBs based on a combination of regulatory capital and bail-in eligible liabilities. These are significant additions to the CDIC's powers as a resolution authority and, along with the non-viable contingent capital regime currently in force, follow similar resolution and recovery reforms for financial institutions introduced in other major jurisdictions following the financial crisis.*

The CDIC has pledged[105] that *Bail-in would not change the insurance protection that CDIC offers to depositors – their deposits would remain protected*, but the lack of specifics and pre-determination of the liabilities subject to bail-in have fueled a certain amount of internet hysteria regarding the safety of deposits.[106]

UK Retail Investors Banned From Buying CoCos

The British Financial Conduct Authority (roughly equivalent to Canadian securities commissions) has announced[107] *CoCos are highly complex and the FCA believes they are unlikely to be appropriate for the mass retail market, so has stepped in to temporarily restrict their distribution only to professional, institutional and sophisticated or high net worth retail investors ahead of consulting on permanent rules later this year.*

Christopher Woolard, FCA director of policy, risk and research said:

"In a low interest rate environment many investors might be tempted by CoCos offering high headline returns. However, they are complex and can be highly risky, and the FCA has used its new powers to ensure that CoCos are not inappropriately made available to the mass retail market while still allowing access for experienced investors."

CoCos can be written off (in part or entirely) or converted into equity when the issuer's capital position falls, while issuers can have unusually broad discretion in relation to coupon payments making it extremely difficult for investors to assess, understand and price CoCos. At present there is little experience of how CoCos operate in practice.

One may speculate regarding whether this flexing of regulatory muscle – which creates an entire class of investment that is reserved for the rich – will be adopted by our wise masters in Canada. It is, after all, a common complaint[108] that preferred shares are complex – an attitude that, frankly, I have never understood. How can things like call provisions be considered complex when you can look up the details in the prospectus? How can one consider a preferred share, with its first-loss protection, to be less susceptible to analysis than the common shares which provide that first-loss protection?

In their announcement, the FCA highlighted a statement by the European Securities and Markets Authority regarding investments in CoCos[109] which included the admission that (emphasis added) *Though certain risk factors are transparent, e.g., trigger level, coupon frequency, leverage, credit spread of the issuer, and rating of instrument, if any,* ***other factors are discretionary or difficult to estimate…***

In October, 2014, the FCA further announced[110] that it was holding consultations with a view not only to making the restriction permanent, but in addition *impose restrictions on funds of CoCos*. The British Wealth Management Association has commented that this amounts to the FCA informing the market of what is and is not suitable.[111] Nevertheless, the FCA has made the ban permanent[112] and has also banned the distribution of pooled funds that invest "wholly or predominantly in CoCos" to retail investors.

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104 Darren Littlejohn and Vladimir Shatiryan, *Amendments to Canada's Bank Restructuring Legislation: Bail-In and Financial Contract Safe Harbours*, Blake, Cassels & Graydon, 2016-5-9, available on-line at http://www.blakesbusinessclass.com/amendments-to-canadas-bank-restructuring-legislation-bail-in-and-financial-contract-safe-harbours/ (accessed 2016-9-10)

105 Canadian Deposit Insurance Corporation, *Bail-in will help strengthen deposit protection for Canadians*, CDIC, Press Release, 2016-6-24, available on-line at http://www.cdic.ca/en/newsroom/newsreleases/Pages/bail-in-strengthen-deposit-protection.aspx (accessed 2016-9-10)

106 E.g., Miriam Yosowich, *Canadians' own bank accounts could be used to save failing financial institutions*, FindLaw Canada, 2016-8-22, available on-line at http://legalblogs.findlaw.ca/legal-business/canadians-own-bank-accounts-could-be-used-to-save-failing-financial-institutions-895/ (accessed 2016-9-10)

107 Financial Conduct Authority, *FCA restricts distribution of CoCos to retail investors*, Press Release, 2014-8-5, available on-line at http://www.fca.org.uk/news/fca-restricts-distribution-of-cocos-to-retail-investors (accessed 2014-8-10)

108 E.g., John Heinzl, *Beware the tax trap of these tempting preferreds*, Globe & Mail, 2013-6-14, available on-line at http://www.theglobeandmail.com/globe-investor/investment-ideas/beware-the-tax-trap-of-rate-reset-preferreds/article12579958/ and Richard Morrison, *Preferred shares an attractive alternative to bonds, stocks*, Financial Post, 2012-10-29, available on-line at http://business.financialpost.com/2012/10/29/preferred-shares-an-attractive-alternative-to-bonds-stocks/ (accessed 2014-8-10)

109 European Securities and Markets Authority, *Potential Risks Associated with Investing in Contingent Convertible Instruments*, Statement, 2014-07-31, available on-line at http://www.esma.europa.eu/system/files/2014-944_statement_on_potential_risks_associated_with_investing_in_contingent_convertible_instruments.pdf (accessed 2014-8-10)

110 Financial Conduct Authority, *Financial Conduct Authority consults on restrictions on the retail distribution of regulatory capital instruments*, Press Release, 2014-10-29, available on-line at http://www.fca.org.uk/news/financial-conduct-authority-consults-on-restrictions-on-the-retail-distribution-of-regulatory-capital-instruments (accessed 2015-1-11)

