TLAC and Bail-in Capital: A “Worthwhile Canadian Initiative”

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Peter E. Hamilton

- Draft regulations implementing Canada’s “bail-in” solvency support regime for banks came into effect on September 23, 2018.
- The bail-in regime essentially requires that banks maintain “embedded contingent capital” in the form of bonds that convert automatically to equity in the event that the issuing bank has ceased or is about to cease to be viable.
- Key to the regime is the concept of “total loss-absorbing capacity”, or TLAC, which is the amount of embedded contingent capital that a bank will now be required to maintain (on a consolidated basis).
- As discussed below, many issues arise with respect to the new regime, including the determination of which shares and liabilities are eligible for bail-in, the conditions for conversion, creditors’ resolution rights, securities law implications for senior bank debt, and others.

Context

In an April 2010 letter to the *Financial Times*, Julie Dickson, then the Superintendent of Financial Institutions, proposed that banks should be required to maintain, in addition to their conventional capital, additional solvency support in the form of what she termed **“embedded contingent capital”**. This embedded contingent capital would take the form of bonds that would function as debt in ordinary circumstances, but which would be automatically be converted into equity in circumstances in which the issuing bank was “in serious trouble”.

Superintendent Dickson’s hope was that an effective embedded contingent capital regime could avoid the need for a taxpayer funded bail-out, and, even if a bail-out could not be avoided, would lessen the demand for taxpayer funds. The regime might also increase market discipline by reversing the presumption that “too big to fail” banks and their creditors would inevitably benefit from a government bail-out were such banks to become distressed.

Embedded contingent capital later came to be referred to as **“bail-in” debt,** presumably on the basis that it operated as an alternative to a bail-out. The amount of embedded contingent capital which a bank would be required to maintain came to be referred to as its **“total loss-absorbing capacity”** or **TLAC**.

Development of the Bail-in Regime

A bail-in regime was first formally proposed in Canada in the Federal Government's 2013 budget, as part of a risk management framework for systemically important banks. This regime was described as one "designed to ensure that, in the unlikely event that a systemically important bank depletes its capital, the bank can be recapitalized and returned to viability through the very rapid conversion of certain bank liabilities into regulatory capital".

The path to full implementation of the bail-in regime included the following milestones:

- On March 16, 2013, OSFI designated the six largest Canadian banks as domestic systemically important banks or D-SIBs. (On November 21, 2017, RBC was designated as the first Canadian G-SIB).
- In 2014, the Department of Finance published a consultation paper outlining a proposed bail-in regime. The proposed regime was stated to be intended to reduce the likelihood of a failure of a systematically important bank and the "unacceptable costs to the economy" that would result from such a failure. The proposed regime was also intended to reduce taxpayer exposure to loss in the event of a bank failure.
- In 2016, federal legislation to implement a total loss-absorbing capacity (TLAC) requirement and a bail-in capital regime was included in the *Budget Implementation Act*. That Act also included major amendments to the resolution regime for all deposit-taking banks under the *Canada Deposit Insurance Corporation Act* (the "CDIC Act").
- In June of 2017, the Department of Finance published, for comment, three draft regulations which were intended to implement the bail-in regime. Simultaneously, OSFI published a proposed capital guideline imposing a TLAC requirement.
- The final regulations were published in the *Canada Gazette* on April 18, 2018. They consist of *The Bank Recapitalization (Bail-in) Issuance Regulations* (the "Issuance Regulations"), adopted pursuant to the *Bank Act*, the *Bank Recapitalization (Bail-in) Conversion Regulations* (the "Conversion Regulations"), adopted pursuant to the CDIC Act and the *Compensation Regulations* (the "Compensation Regulations"), also adopted pursuant to the CDIC Act. On the same day, OSFI published the final TLAC guideline (the "OSFI TLAC Guideline").
- The regulations came into force on September 23, 2018 (the 180th day after the date of their registration).

The concept of embedded contingent capital has evolved from what then Superintendent Dickson proposed in 2010. However, both the legislation and the proposed regulations are broadly consistent with what was proposed in the Department of Finance 2014 consultation paper.

