Notes

1 The official text of the Brazilian Agreement, entered into 23 September 2014, is available online in English: www.treasury.gov/resource-center/tax-policy/treaties/Documents/FATCA-Agreement-Brazil-9-23-2014.pdf.

2 In reference to Article 11(2) of Law 9,311/1996.

3 All in reference to Articles 2, 3, 4, 5, 6, 7 and 9 of the Complementary Law 105/2001.

4 Jurisprudence of Brazilian Supreme Court (Superior Tribunal Federal – STF) consolidated by Extraordinary Appeal 389.808/PR, Tribunal Pleno, Min. Marco Aurélio, DJ. 12/15/2010, DJe-086 DIVULG 09-05-2011 PUBLIC 10-05-2011 EMENT VOL-02518-01 PP-00218.

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Emerging tools for bank resolution in Canada

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The 2007–2008 financial crisis illustrated the costs of public authorities propping up institutions deemed 'too big to fail' in order to avoid the significant adverse consequences of large bank failure. In response, financial regulators have sought to shift more of the risk of systemically important bank failure into the hands of private investors. Non-Viable Contingent Capital (NVCC) and bail-in debt are two instruments Canadian regulators are using to facilitate the conversion of non-common share securities in order to recapitalise a failing bank.

Contingent capital instruments are subordinated securities such as preferred shares and subordinated debt that convert to common shares under certain conditions. The conditions are set out in the contract governing the security, allowing investors to price the risk of conversion. Bail-in debt mirrors this structure in that senior debt instruments are subject to conversion under certain conditions. In both cases, defining the triggering event and determining the appropriate conversion formula is central to the pricing and effectiveness of these instruments.

Canadian banks have the oft-mentioned benefit of being well-capitalised and conservatively managed, traits that helped them weather the financial crisis relatively unscathed. However, Canada's financial regulators have embraced contingent capital measures nationally and advocated for them internationally. The impact of these regulatory reforms is very much up for debate as market participants, banking lawyers and regulators find a way forward.

This article discusses the structure and features of the NVCC and bail-in debt regimes with a particular focus on the Canadian experience to date.

Non-Viable Contingent Capital

In 2011, the Basel Committee on Banking Stability introduced the requirement that all new non-common share regulatory capital be subject to conversion. As such, Canada's primary banking regulator, the Office of the Superintendent of Financial Institutions (OSFI), has required that all non-common Tier 1 and Tier 2 capital instruments issued by deposit-taking institutions after 1 January 2013 include contractual provisions to permit their conversion into common shares at the point of non-viability. OSFI has elected to provide for conversion rather than write down NVCC instruments to maintain consistency with prevailing insolvency priorities.

NVCC conversion

OSFI requires that conversion clauses of NVCC instruments include, at minimum, two triggers. The first is a public statement made by OSFI that the bank is, or is about to be, non-viable. The second is the acceptance of provincial or federal government support, without which OSFI would have declared the bank non-viable. In both cases, the determination as to non-viability is made through a national committee of financial regulators. Coordination is required as efforts to maintain an institution will likely require additional actions outside of OSFI's powers.

The conversion of NVCC instruments would erase their relative priority in liquidation proceedings and significantly dilute the value of existing common shares. From an institutional perspective, conversion is beneficial because it reduces the bank's liabilities and removes leverage, in addition to recapitalising the bank. The issuer sets the conversion formula in the contract governing that instrument. The only OSFI requirement regarding conversion formulas is that they reflect the hierarchy of the former securities in liquidation; that is, subordinated debt holders must receive more favourable economic entitlements than former preferred shareholders.

NVCC clauses align the interests of investors and regulators to the extent that they encourage support for more cautious capital management approaches. However, pre-set conversion formulas can create perverse incentives. An institution could be pushed to non-viability if recapitalisation on the open market becomes near impossible as short-sellers push down the price of common shares and acquire NVCC or bail-in instruments in anticipation of conversion. Concerns about such a 'death spiral' were likely a factor in the one-year delay Canadian banks took before issuing NVCC instruments after their introduction in 2013.

The market has embraced NVCC instruments

Two years after NVCC became mandatory, investors have shown strong demand for NVCC instruments issued by Canadian banks. Though 2013 was silent as issuers considered how to structure their offerings, NVCC instruments arrived in 2014 to strong demand. By October 2014, ten issues of preferred share had gone ahead for a total of C$4.5 billion and four subordinated NVCC bond issues have yielded C$4 billion.

Under the conversion formulas adopted so far, the number of common shares received by holders of preferred shares is equal to the value of the preferred shares divided by the market price of common shares, subject to a five dollar floor price. The value of preferred shares is defined as issue price plus declared and undistributed dividends. NVCC bonds use essentially the same formula, with necessary adjustments for par value and accrued and unpaid interest, but benefit from a multiplier of 1.5 to inflate their entitlement in recognition of their superior position in liquidation. To date, investors have not balked at the conversion risk posed by NVCC instruments. The estimated premium on preferred shares relative to a similar non-NVCC instrument has been only ten to 30 basis points.