111 Jonathan Yarker, *FCA 'undermines suitability' stance in CoCo consultation*, Wealth Manager, 2015-1-30, available on-line at http://citywire.co.uk/wealth-manager/news/fca-undermines-suitability-stance-in-coco-consultation/a795517 (accessed 2015-2-15)

112 Matthew Jeynes, *FCA confirms retail distribution ban on CoCo bonds*, FT Adviser, 2015-6-12, available on-line at http://www.ftadviser.com/2015/06/12/investments/fixed-income/fca-confirms-retail-distribution-ban-on-coco-bonds-AGzo0OTRGQhJpiOUKZ5t7L/article.html (accessed 2015-6-14)

Meanwhile the Australian Securities and Investments Commission, consumed with jealousy over the FCA's powers, is pushing for broad product intervention power to "enable ASIC to be more proactive and allow for more-targeted and timely intervention". The law firm Ashurst Australia gloomily concludes: "it is inevitable that product intervention powers will find their way to Australia."[113]

Julien De Saussure, a fund manager with Edmond de Rothschild Asset Management (France) comments (with respect to the new Solvency II regime outlined above):[114] *In terms of demand, we expect this supply to be met by a decent appetite for the asset class considering (i) the likely investment grade ratings of these instruments (in any case, better ratings than bank AT1) and (ii) the search for yield in a zero yield environment. However, we still wonder whether institutional investors will be able to buy the asset class, as perpetual instruments are badly treated under Solvency II guidelines. The same applies for retail clients, where we anticipate that FCA restriction or ESMA guidelines on CoCos would include Solvency II Tier 1 at some point.*

Despite these problems, it is interesting to note that in 2014 the amount of European CoCos outstanding surpassed €100-billion, roughly triple the amount outstanding at the beginning of the year, while Asian issuance is now about USD 46-billion.[115] Asian issuance is typically low-trigger, comparable to NVCC in Canada, while European issuance is typically high-trigger.

This issue bears watching given the increasing discretion the bureaucrats are acquiring with respect to the potential failure of a Canadian bank. While it is some consolation that the regulators recognize the ill-effects of their discretionary power, this is in turn being used to justify the restriction of investment choices by retail investors.

Canadian Market Effects

There has been a huge change in the market since the advisories were issued, with the market sharply differentiating between insurers and banks in terms of the likelihood of issues being called due to the OSFI advisories. However, non-bank issues (both insurers and unregulated companies) have been affected, in that the relative pricing of high- and low-coupon issues changed substantially.

For quite a long period, Implied Volatility Calculations[116] for major issuers did not provide any useful information regarding relative pricing for any issuer; all Straight Perpetuals regardless of issuer (bank, insurer or non-regulated company) were priced in accordance with an overwhelming expectation of directionality (towards par), which negates the fundamental assumption of the Black-Scholes model from which Implied Volatility is derived. However, this situation reversed in June, 2013, amidst a severe downdraft in prices of non-bank Straight Perpetuals; current results for these calculations appear later in this essay.

The CM issues which were granted NVCC status (CM.PR.D[117], CM.PR.E[118] and CM.PR.G[119]) have all been redeemed or called for redemption, but became differentiated from the set of bank DeemedRetractibles during the downdraft (as much as can be determined from the small sample size), although this may have been due to credit concerns. The NVCC-eligible issue, RY.PR.W and other NVCC-compliant issues are now strongly differentiated from non-NVCC issues as shown in Chart DR-1; this is confirmed by the Implied Volatility calculation displayed in Chart DR-2.

It will be noted that although I consider RY.PR.W to be NVCC-eligible, it is not necessarily the case that it will eventually become NVCC-compliant, although prudence dictates that we assume that it does. The floor price of RY common used to determine conversion ratios is $2.50,[120] while other preferreds have a floor price of $5.00. This means that in the event of NVCC conversion, holders of RY.PR.W will be paid in full (based on preferred share par value and common share market value) while other preferred shareholders get less than full value for their shares if the price is less than $5.00. If the price is less than $2.50, then the recovery of RY.PR.W holders, while less than 100%, will be double that of other holders. This consideration may give the bank or OSFI reason to refrain from giving the issue NVCC-compliant status.[121]

113 Ashurst Australia, *ASIC urges the government to provide it with new product intervention powers*, Financial Services Update, March 2015, available on-line via https://www.ashurst.com/home.aspx?id_Content=2 (accessed 2015-3-15)

114 Bank+Insurance Hybrid Capital (with Credit Agricole), *Solvency II Tier 1 Take-off*, Publication, April 2015, available on-line at http://bihcapital.com/2015/04/solvency-ii-tier-1-take-off/ (accessed 2015-9-13)

115 "Mani", *European Banks' Coco Market Size Surpasses Euro 100 Billion: HSBC*, Value Walk, 2015-4-29, available on-line at http://www.valuewalk.com/2015/04/european-banks-coco/ (accessed 2015-5-10)