The proposed bail-in regime and TLAC are also broadly consistent with the Financial Stability Board's "Key Attributes of Effective Resolution Regimes for Financial Institutions" and "Principles on Loss-Absorbing and Recapitalisation Capacity of G-SIBs in Resolution Total Loss-Absorbing Capacity (TLAC) Term Sheet".

Understanding TLAC

Section 485 (1.1) of the *Bank Act* requires that D-SIBs maintain a total loss absorption capacity or TLAC as established by the Superintendent of Financial Institutions.

The OSFI TLAC Guideline establishes, and provides for the definition of, two TLAC measures

- A risk based TLAC ratio - which builds upon the Basel III risk weighted assets framework, as implemented in Canada in the Capital Adequacy Requirements ("CAR") guideline; and
- A leverage based TLAC ratio - which builds upon the Basel III leverage framework, again as implemented in Canada in the CAR guideline.

The risk based TLAC ratio will be calculated as:

The TLAC measure
Risk weighted assets

The leverage based TLAC ratio will be calculated as:

The TLAC measure
Exposure measure

These TLAC requirements will apply to all banks designated by the Superintendent as D-SIBs.

These measures will apply on a consolidated basis. The consolidated entity for this purpose will include all subsidiaries of the D-SIB other than insurance subsidiaries. This is consistent with the approach to consolidation for other regulatory capital purposes.

On August 21, 2018, OSFI announced that the Superintendent had issued orders to each D-SIB requiring that they maintain:

- A minimum risk based TLAC ratio at least 21.5%;
- A minimum leverage based TLAC ratio of at least 6.75%.

For purposes of both calculations, the TLAC Measure will be equal to the sum of:

- Tier 1 Capital, consisting of CET 1 and AT 1;
- Tier 2 Capital;
- Prescribed shares and liabilities ("other TLAC Instruments") that are subject to conversion into common share pursuant to Section 39.2 (2.3) of the CDIC Act and which meet all of the eligibility criteria set out in the TLAC guideline.

There are a couple of additional adjustments to the capital rules for purposes of the inclusion of capital elements in TLAC calculations:

- Capital instruments issued out of subsidiaries after December 31, 2021 will not be recognized for TLAC, but may still be counted for conventional capital purposes;
- Regulatory capital instruments issued indirectly by a wholly- and directly-owned funding entity or via a special purpose vehicle after December 31, 2021, will not be recognized for TLAC purposes but may still be counted for conventional capital purposes;
- Tier 2 instruments subject to amortization for conventional capital purposes may be fully recognized for TLAC purposes so long as residual maturity is at least 365 days.

In order for an "other TLAC Instrument" to count towards the TLAC requirement, the "other TLAC Instrument":

- Must be subject to permanent conversion into common equity under Section 39.2 (2.3) of the CDIC Act and the Conversion Regulations;
- Must be directly issued by the D-SIB, indirect issuances by subsidiaries or SPVs will not qualify;
- Must satisfy all of the requirements set out in the Bank Recapitalization (Bail-in) Issuance Regulations;
- Must be paid for in cash or, with the prior approval of the Superintendent, in property;

- Must not have been purchased as principal by the bank nor by a related party over which the bank exercises control or significant influence except for purposes of re-sale (and where purchased for re-sale such instrument has been re-sold), nor can the bank directly or indirectly have provided financing to any person for the express purpose of investing in the instrument;
- Must have only limited acceleration rights, with a 30 day cure period for payment defaults;
- Must be 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 bank's depositors and/or other general creditors;
- Must not be subject to set-off or netting;
- Must have no incentive to redeem;
- Must be perpetual or have a residual term to maturity in excess of 365 days; and
- Must have no credit-sensitive coupon or dividend feature.

Where an amendment to 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.

Where the instrument is governed by foreign law, the D-SIB is required to provide an external legal opinion addressed to OSFI, confirming that the instrument is effectively subject to the conversion power.

