

Notice relating to the eligibility of limited recourse capital notes as Tier 1 capital instruments other than Common Shares, Category B or Tier 1B capital instruments

Initially published on May 12, 2022; revised on June 29, 2023 to clarify the LRCN limitations applicable to P&C insurers.

Federally incorporated financial institutions first issued capital instruments called “Limited Recourse Capital Notes” (“LRCNs”) in 2020. Financial institutions subject to the laws of Québec might also consider issuing such notes. Consequently, and through its role, the Autorité des marchés financiers (the “AMF”) sets out in this notice its interpretation regarding the eligibility of LRCNs as Tier 1 capital instruments other than Common Shares, Category B or Tier 1B capital instruments (the “recognized instruments”).

The objective of this notice is to:

- Present the AMF’s main considerations in determining the eligibility of LRCNs as recognized instruments under the following guidelines (the “Capital Adequacy Requirements Guidelines”):
 - The *Capital Adequacy Requirements Guideline – Life and Health Insurance* (“CARLI”);
 - The *Guideline on Capital Adequacy Requirements – Property and Casualty Insurance* (“MCT”);
 - The *Capital Adequacy Guideline – Financial services cooperatives belonging to a network, credit unions not member of a federation, trust companies, savings companies and other authorized deposit institutions* (“DI Guideline”);
- Provide the AMF’s basis for evaluating the eligibility of LRCNs as recognized instruments;
- Outline the applicable rules limiting the recognition of LRCNs as recognized instruments.

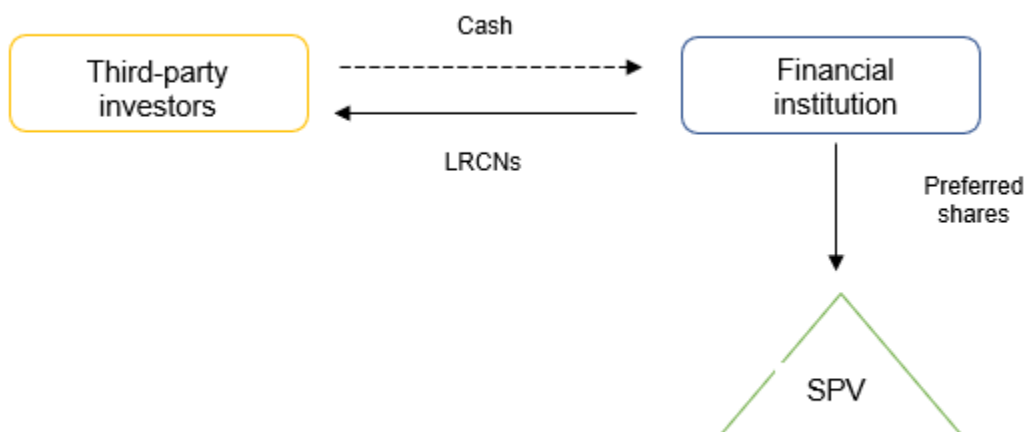
Scope

For the purposes of this notice, the evaluation concerns the structure of LRCNs already issued in the Canadian market and having the following features:

- The structure of LRCNs issued by a financial institution consists of two instruments:
 1. Deeply subordinated interest-bearing LRCNs¹ with a term to maturity of 60 years issued directly to third-party investors; and

¹ These notes are subordinated to policyholders or depositors, general creditors and subordinated debt holders of the financial institution.

2. Perpetual, non-cumulative preferred shares² issued to a special purpose vehicle (“SPV”) for the benefit of LRCN holders.



- In the event of the non-payment of principal or interest in cash on any interest payment date, upon an event of default,³ or at maturity, the sole recourse against the financial institution for the claims of LRCN holders will be the delivery of the preferred shares held by the SPV.
- Upon a non-viability trigger event, as described in Chapter 2 of the DI Guideline, occurring for a financial institution subject to those guidelines, the LRCN's principal, plus accrued and unpaid interest, will become due and payable. Upon non-payment of such principal and interest, LRCN holders will receive common shares of the financial institution issued upon conversion of the preferred shares held by the SPV.
- Redemptions or purchases of the LRCNs or underlying preferred shares by the issuing entity will be subject to prior approval by the AMF.