116 See the January, 2010, edition of this newsletter

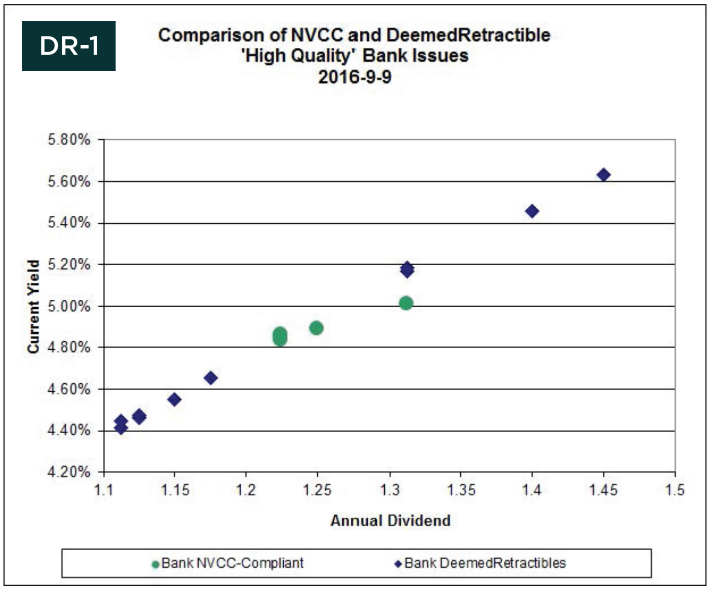
117 Canadian Imperial Bank of Commerce, *CIBC to Redeem Preferred Shares Series 26*, Press Release, 2014-9-30, available on-line at http://micro.newswire.ca/release.cgi?rkey=2209309793&view=14730-0&Start=&htm=0 (accessed 2015-3-15)

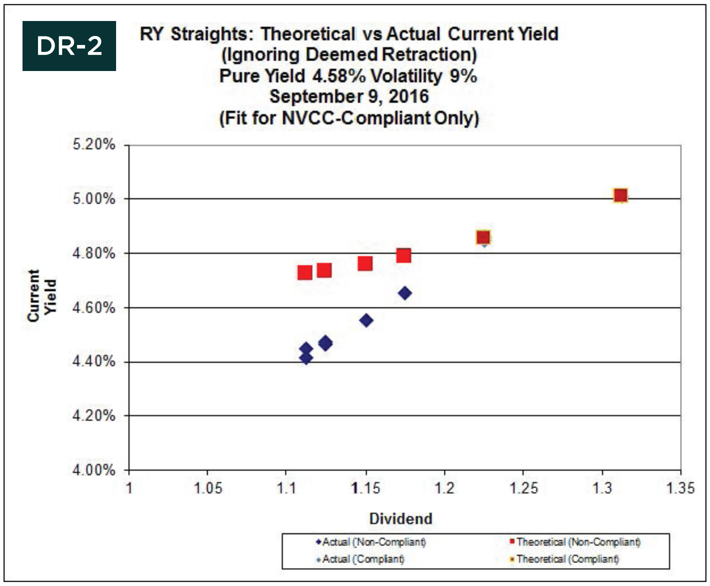
118 Canadian Imperial Bank of Commerce, *CIBC to Redeem Preferred Shares Series 27*, Press Release, 2014-12-8, available on-line at http://micro.newswire.ca/release.cgi?rkey=2212089049&view=14730-0&Start=&htm=0 (accessed 2014-12-14)

119 Canadian Imperial Bank of Commerce, *CIBC to Redeem Preferred Shares Series 29*, Press Release, 2015-3-2, available on-line at http://micro.newswire.ca/release.cgi?rkey=2303029843&view=14730-0&Start=&htm=0 (accessed 2015-3-15)

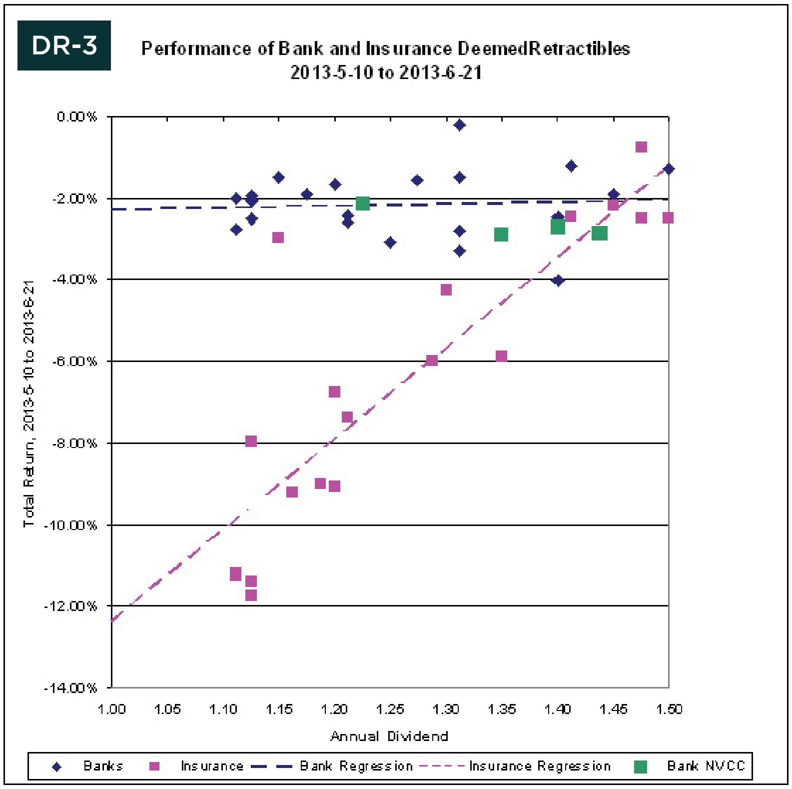
120 Royal Bank of Canada, *Royal Bank of Canada $300,000,000 12,000,000 Non-Cumulative First Preferred Shares Series W*, Short Form Prospectus, 2005-1-21, available on-line via SEDAR, http://www.sedar.com, "Royal Bank of Canada Jan 21 2005 17:26:11 ET Final short form prospectus – English PDF 213 K" (accessed 2015-12-19)