Public disclosure of a D-SIB's TLAC ratio will begin for the reporting period ending January 31, 2019.

Instruments which have a step-up feature or other incentive to redeem are deemed to mature on the date the incentive to redeem becomes effective.

Note that being subject to bail-in under Section 39.2(2.3) of the CDIC Act and the Conversion Regulations is a necessary but not a sufficient condition to TLAC recognition and certain instruments subject to bail-in will not be recognized as TLAC eligible.

Bank Recapitalization (Bail-in) Regulations: Eligibility for Bail-in

The *Conversion Regulations* define the shares and liabilities which are subject to bail-in. These include the following:

- Any debt obligation - other than subordinated indebtedness, that is issued by a D-SIB and:

    - is perpetual, or has an initial term to maturity of at least 400 days or has unexercised options when if exercised would result in a term of 400 days – the expression of the test differs depending on whether it is an issuer or holder option;
    - is unsecured or only partially secured (if partially secured only the non-secured portion is subject to bail-in); and
    - has been assigned a CUSIP, ISIN or other similar number to facilitate trading; and

- Any share or subordinated debt which is not a common share and which is not subject to the NVCC rules (as a practical matter, most if not all new preferred share and subordinated debt issuances will be subject to the NVCC rules.

Shares and liabilities are subject to bail-in only if they are issued after the date the regulations come into force or unless after that date they are amended to increase the principal amount or increase its term to maturity;

The following instruments are excluded from the definition of a “prescribed share or liability", and are therefore not subject to bail-in:

- Covered bonds as defined in Section 21.5 of the *National Housing Act*;
- Eligible financial contracts as defined in Section 39.15 of the CDIC Act;
- Structured notes defined as an obligation whose stated term to maturity, or a payment to be made by its issuer, is determined in whole or in part by a value or price, index or other embedded derivative;
- Any conversion or exchange privilege that is convertible at any time into shares;
- Options or rights to acquire shares;
- Shares issued pursuant to the exercise prior of a conversion right that existed prior to 2013.

The following debt obligations are deemed not to be structured notes:

- A debt obligation in respect of which the stated term to maturity, or a payment to be made by its issuer, is determined in whole or principally by reference to the performance of a security of that issuer; and
- A debt obligation that:
    - specifies that the return on the debt obligation is determined by a fixed or floating interest rate or a fixed spread above or below a fixed or floating interest rate, regardless of whether the return is subject to a minimum interest rate or whether the interest rate changes between fixed and floating;
    - has no other terms affecting the stated term to maturity or the return on the debt obligation, with the exception of the right of the issuer to redeem the debt obligation or the right of the holder or issuer to extend its term to maturity; and
    - is payable in cash.

Bank Recapitalization (Bail-in) Regulations: Conditions for Conversions

The Conversion Regulations also provide for the circumstances in which a conversion may be triggered.

Conversion is triggered by a determination by OSFI that a bank has ceased, or is about to cease, to be viable and the viability of the bank cannot be restored or preserved by the exercise of the Superintendent's general supervisory powers under the *Bank Act*.

In that event, the Governor in Council may, on the recommendation of the Minister made under Section 39.12 of the CDIC Act, make one or more of the following orders under Section 39.13 of the CDIC Act:

- An order vesting in the CDIC the shares and subordinated debt of the bank;
- An order appointing the CDIC as receiver in respect of the bank;
- An order directing the Minister of Finance to incorporate a bridge institution; and/or
- An order directing the CDIC to carry out a conversion of bail-in debt under Section 39.2(2.3) of the CDIC Act.

In the event a conversion is ordered, the CDIC is directed to use best efforts to insure that the bail-in happens after, or at the same time as, the conversion of all NVCC instruments.

There is flexibility around both the amount of bail-in debt to be converted and the terms of the conversion. There is, however, a requirement to respect relative (but not absolute) priority;

- Prior ranking instruments should receive a greater number of common shares per dollar of the converted part of their liquidation entitlement than subordinate instruments;
- Instruments of the same rank should be converted pro rata and must receive the same number of common shares per dollar of the converted part of their liquidation entitlement;
- Bail-in debt is to be treated at least as favorably as NVCC instruments of equal rank.