Main considerations in determining the eligibility of LRCNs as recognized instruments

In evaluating the eligibility of regulatory capital instruments as recognized instruments, the AMF will consider structures holistically. The AMF's approach to reviewing the eligibility of instruments, including the LRCN structure, will also emphasize economic substance over legal form.

Taking into account the foregoing considerations, the AMF will assess the LRCNs and the underlying securities held by the SPV both individually as well as in combination relative to the eligibility criteria set out in the Capital Adequacy Requirements Guidelines. The evaluation basis that will be used by the AMF on key interpretative questions is summarized below.

² Based on the criteria in the Capital Adequacy Requirements Guidelines.

³ The events of default for available capital or regulatory capital instruments issued by financial institutions are limited to liquidation, insolvency, wind-up and bankruptcy.

Issue 1: Does the financial institution's obligation to settle coupon payments in cash or, at its discretion, through the delivery of the SPV's underlying preferred shares comply with the Capital Adequacy Requirements Guidelines expectation that institutions must have full discretion to cancel payments and such cancellation of payments must not be an event of default or otherwise impose restrictions on the issuer?⁴

Yes. The LRCNs will be able to satisfy the criterion in question if the financial institution has full discretion to trigger the delivery of the preferred shares to the LRCN holders in lieu of making interest payments on the LRCNs and if, upon doing so, the LRCNs are cancelled. In this situation, foregone interest payments will then have to be cancelled, will not have to be cumulative and will not have to result in events of default or other restrictions.

Issue 2: Given the fixed maturity date of the LRCNs in year 60, do the LRCNs satisfy the Capital Adequacy Requirements Guidelines requirement that recognized instruments be perpetual?⁵

Yes. The LRCNs will be able to satisfy the criterion in question if LRCN noteholders' recourse is limited to perpetual Tier 1 or Tier 1B-qualifying instruments (financial institution preferred shares or common shares) in all circumstances, including at maturity of the notes in year 60. The AMF will be able to conclude that the LRCN structure is then perpetual based on its economic substance and consideration of the structure holistically rather than its component instruments.

Issue 3: Does the LRCN structure comply with the Capital Adequacy Requirements Guidelines requirement that recognized instruments must not embed incentives to redeem?⁶

Yes. However, the LRCNs must not constitute an incentive to redeem that would be contrary to the Capital Adequacy Requirements Guidelines. For example, the LRCNs will be able to satisfy the criterion in question if they do not include step-ups or call options that constitute an incentive for issuers to redeem the notes. In addition, the delivery of the preferred shares in exchange for the LRCNs under certain events must not be dilutive to the financial institution's shareholders' equity, a key consideration in assessing incentives to redeem for instruments with mandatory or holder-initiated conversions to common shares.

The AMF's evaluation

The AMF concludes that, if the LRCN structure meets all of the applicable eligibility criteria, the LRCNs will be eligible for recognition as:

- Tier 1 capital instruments other than Common Shares, under CARLI;
- Category B capital instruments, under the MCT; and
- Tier 1B capital, under the DI Guideline.

The considerations for this evaluation would also apply to instruments with equivalent terms and conditions that would not be characterized as LRCNs.

⁴ Refer to eligibility criterion 7 in CARLI section 2.1.1.2, Annex 2 of the TCM and section 2.1.1.2 of the DI Guideline.

⁵ Refer to eligibility criterion 4 in CARLI section 2.1.1.2, Annex 2 of the TCM and section 2.1.1.2 of the DI Guideline.

⁶ Refer to eligibility criterion 4 in CARLI section 2.1.1.2, Annex 2 of the TCM and section 2.1.1.2 of the DI Guideline.

Financial institutions wishing to obtain confirmation of the eligibility of prospective instruments as recognized instrument must seek it from the AMF prior to issuance. The AMF's confirmation will be based on the actual features of the instruments to be issued.

Moreover, recognition of the LRCNs will be subject to the following rules.

Limitations on investor base

1. The LRCNs can only be issued to institutional investors or, in the case of closely-held financial institutions, to affiliates.
2. The LRCNs can only be issued in minimum denominations of at least \$200,000 and integral multiples of \$1,000 in excess thereof.