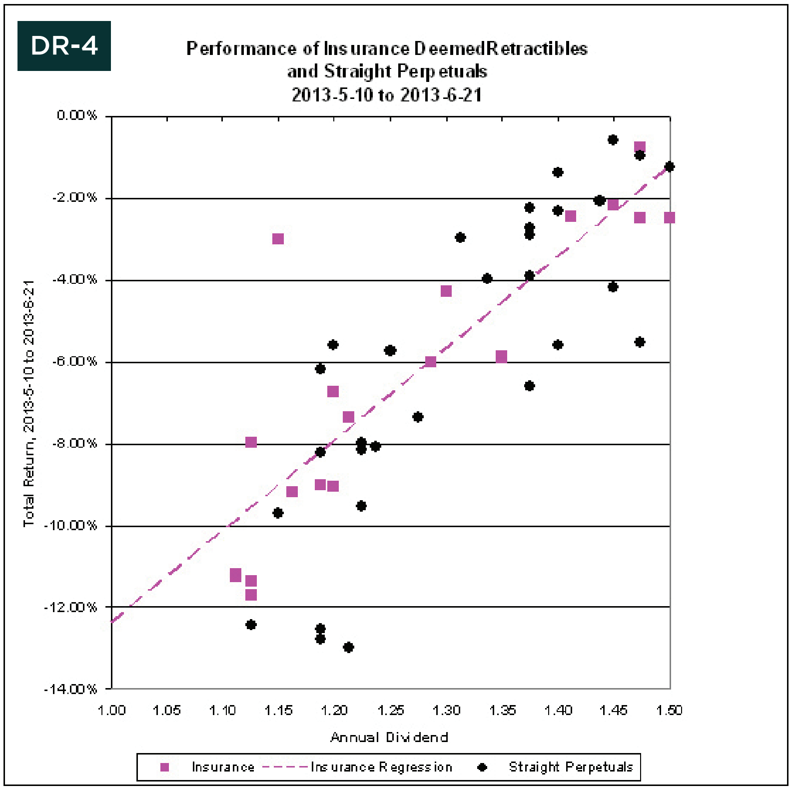
121 Thanks to the reader of my blog, *prefguy*, for bringing this wrinkle to my attention http://prefblog.com/?p=16029#comment-193664



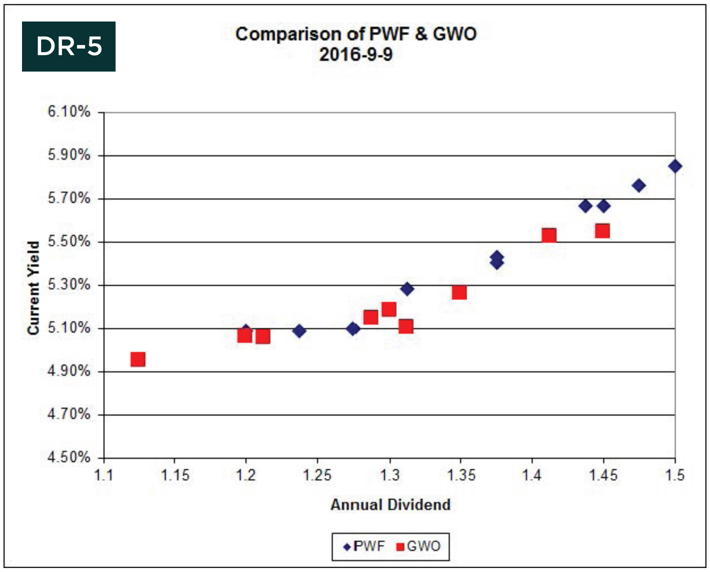


On the other hand, it is very clear that the market treats insurance issues in the same way as it treats unregulated Straight Perpetuals and not at all as it does bank DeemedRetractibles. This was violently illustrated during the height of the summer 2013 downdraft, as shown in Charts DR-3 and DR-4.





The current comparison of the Current Yield/Dividend relationships is shown for PWF/GWO in Chart DR-5. This chart indicates that there is differentiation between PWF and GWO Straight Perpetuals in the marketplace, but more sensitive tests are available – and there are interfering factors that must be understood as well.



One confounding factor that may serve to give a false signal of differentiation due to regulatory status is that there are significant differences in the call provisions of these shares – significant enough that there certainly should be a wide divergence in the current yields of these issues based on these differences alone, ignoring DeemedRetractible status, as shown in Table DR-1.

