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Canada publishes bail-in regulations

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Background

The 2008 global financial crisis has led a number of governments (especially members of G20) to pass financial regulations over the last few years as part of their reform agenda. An important part of this agenda is to address the potential risks to the financial system and broad economy of institutions perceived as "too big to fail." One of the tools adopted by the G20 members to address this risk is "bail-in" – i.e., the power for domestic authorities to convert some of a failed bank's debt into equity to recapitalize the bank, absorb losses, and help restore it to viability without relying on government bailouts.

Canada, as an active participant in the G20's financial reform agenda, had previously announced its intention to adopt regulations to implement a bail-in regime and apply it to Canada's domestic systemically important (D-SIB) banks (Canada's six largest banks were named as systemically important by the Office of the Superintendent of Financial Institutions (OSFI) in 2013).

In 2014, the Canadian government issued a consultation paper announcing its intention to implement a bail-in regime in Canada. In its 2016 budget, the Canadian government announced a legislative framework for the bail-in regime via amendments to the *Bank Act* and *Canada Deposit Insurance Corporation Act* (CDIC Act) (see our May 2016 Osler Update which discusses the bail-in regime). Although the 2016 amendments to the *Bank Act* and CDIC Act established the bail-in legislative framework, they left the details of the bail-in regime to be implemented through regulations.

On June 16, 2017, the Canadian federal government published its bail-in regulations for comments. In connection with this publication (and also on June 16), the OSFI released for comment a draft guideline on Total Loss Absorbing Capacity (TLAC). OSFI's draft guideline will apply to D-SIBs as part of the federal government's bail-in regime and will require D-SIBs to maintain sufficient TLAC (i.e., capital plus debt convertible into equity under the

recapitalization regime) in line with internationally established TLAC standards.

Proposed bail-in regulations

The bail-in regulations are divided into three separate regulations:

- Under the CDIC Act, the proposed *Bank Recapitalization (Bail-in) Conversion Regulations* (the Bail-in Scope and Conversion Regulations) set out the scope of liabilities of D-SIBs that would be eligible for a bail-in conversion and conversion terms if a bail-in were to be executed.
- Under the *Bank Act*, the proposed *Bank Recapitalization (Bail-in) Issuance Regulations* (the Bail-in Issuance Regulations) set out requirements that D-SIBs would have to follow when issuing bail-in eligible securities.
- Under the CDIC Act, the proposed *Compensation Regulations* set out an updated process for providing compensation to shareholders and creditors if they are made worse off as a result of CDIC's actions to resolve the institution (including through bail-in) than they would have been if the institution were liquidated.

The Bail-in Scope and Conversion Regulations and the Bail-in Issuance Regulations apply only to D-SIBs; however, the Compensation Regulations apply to all CDIC federal member institutions.

Key takeaways

When compared to the government's previously announced guidance on Canada's bail-in regime, the proposed regulations do not contain any surprises. However, the following points are particularly noteworthy:

- **Not retroactive**: The bail-in power would not be retroactive. The proposed regulations would apply only to instruments that are issued, or amended to increase their principal value or extend their term, after the regulations come into force.
- **Scope**: The scope for the bail-in power is consistent with the government's 2014 consultation paper on a proposed bail-in regime: namely, long-term (400 or more days), unsecured senior debt that is tradable and transferable. All newly issued instruments that have these features would be eligible for a bail-in conversion. An instrument is considered tradable and transferable if it has a Committee on Uniform Securities Identification Procedures (CUSIP) number, International Securities Identification Number (ISIN) or other similar identification.
- **TLAC guideline and terms of bail-in liabilities**: OSFI's TLAC guideline sets out a number of eligibility criteria that must be met for bail-in debt to qualify under the TLAC guideline (e.g., restrictions on acceleration rights, restrictions on redemption rights, etc.). Although the proposed regulations do not directly touch on these points, as a practical matter, we expect that any bail-in debt issued by banks would have to meet the requirements of TLAC guideline.
- **Exclusions:** The bail-in regime does not apply to deposits (e.g. chequing accounts, savings

accounts and Guaranteed Investment Certificates), secured liabilities (e.g. covered bonds), eligible financial contracts (e.g. derivatives) or structured notes. Structured notes are debt obligations whose returns may be based on, among other things, the performance of equity indexes, a single equity security, a basket of equity securities, interest rates, commodities, and/or foreign currencies.