Bank Recapitalization (Bail-in) Issuance Regulations

The Issuance Regulations provide for the requirements which a D-SIB must meet at the time it issues a bail-in debt or share instrument.

- Each debt instrument subject to bail-in is required to include:
  - a contractual submission to the operation of the conversion in Section 39.2 (2.3) of the CDIC Act;
  - an attornment to Canadian jurisdiction for purposes of Section 39.2 (2.3) of the CDIC Act;
- The attornment and contractual submissions to jurisdiction are required to be effective notwithstanding any foreign law to the contrary. This requirement, relative to foreign law, is intended to address a concern relative to whether the conversion would be effective and binding upon a foreign holder, especially a foreign holder whose debt instrument is expressed to be governed by foreign law;
- Bail-in shares have to provide for conversion within their share terms;
- A D-SIB must include, in a prospectus, an information circular or other similar offering document and disclosure that the bail-in instrument is subject to conversation under Section 39.2(2.3) of the CIDC Act;
- A D-SIB may not advertise or otherwise promote a bail-in instrument as a deposit.

Compensation

Section 5.2 of the Financial Stability Board's "Key Attributes of Effective Resolution Regimes for Financial Institutions "provides that creditors of a financial institution which has been subjected to resolution powers (including bail-in) should have a right to compensation where they do not receive not less than what they would have received in a liquidation of the bank under the applicable insolvency regime".

This principle, sometimes referred to as "no creditor worse off than in liquidation", is provided for in Section 39.23 of the CDIC Act. Section 39.23 provides for a right to compensation in any circumstance where the CDIC exercises its resolution powers under Section 39.13(1) of that Act.

Section 39.23 provides that the CIDC shall pay compensation to such persons and in such amounts as are provided for in the Compensation Regulations. The Compensation Regulations provide for the payment of compensation to a broad range of persons who hold interests in the bank subject to the CDIC resolution powers.

The compensation regime will apply in respect of persons who hold liabilities of the bank which are converted pursuant to the bail-in power (but not assignees or transferees of such persons).

Persons entitled to compensation also include persons who hold any of the following interests:

- Shares of the bank;

- Subordinated debt of the bank that is vested in the CDIC under an order made under Section 39.12 of the CDIC Act;
- Liabilities of the bank, other than liabilities that, after the order is made, are assigned to or assumed by a bridge institution or third party, if a winding-up order is made under the *Winding-up and Restructuring Act* ("WURA") with respect to the bank as a result of an application made under Section 39.22 or 39.3717 of the CDIC Act;
- Liabilities of the bank that, after the order is made, are assigned to or assumed by a corporation that is described in subsection 10(2) of the CDIC Act and that is then liquidated, during a period in which a majority of the corporation's voting shares are held by, on behalf of or in trust for the corporation, other than liabilities that, after being assigned to or assumed by that corporation, are assigned to or assumed by a third party; or
- Liabilities of the bank that, after the order is made, are assigned to or assumed by a bridge institution — other than liabilities that, after being assigned to or assumed by the bridge institution, are assigned to or assumed by a third party — when a winding-up order is made under the WURA with respect to the bridge institution.

The theory upon which compensation is paid is that the holder of the relevant interest has been made worse off as a result of the exercise of the CDIC's resolution powers compared to where they would have been had the bank been liquidated.

Under Section 3(1) of the Compensation Regulations, compensation is paid based on the difference between the resolution value and the liquidation value of a particular interest, based on the treatment of the interest (and not the specific circumstances of any claimant).

The Liquidation Value of an interest is to be estimated based on the value of what the holder of the interest would have received if an order had been made to liquidate the bank under the WURA immediately before the making of the order under Section 39.13(1) of the Act in respect of the bank. The liquidation value is to be estimated without taking into consideration any assistance, financial or other, that may have been provided to the bank by a public authority in Canada after any order to wind up the bank was been made.