The proposed bail-in regime

In August 2014, the Department of Finance released for comment its proposed bail-in debt regime. The Taxpayer Protection Plan (TPP) calls for a statutory power to convert some or all of a bank's long-term unsecured debt into common shares if NVCC conversion proves insufficient to recapitalise the affected institution. It would apply only to Canada's six Domestic Systemically Important Banks[2] (D-SIBs).

The TPP would apply to securities issued, originated or renegotiated after the implementation date, which has not yet been set, and include non-NVCC preferred shares or subordinated debt as well as long-term senior debt. Long-term senior debt means unsecured debt that is tradable and transferable with an original term to maturity of more than 400 days.

Canada is in line with jurisdictions such as the EU, UK, and US, which have either implemented or are in the process of implementing bail-in regimes. Similarly, the Financial Stability Board[3] is pushing a total loss absorbing capacity requirement on some of the largest global banks, which will likely have to undertake significant capitalisation efforts to meet the requirements.

It is worth noting that the bail-in regime is being developed by the Department of Finance, rather than OSFI, as it is not a bank capital programme.

Conversion of long-term senior debt

The TPP creates a statutory power, in contrast to contractual conditions in the NVCC. It would give the Canadian Deposit Insurance Corporation (CDIC) the power to convert some or all of a D-SIB's long-term senior unsecured debt into common shares, and even cancel existing shares. The TPP is intended to complement the CDIC's existing powers under the depositors' insurance scheme generally and the bank resolution framework more specifically.

The proposed statutory power would allow CDIC a measure of discretion regarding the bail-in. The proposal sets out two conditions that must be met prior to a bail-in: an OSFI declaration of non-viability and complete conversion of outstanding NVCC instruments. CDIC would then have discretion to convert bail-in debt in whatever proportion it deemed appropriate, on a pro rata basis.

The conversion factor is designed to ensure that priority in liquidation is respected and bailed-in securities receive more than the NVCC instruments that preceded them. The proposed conversion formula calls for a set multiple, currently estimated at 1.1–2.0, of the most favourable conversion formula among the bank's NVCC instruments, applied to each dollar of par value of the instrument. This approach provides some predictability to the market and respects the priority of senior debt holders by granting them more favourable treatment relative to the lower-ranking NVCC instruments. Additionally, the proposal would see compensation provided under the Canada Deposit Insurance Corporation Act for creditors or shareholders who are made worse off than they would have been under liquidation, unless they specifically agreed to conversion as a contractual term of the security.

Higher Loss Absorbency Requirement

The TPP also proposes to introduce a Higher Loss Absorbency (HLA) requirement for D-SIBs to further insulate bank failure from public funds. The proposal suggests banks would have to hold a mix of regulatory capital and bail-in eligible debt equal to an as yet undetermined figure within the range of 17–23 per cent of risk-weighted assets. That figure exceeds the D-SIB total regulatory capital requirements under OSFI's Capital Adequacy Requirements by at least 5.5 per cent, with the possibility of higher requirements for specific banks.

Though the full details of the bail-in regime are not expected until mid-2015, banks have begun loading up on capital in light of the impending requirements. Analysts have suggested that meeting the HLA could require Canadian banks to hold twice as much capital as they did prior to the financial crisis.

The challenge going forward

The full legal and business implications of regulators' push to impose the risk of bank failure on private investors is still to be determined. Some are sceptical about the willingness and ability of regulators to actually trigger conversion of these instruments in the event of impending bank failure, given the significant consequences on confidence in financial securities.

One consequence of this uncertainty is resistance to including NVCC and bail-in instruments in indexes, skewing market views and demand. We cannot know until an institution becomes non-viable, which will hopefully not be anytime soon. In the interim, the Canadian experience to date has demonstrated that the cost to well-regarded stable institutions of issuing these contingent securities, while not insignificant, may not be that high. These considerations will be front of mind as the bail-in regime continues to be developed in Canada and in other jurisdictions as the FSB rolls out global bail-in requirements to some of the largest banks in the world.

Notes

1 This paper builds on an earlier paper written by Eric Belli-Bivar, 'Implementation of Basel III in Canada' (November 2014; available online at www.davis.ca).

2 OSFI has designated the following six Canadian banks as D-SIBs: Bank of Montreal, Bank of Nova Scotia, Canadian Imperial Bank of Commerce, National Bank, Royal Bank, and Toronto-Dominion Bank.

3 The Financial Stability Board, currently chaired by former Bank of Canada Governor Mark Carney, is comprised of economic regulators from 25 member states and ten international economic organisations. It was created in 2009 as a more inclusive successor of the Financial Stability Forum and, like the BCBS, is hosted at the Bank for International Settlements in Basel.