- **Conversion:** The proposed regulations do not include a fixed conversion multiplier. Instead, they provide CDIC with discretion to determine the conversion rate within the parameters set out in the proposed regulations. This discretion is intended to (i) provide flexibility for CDIC to set appropriate conversion terms based on the circumstances, (ii) mitigate concerns related to arbitrage trading, and (iii) be more consistent with approaches to bail-in taken in other jurisdictions (e.g. the United States, Switzerland and the European Union). The parameters relating to conversion include the following:
  - Adequate recapitalization — CDIC must take into consideration the requirement in the *Bank Act* for banks to maintain adequate capital.
  - Order of conversion — bail-in eligible instruments can be converted only after all subordinate ranking bail-in eligible instruments and non-viability contingent capital (NVCC) have been converted.
  - Treatment of equally ranking instruments — equally ranking bail-in eligible instruments must be converted in the same proportion (pro rata) and receive the same number of common shares per dollar of the claim that is converted.
  - Relative creditor hierarchy — holders of bail-in eligible instruments must receive more common shares per dollar of the claim that is converted than holders of subordinate ranking bail-in eligible instruments and NVCC that have been converted.

The government has indicated that the Governor in Council and CDIC would also be able to ensure that senior bail-in debt holders are better off than holders of legacy capital instruments (i.e., those that are not NVCC and which would not be eligible for conversion under the bail-in power). For example, resolution actions could result in holders of legacy capital instruments incurring losses where those instruments are vested in CDIC by the Governor in Council under the CDIC Act.

- **Contractual terms:** To facilitate enforceability of the bail-in power, shares and liabilities within the scope of bail-in must indicate in their contractual terms that the holder of the instrument is bound by the application of the CDIC Act, including the conversion of the instrument into common shares under the bail-in power. These new contractual terms must be governed by Canadian law, even where the rest of the contract is governed by foreign law.
- **Disclosure to investors:** The proposed regulations require disclosure to investors that an instrument is eligible for a bail-in conversion in the prospectus or other relevant offering or disclosure document.
- **Possible inclusion of certain preferred shares and subordinated debt**: Newly issued preferred shares and subordinated debt would also be eligible for bail-in, if they are not NVCC. We do not expect that such instruments would ordinarily be issued given that banks would not obtain capital treatment for such instruments. NVCC instruments are not included in the bail-in scope because they are already convertible into common shares

under their terms.

- **Effective date:** The proposed Bail-in Scope and Conversion Regulations and Bail-in Issuance Regulations would come into force 180 days after the day on which they are registered (we expect these regulations to be registered before the end of 2017). The proposed Compensation Regulations are drafted to come into force on January 1, 2018, but if they are registered after that day, they would come into force on the day on which they are registered.

Bail-in process

Based on the proposed regulations, the bail-in process for a non-viable bank can be summarized as follows:

- **Determination by Superintendent and Governor in Council approval**: The use of the bail-in conversion tool would require (i) a determination by the Superintendent of Financial Institutions (Superintendent) that the bank has ceased, or is about to cease, to be viable, and (ii) Governor in Council approval, on the recommendation of the Minister of Finance, for CDIC to take temporary control or ownership of the non-viable bank and carry out a bail-in conversion.
- **CDIC taking control**: CDIC would take temporary control or ownership of the non-viable bank. CDIC would execute a bail-in conversion to recapitalize the bank, and undertake any other restructuring measures necessary to restore the bank to viability (e.g. selling off troubled assets or subsidiaries).
- **Return to private control**: After the completion of the bail-in conversion and other necessary restructuring measures, CDIC would return the bank to private control. The return to private control must happen within one year, although the Governor in Council may extend this time frame up to a maximum total period of five years.
- **Offer of compensation**: Following the resolution, CDIC would make an offer of compensation to the relevant shareholders and creditors, if they have been made worse off as a result of CDIC's actions than they would have been if the institution had been liquidated. CDIC's offer would be reviewed by a third-party assessor that is appointed by the Governor in Council if persons who hold 10% of the value of a given class of shares or debt object to CDIC's offer. The assessor's own determination of compensation owed would be final and conclusive. The appointed third-party assessor is required to be a federal judge.