Limitations on LRCNs' and preferred shares' terms and conditions⁷

3. LRCNs and preferred shares must have a minimum par or stated value of \$1,000 and be traded on institutional desks (i.e. not exchange-listed).
4. The LRCNs must have an initial term to maturity of at least 60 years.
5. In addition to any expectations set out under the AMF's Capital Adequacy Requirements Guidelines, including the prior approval of the AMF, unless the instrument has been replaced with an instrument of higher capital quality (i.e. common shares or retained earnings) or the financial institution demonstrates that its capital position will be well above the AMF's internal capital target ratio(s) or target capital requirements after the call option is exercised, the issuer will only be permitted to redeem the LRCNs or preferred shares where the carrying cost of the LRCNs or preferred shares exceeds the cost of replacement capital of equivalent quality (i.e. Additional Tier 1, Category A, Category B, or Tier 1 capital).

Limits on LRCN issuances

6. LRCN issuances will be subject to a limit, or "Cap", as measured on the date of issuance.⁸ In calculating this limit, the issuer should compare (i) the aggregate of its outstanding and proposed issuances of LRCNs on the date of issuance to (ii) the Cap. The limit should consider the capital available and the issuer's regulatory capital at the last reporting date with adjustments for subsequent transactions, including issuances, redemptions, buybacks, and acquisitions.
7. LRCNs issued in excess of the Cap may be counted towards a financial institution's Tier 2 capital instruments, Category C capital instruments or Tier 2 capital subject to any applicable Tier 2 capital composition limits. Such excess can be subsequently reallocated to Tier 1 capital instruments other than Common Shares, Category B capital instruments or Tier 1B capital when the financial institution has established capacity under its Cap.

⁷ For clarity, any provision under these conditions applicable to a "preferred share" also applies to any other instruments recognized by the AMF as Tier 1 capital instruments other than Common Shares, Category B capital instruments or Tier 1B capital.

⁸ Refer to the Appendix for the specific Caps applicable to each financial institution sector.

8. The Cap may be removed with the AMF's prior approval. In seeking this approval, a financial institution must demonstrate that it has issued to institutional investors preferred shares or other Tier 1 capital instruments other than Common Shares, Category B capital instruments or Tier 1B capital (other than LRCNs) targeted towards institutional investors that, in aggregate, are no less than the applicable limit, or Floor, set out in the Appendix. If the financial institution's outstanding capital instruments other than LRCNs issued to institutional investors were to subsequently drop below the Floor, the financial institution would not be permitted to issue additional LRCNs in excess of the Cap until it has re-established compliance with the Floor. The Floor will not apply where the LRCNs are issued exclusively to a financial institution's affiliates.

The AMF may add to, amend, or delete these limitations at any time. Limitations may also vary by issuer or issuance.

Disclosure

9. The disclosure and marketing of the LRCNs to investors must clearly disclose how the LRCNs' risks are equivalent to the risks of investing directly in the assets held by the SPV for the benefit of LRCN holders.

If you have any questions, please contact:

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Appendix – LRCN issuance limitations by financial institution sector

Note: For life and health insurers and P&C insurers, the following limitations supplement and are subject to the existing capital composition limits set out in CARLI and the MCT.

Financial institution sector	Available capital or regulatory capital treatment	LRCN issuance Cap	Floor
Life and health insurers	Tier 1 capital instruments other than Common Shares	Greater of: <ul style="list-style-type: none"> • \$150 million, or • 12.5% of Net Tier 1 capital 	5.0% of Net Tier 1 capital
P&C insurers	Category B capital instruments	Greater of: <ul style="list-style-type: none"> • \$150 million, or • 20% of available capital, excluding accumulated other comprehensive income 	8.0% of available capital, excluding accumulated other comprehensive income
Deposit institutions	Tier 1B capital	Greater of: <ul style="list-style-type: none"> • \$150 million • 0.75% RWA, or • 50% of the institution's aggregate net Tier 1B capital 	Lesser of: <ul style="list-style-type: none"> • 0.30% RWA, or • 20% of all the institution's aggregate net Tier 1B capital