Table DR-1: Current Yields and Yields-to-Worst of PWF and GWO Straight Perpetuals

Ticker	Dividend	Bid	Current Yield	YTW Scenario	YTW	First Par Call Date
PWF.PR.E	1.375	25.32	5.43%	Immediate Call	-2.70%	Current
PWF.PR.F	1.3125	24.86	5.28%	Limit Maturity	5.34%	Current
PWF.PR.G	1.475	25.61	5.76%	Immediate Call	-15.06%	Current
PWF.PR.H	1.4375	25.38	5.66%	Immediate Call	-4.96%	Current
PWF.PR.I	1.50	25.64	5.85%	Immediate Call	-16.17%	Current
PWF.PR.K	1.2375	24.34	5.08%	Limit Maturity	5.14%	Current
PWF.PR.L	1.275	25.00	5.10%	Limit Maturity	5.15%	Current
PWF.PR.O	1.45	25.59	5.67%	Call at 25.00, 2018-10-31 *	4.97%	2018-10-31
PWF.PR.R	1.375	25.45	5.40%	Call at 25.00, 2021-4-30 *	5.23%	2021-4-30
PWF.PR.S	1.20	23.59	5.09%	Limit Maturity	5.13%	2022-4-30
GWO.PR.F	1.475	25.89	5.70%	Immediate Call	-36.92%	Current
GWO.PR.G	1.30	25.09	5.18%	Immediate Call *	-2.80%	Current
GWO.PR.H	1.2125	23.99	5.05%	Deemed Maturity 2025-1-31	5.45%	Current
GWO.PR.I	1.125	22.73	4.95%	Deemed Maturity 2025-1-31	5.88%	Current
GWO.PR.L	1.4125	25.57	5.52%	Call at 25.50, 2016-12-31 *	3.64%	2018-12-31
GWO.PR.M	1.45	26.16	5.54%	Immediate Call	-16.80%	2019-3-31
GWO.PR.P	1.35	25.65	5.26%	Call 2020-3-31 at 25.25	4.80%	2021-3-31
GWO.PR.Q	1.2875	25.03	5.14%	Deemed Maturity 2025-1-31	5.12%	2021-9-30
GWO.PR.R	1.20	23.71	5.06%	Deemed Maturity 2025-1-31	5.57%	2021-12-31
GWO.PR.S	1.3125	25.71	5.11%	Deemed Maturity 2025-1-31	4.82%	2025-1-30

The YTW scenarios for PWF.PR.O, PWF.PR.R, GWO.PR.G and GWO.PR.L have changed since the July edition.

It should be remembered that Yield-to-Worst has, historically, been a good indicator of relative expected future returns.[122]

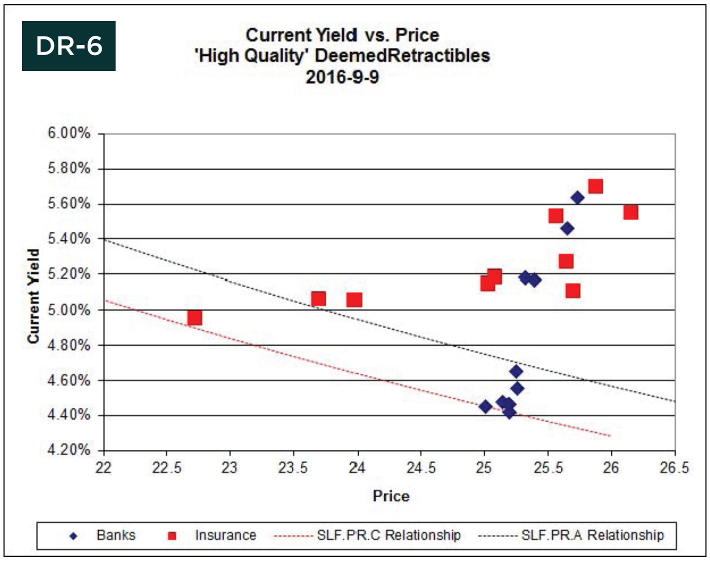
Although calls by the issuer do not show up to a major extent in Table DR-1, a quick glance is sufficient to show that there is a higher proportion of PWF issues trading near or above par; hence call risk is a greater influence on the PWF series than on the GWO series. Implied Volatility analysis, which allows for any probability of call to be considered on a consistent basis, rather than the binary on/off switches implicit in YTW analysis (or the 'always off' assumption of Current Yield), shows the differentiation between the two series. This is discussed below.

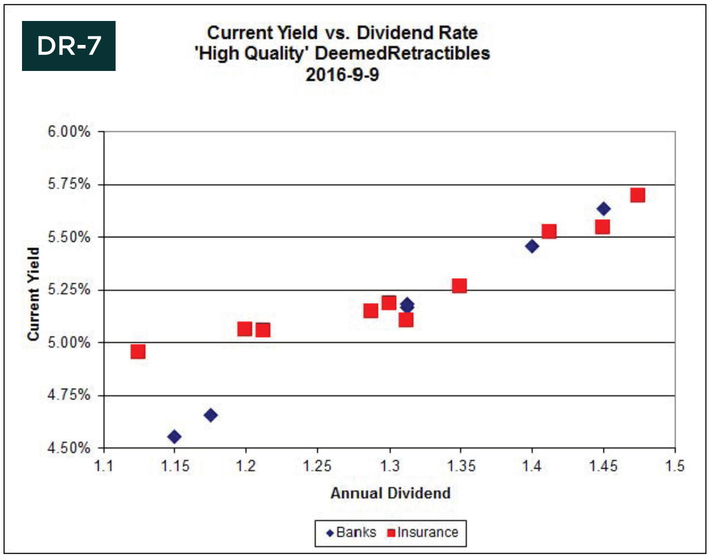
No useful purpose is served by plotting Current Yield against the "Expected Gain Rate" for the two series of data, or Yield-to-Worst vs. Price, so the plots of Current Yield vs. Price (Chart DR-6) and Current Yield vs. Dividend Rate (Chart DR-7) will have to make up the illustrations of the difference between bank and insurer pricing this month.