TLAC guideline

- **Background**: Upon its coming into force, subsection 485(1.1) of the *Bank Act* will require D-SIBs to maintain a minimum capacity to absorb losses. The purpose of the TLAC requirement is to provide a non-viable D-SIB with sufficient loss absorbing capacity to support its recapitalization. In connection with the TLAC requirements, the Superintendent will establish two minimum standards: (i) the risk-based TLAC ratio, which builds on the risk-based capital ratios described in the OSFI's Capital Adequacy Requirement (CAR)

guideline; and (ii) the TLAC Leverage Ratio, which builds on the Basel III Leverage Ratio described in OSFI's Leverage Requirements guideline.

- **Effective date**: Beginning in fiscal Q1-2022 (i.e., November 1, 2021), D-SIBs will be expected to maintain a minimum risk-based TLAC ratio of at least 21.5% of risk-weighted assets and a minimum TLAC Leverage ratio of at least 6.75%. The Superintendent may subsequently vary the minimum TLAC requirements for individual D-SIBs or groups of D-SIBs. D-SIBs will also be expected to hold buffers above the minimum TLAC ratios.
- **Composition of TLAC**: The following are eligible to be recognized as TLAC:
  - Tier 1 capital, consisting of:
    - Common Equity Tier 1 capital;
    - Additional Tier 1 capital;
  - Tier 2 capital; and
  - prescribed shares and liabilities (Other TLAC Instruments) that are subject to conversion – in whole or in part – into common shares under the CDIC Act and meet all of the eligibility criteria set out in this guideline.
- **Eligibility criteria for Tier 1 and Tier 2**: The criteria for the capital elements comprising Tier 1 and Tier 2 capital, as well as the various limits, restrictions and regulatory adjustments to which they are subject, are described in OSFI's CAR guideline.
- **Eligibility Criteria for Other TLAC Instruments:** The criteria for Other TLAC Instruments to qualify as TLAC include the following:
  - The instrument is subject to a permanent conversion under the CDIC Act (where the instrument is governed by foreign laws, the D-SIB should provide evidence that there are no impediments to the application of Canadian statutory bail-in powers under the foreign law or within the terms of the instrument).
  - The instrument is directly issued by the Canadian parent bank (indirect issuances by subsidiaries or through special purpose vehicles will not be eligible as TLAC).
  - The instrument satisfies all of the requirements set out in the Bail-in Issuance Regulations.
  - The instrument must be issued and paid for in cash or, with the prior approval of the Superintendent, in property.
  - Neither the institution nor a related party over which the institution exercises control or significant influence can have purchased the instrument, nor can the institution directly or indirectly have funded the purchase of the instrument.
  - The instrument is neither fully secured at the time of issuance nor covered by a guarantee of the issuer or related party or other arrangement that legally or economically enhances the seniority of the claim vis-à-vis the institution's depositors and/or other general creditors.
  - The instrument is not subject to set-off or netting rights.
  - Except as provided below, the instrument must not provide the holder with rights to accelerate repayment of principal or interest payments outside of bankruptcy, insolvency, wind-up or liquidation. Events of default relating to the non-payment of scheduled principal and/or interest payments will be permitted where they are subject

to a cure period of no less than 30 business days and clearly disclose to investors that: (i) acceleration is only permitted where an order has not been made pursuant to subsection 39.13(1) of the CDIC Act in respect of the institution; and that (ii) notwithstanding any acceleration, the instrument continues to be subject to bail-in prior to its repayment.

- The instrument is perpetual or has a residual maturity in excess of 365 days (where the instrument has a step-up or other incentive to redeem, the instrument is deemed to mature on the date on which the incentive to redeem becomes effective. For such instruments, the residual maturity would be measured with reference to the effective date of the incentive to redeem rather than the contractual maturity date).
- The instrument can be called or purchased for cancellation at the initiative of the issuer only and, where the redemption or purchase would lead to a breach of the D-SIB's minimum TLAC requirements, with the prior approval of the Superintendent.
- The instrument does not have credit-sensitive dividend or coupon features that are reset periodically based in whole or in part on the institution's credit standing.
- Where an amendment or variance of the instrument's terms and conditions would affect its recognition as TLAC, such amendment or variance will only be permitted with the prior approval of the Superintendent.

Tax implications

The issuance of bail-in eligible instruments by banks may raise tax implications both for issuers and investors. These issues should be carefully considered in the context of structuring, issuing or purchasing such instruments.

Deadline for comments

The deadline for submitting comments on the draft bail-in regulations and the draft TLCA guideline is July 17, 2017.