The Resolution Value is the total of the estimated values held by the holder of an interest as a result of the exercise of the resolution powers, including, in the case of a bail-in, the value of the common shares of the bank received through the bail-in and the value of the remaining non-converted debt.

The compensation claim is not transferable. A person's successor in interest is entitled to compensation, but not an assignee or transferee of the interest.

The holder of a share or liability which is converted into common shares in accordance with the terms of that share or liability, as in the case of a NVCC instrument, is not entitled to compensation.

The Compensation Regulations also provide for the manner in which CDIC must offer compensation and the manner in which disputes are resolved. CDIC must within a reasonable period of time extend a compensation offer to a holder or a notice stating that no offer of compensation is being made because that person is not entitled to compensation.

The practical expectation is that in most cases more value will be recognized through resolution so that no compensation will be payable.

The holder has 45 days to accept the offer. If more than 10% of any class of holders object, then an assessor can be appointed. Within 45 days after the day on which an assessor is appointed, the CDIC must provide, to each person whose compensation is to be determined by the assessor, a notice of the appointment of the assessor indicating that the person is bound by the assessor's determination of the amount of compensation to be paid which may be lower or higher than that contained in the offer.

The decision of the assessor is final.

Other Implications

The change in the status of senior bank debt which is now made subject to bail-in raises the question of other implications. For example, senior debt issued or guaranteed by a bank is generally exempt from prospectus and dealer registration requirements under Canadian securities laws. The bail-in rules may call those exemptions into question.

On August 23, 2018, the Canadian Securities Administrators (CSA) published CSA Staff Notice 46-309 Bail-in Debt. The Staff Notice cautions that CSA staff may take regulatory action (including through the issuance of cease-trade orders) if it becomes aware of trades in debt securities subject to bail-in that are made by market participants in the business of trading in securities, other than trades made by or through duly registered dealers or in reliance on the "international dealer" exemption under National Instrument 31-103 Registration Requirements, Exemptions and Ongoing Registrant Obligations. See our previous commentary here.

Although bail-in able debt securities will still constitute senior-ranking indebtedness, the view of the CSA is that such securities present different characteristics compared to senior debt instruments currently issued by Canadian financial institutions and not subject to bail-in. As such, the CSA consider that if a trade in debt securities subject to bail-in is made by or through a market participant in the business of trading in securities, such participant should be duly registered and comply with regulatory investor protection requirements (including "know-your-client", "know-your-product" and suitability requirements) in connection with such trades – subject to the availability of the international dealer exemption for foreign securities dealers.

While not directly raised in Staff Notice 46-309, if senior debt subject to bail-in is now to be made subject to dealer registration requirements, it may arguably also be subject to prospectus requirements.

These actions, and potential actions, on the part of securities administrators raise at least two questions. First, given that senior debt subject to bail-in will benefit from a compensation regime, the intent of which is to put the holder of the senior debt in the same position as would have availed had there been liquidation without bail-in, is it in fact correct to say that the rights of a holder of a senior debt instrument subject to bail-in have been significantly altered. Second, from a constitutional perspective, is it competent for provincial securities authorities to regulate the manner of issuance of senior debt by a federally regulated bank.

Both of these are issues which we expect will attract further discussion.

Conclusions

In our view, an opportunity was lost when the bail-in provisions were made applicable to all debt instruments with a maturity of more than 400 days. An alternative approach would have been that each D-SIB had to meet the TLAC requirements, but that they would have greater flexibility as regards how they met that requirement.

On this approach, deposits could still be expressed to be not subject to bail-in. However, the incentive to game the system by issuing shorter term debt would be gone. In addition, D-SIBs which had already met the TLAC minimum standards would have the ability to issue senior debt not subject to bail-in, and could have better access to debt and capital markets in times of stress.

In addition, if D-SIBs had the ability to issue both bail-in and non-bail-in debt, with otherwise equivalent terms, the difference in value between debt subject to bail-in and debt not so subject could have provided a useful indication of perceived risk and, as a result, an element of market discipline.