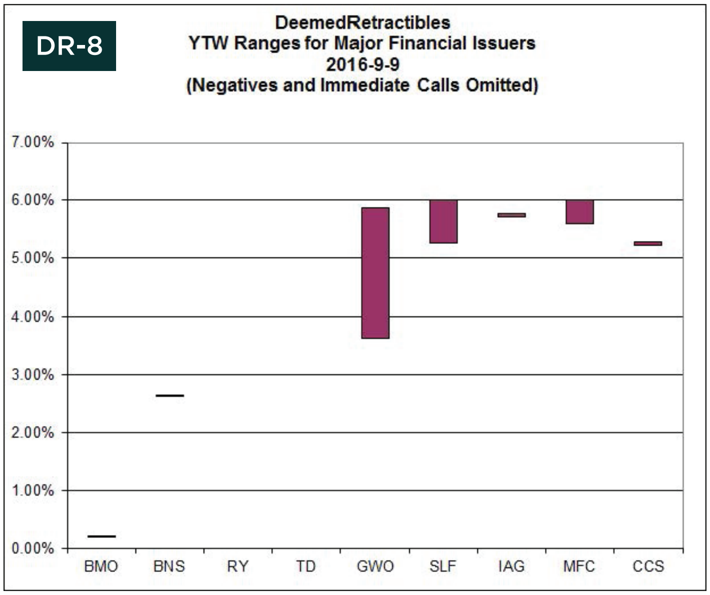
"Relationship lines" have been added to chart DR-6 to show the relationship between Current Yield and Price for two issues (the issues must be somewhere on their indicated line, by definition); for consistency with prior editions of this newsletter I am retaining the lines for two SLF issues although these have now been dropped from the "Pfd-1(low)" group. Note that if GWO.PR.I were to be priced like a bank issue, the price would increase from 21.74 to about 25.00.

Finally, Chart DR-8 shows the range of YTWs available in the DeemedRetractible sector, disaggregated by issuer.

[122] See my article "A Call, too, Harms" at http://www.himivest.com/media/advisor_0606.pdf







Recent Performance of DeemedRetractibles

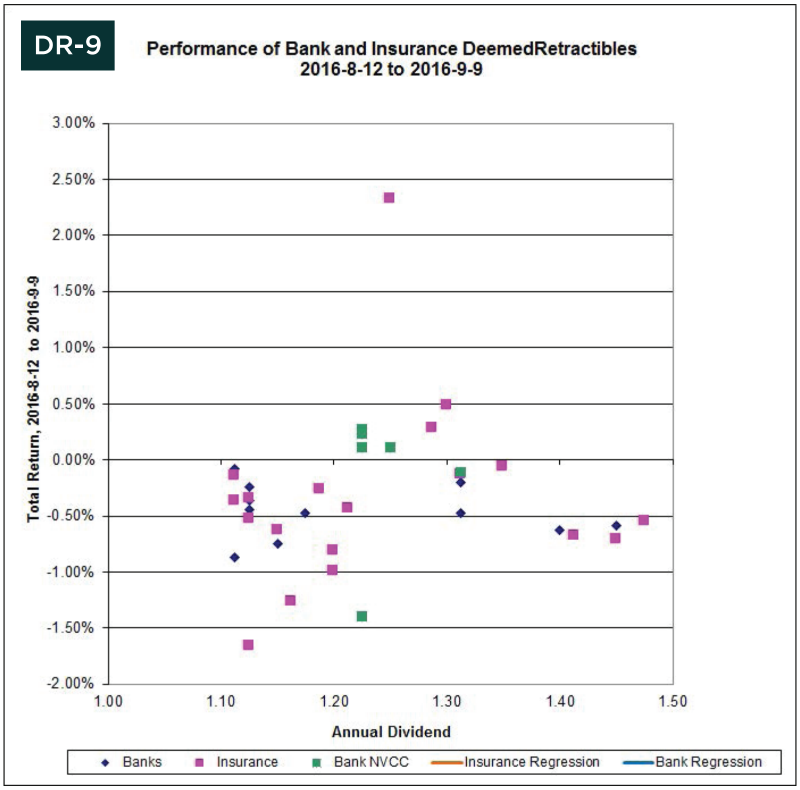
The difference in market perception of bank and insurance Deemed Retractibles is brought out in stark relief by a comparison of the performances of these two classes in the first stage of the 2013 downdraft, as was illustrated in Chart DR-3. The performance of Bank Deemed Retractibles was essentially independent of the coupon rate – the slight slope indicated by the chart is less than the error in this slope determined by regression. However, it is quite apparent that insurance Deemed Retractibles performed in a manner largely determined by their coupon rate, as will normally be the case when:

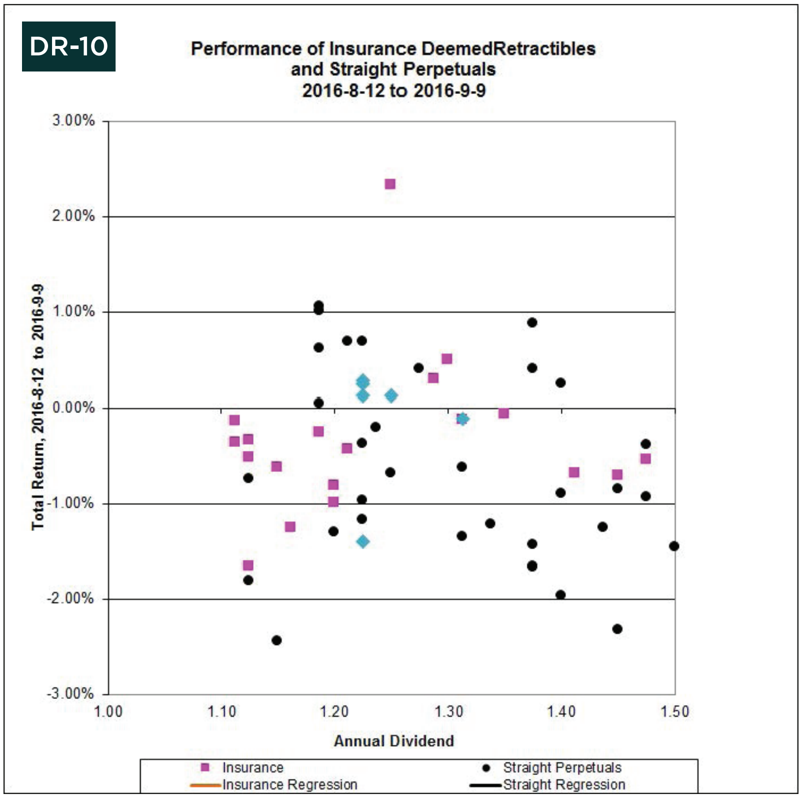
i) the coupon rate is sufficiently close to the market rate that the instruments will trade reasonably close to par

ii) differences in details of the call schedules are either negligible or are ignored by the market

iii) the market recognizes, in at least a qualitative manner, Black-Scholes option pricing theory, with a non-negligible level of Implied Volatility.

This month the market were flat to slightly down; insurance issues were not differentiated from bank issues (see Chart DR-9) or from non-regulated issues (see Chart DR-10). Correlations were were poor in all cases.


DR-9
Performance of Bank and Insurance DeemedRetractibles
2016-8-12 to 2016-9-9
Total Return, 2016-8-12 to 2016-9-9
3.00%
2.50%
2.00%
1.50%
1.00%
0.50%
0.00%
-0.50%
-1.00%
-1.50%
-2.00%
1.00
1.10
1.20
1.30
1.40
1.50
Annual Dividend
Banks
Insurance
Bank NVCC
Insurance Regression
Bank Regression


DR-10
Performance of Insurance DeemedRetractibles
and Straight Perpetuals
2016-8-12 to 2016-9-9
Total Return, 2016-8-12 to 2016-9-9
3.00%
2.00%
1.00%
0.00%
-1.00%
-2.00%
-3.00%
1.00
1.10
1.20
1.30
1.40
1.50
Annual Dividend
Insurance
Straight Perpetuals
Insurance Regression
Straight Regression

The Return of Implied Volatility

The noteworthy dependence of performance over the past while on the coupon rate suggests that Black-Scholes analysis of the relative pricing of these instruments has become possible, after a long hiatus in which there was such an overwhelming market feeling that all instruments would mature at par that the assumptions embedded in the theory became inoperable.

And, in fact, we do see that relative pricing is reasonably consistent with Black-Scholes theory, as determined by the spreadsheet previously made available to readers[123] and explained in the January, 2010, edition of this newsletter (which has recently been made public[124]); results for the series of Straight Perpetuals issued by PWF and GWO are shown in Charts DR-11 and DR-12, respectively, with details in Table DR-2.

The fitting of the data is very sensitive to outliers, but this month there is significant differentiation between the GWO and PWF series, as is shown by Chart DR-13, in which the GWO data is presented with the theoretical parameterization derived from the PWF data. The Sum of Squared Errors (with "error" defined as the difference between the calculated theoretical price and the actual price) is 0.76 in the GWO best fit and 2.09 when fitted to the PWF parameters – there is clearly a large difference between the two series this month.

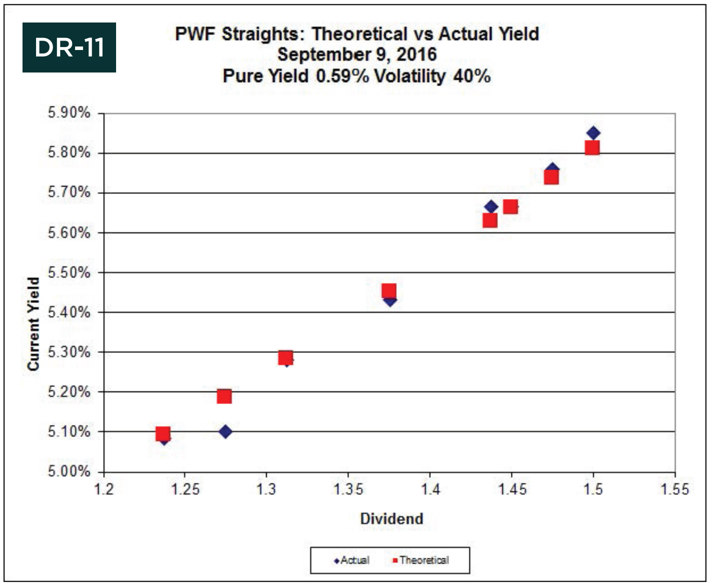
It is also noteworthy that the calculated Implied Volatility of the PWF series has exploded with this month's calculation – this suggests that directionality (towards par) has crept into market expectations of future PWF performance. As usual it has gone too far – as the market has gone up and prices have risen above par, people have forgotten that the market can also go down, at which point a healthy 'buffer' of excess coupon over market rates might well prove valuable.

Table DR-2: Results of Implied Volatility Analysis

Value	GWO	PWF
"Pure" Yield	4.38% (-0.52%)	0.59% (-4.22%)
Volatility	17% (+5%)	40% (+23%)
Years	3	3

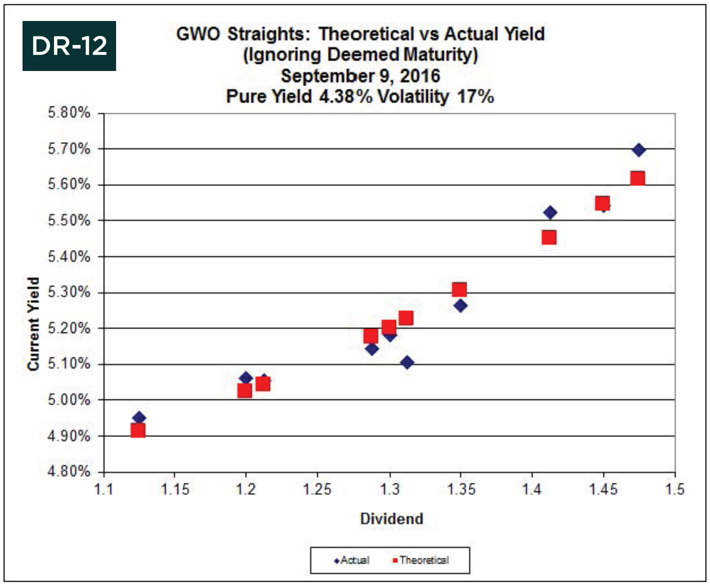
"Years" is a simplifying assumption; it is the number of years until all options are assumed to become exercisable at par.

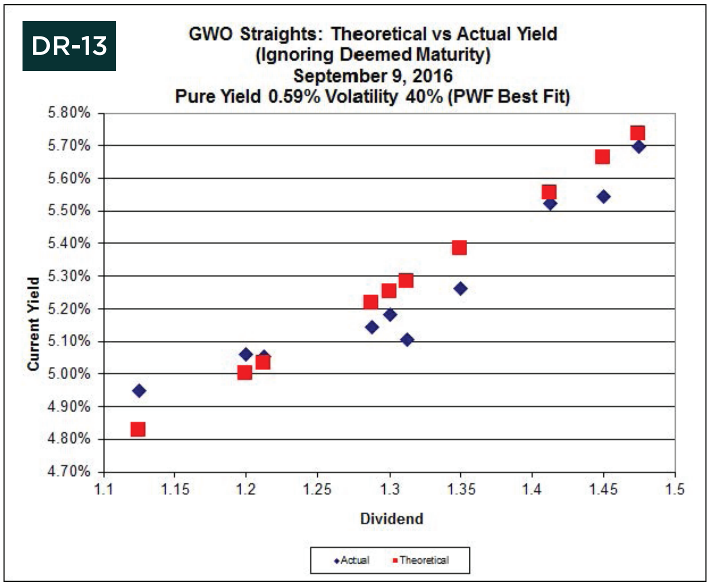
Bracketted figures indicate the change from the analysis performed with 2016-7-8 prices



[123] See spreadsheet at http://www.prefblog.com/xls/PDTheoreticalPricing.xls or the updated version incorporating tabs for FixedResets at http://www.prefblog.com/xls/ImpliedVolatility.xls

[124] See http://www.himivest.com/media/impliedVolatilityStraights.pdf


DR-12
GWO Straights: Theoretical vs Actual Yield
(Ignoring Deemed Maturity)
September 9, 2016
Pure Yield 4.38% Volatility 17%
Current Yield
5.80%
5.70%
5.60%
5.50%
5.40%
5.30%
5.20%
5.10%
5.00%
4.90%
4.80%
1.1
1.15
1.2
1.25
1.3
1.35
1.4
1.45
1.5
Dividend
Actual
Theoretical


DR-13
GWO Straights: Theoretical vs Actual Yield
(Ignoring Deemed Maturity)
September 9, 2016
Pure Yield 0.59% Volatility 40% (PWF Best Fit)
Current Yield
5.80%
5.70%
5.60%
5.50%
5.40%
5.30%
5.20%
5.10%
5.00%
4.90%
4.80%
4.70%
1.1
1.15
1.2
1.25
1.3
1.35
1.4
1.45
1.5
Dividend
Actual
Theoretical