Canadian Government Tables Bail-In Regulations

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The Canadian government is now seeking to fully implement a bail-in regime in Canada through three proposed regulations

Background

Following the Canadian government's commitment in Budget 2016 to implement a bail-in regime, and the subsequent creation of a legislative framework for such a regime through amendments to the *Bank Act* and *Canada Deposit Insurance Corporation Act* (the "CDIC Act"), the Canadian government is now seeking to fully implement a bail-in regime in Canada through three proposed regulations. Once implemented, the regime will allow authorities to convert shares (essentially, preferred shares) and certain liabilities (collectively, "bail-in eligible securities") of a failing domestic systemically important bank ("DSIB")[1] into common shares to recapitalize the bank and allow it to remain in operation.

As we previously reported in our bulletin on April 29, 2016, the introduction of a bail-in regime in Canada is one component of Canadian efforts, since the 2008 global financial crisis, to strengthen the banking sector and reduce the probability and impact of bank failures.[2] The financial crisis highlighted that certain banks are of such importance to the functioning of the financial system and the economy that they cannot be wound down under a conventional process without imposing unacceptable costs on the economy. In other words, they are "too-big-to-fail." One of the key tools for addressing the "too-big-to-fail" issue is bail-in (*i.e.*, the power of authorities to convert some of a bank's debt into equity in order to recapitalize the bank and help restore it to viability without the use of government bailouts).

Three Proposed Regulations to Implement the Bail-in Regime in Canada

The legislative framework for bail-in referred to above provides for the introduction of regulations. Three regulations have been proposed as follows:

1. *Bank Recapitalization (Bail-in) Conversion Regulations* (the "Bail-in Scope and Conversion Regulations"). Proposed to be implemented under the CDIC Act,

these regulations set out the scope of bail-in eligible securities of Canadian DSIBs, and the conversion terms if a bail-in were to be executed.
2. *Bank Recapitalization (Bail-in) Issuance Regulations* (the "Bail-in Issuance Regulations"). Proposed to be implemented under the *Bank Act*, these regulations set out requirements that Canadian DSIBs will have to follow when issuing bail-in eligible securities. The proposed regulations do not create a requirement for banks to issue securities that are subject to bail-in.
3. *Compensation Regulations* (the "Compensation Regulations"). Proposed to be implemented under the CDIC Act, these regulations set out an updated process for providing compensation to shareholders and creditors of CDIC federal member institutions 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 will apply only to DSIBs. The Compensation Regulations will apply to all CDIC federal member institutions.

We examine each proposed regulation in turn below.

Details on the Proposed Regulations

1. Bail-in Scope and Conversion Regulations

Bail-in Eligible Securities

Pursuant to the Bail-in Scope and Conversion Regulations, the bail-in regime applies only to long-term (400 or more days), unsecured senior debt that is tradable and transferable. For these purposes, an instrument is considered tradable and transferable if it has a CUSIP number, ISIN or other similar identification.

All newly issued instruments that have these features are eligible for a bail-in conversion. Newly issued preferred shares and subordinated debt are also eligible for bail-in, provided they are not non-viability contingent capital (NVCC).

The bail-in power is not retroactive, meaning that it applies only to instruments that are issued, or amended to increase their principal value or extend their term, after the coming into force of the Bail-in Scope and Conversion Regulations.

Deposits, secured liabilities (*e.g.*, covered bonds), eligible financial contracts (*e.g.*, derivatives), and structured notes are not eligible for bail-in conversion.

Conversion Parameters

A bail-in conversion must meet the following parameters:

1. Adequate recapitalization. In carrying out a bail-in, CDIC must take into consideration the requirement in the *Bank Act* for banks to maintain adequate capital.

2. Order of conversion. Bail-in eligible securities can only be converted after all subordinate ranking bail-in eligible securities and NVCC have been converted.
3. Treatment of equally ranking bail-in eligible securities. Equally ranking bail-in eligible securities 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.
4. Relative creditor hierarchy. Holders of bail-in eligible securities must receive more common shares per dollar of the claim that is converted than holders of subordinate ranking bail-in eligible securities and NVCC that have been converted.

2. Bail-in Issuance Regulations

Under the Bail-in Issuance Regulations, certain parameters must be met if a bank issues or amends bail-in eligible securities:

1. The contractual terms of bail-in eligible securities must indicate that the holder of the security is bound by the application of the CDIC Act, including the conversion of the security into common shares under the bail-in power. These contractual terms must be governed by Canadian law, even if the contract itself is governed by foreign law.
2. The prospectus or other relevant offering document must include disclosure that the bail-in eligible security is qualified for bail-in conversion.

Failure to meet these requirements will not, however, prevent an issuance from being eligible for bail-in.

3. Compensation Regulations

The Compensation Regulations establish a compensation process to reimburse shareholders and creditors of CDIC federal member institutions who have been made worse off as a result of CDIC's actions, including bail-in actions, than they would have been if the institution had been liquidated. This process has the following features:[3]

1. A prescribed list of persons entitled to compensation, including persons who hold bail-in eligible securities that were subsequently converted into common shares pursuant to the bail-in power.
2. A restriction on the ability to transfer the right to compensation.
3. A mechanism to determine the amount of compensation offered by CDIC to persons entitled to compensation. The amount offered is based on the difference between an estimate of what the person would have received if the institution had been wound up and an estimate of the value the person received (or will receive) through the resolution process. CDIC must make the same offer of compensation to prescribed persons who hold bail-in eligible securities of the same class (in proportion to their claim).
4. The conditions under which the Governor in Council is required to appoint a judge as an assessor to review CDIC's determination of compensation. The threshold for requiring an assessor to be appointed is if persons who held at least 10% of the value of debt or at least 10% of the shares of a given class object to CDIC's offer. The CDIC Act requires the appointed third-party assessor to be a federal judge.

How the Proposed Regulations Work Within the Bail-In Regime

Under the bail-in regime, CDIC will take temporary control or ownership of the non-viable bank, executing a bail-in conversion in accordance with the Bail-in Scope and Conversion Regulations to recapitalize the bank, and undertaking any other restructuring measures necessary to restore the bank to viability. The bail-in eligible securities converted will be those issued by the bank in accordance with the Bail-in Issuance Regulations.

After the completion of the bail-in conversion and other necessary restructuring measures, CDIC will 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 for up to a maximum total period of five years.

Following the resolution, CDIC will make an offer of compensation to the relevant shareholders and creditors in accordance with the Compensation Regulations, 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. If the conditions in the Compensation Regulations are met, CDIC's offer will be reviewed by a third-party assessor.

Contact Us

If you have any questions about the proposed regulations, please contact one of the authors of this bulletin or any member of BLG's Financial Services Regulatory Group and Derivatives Group.

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[1] Canada's six largest banks were named as systemically important by the Office of the Superintendent of Financial Institutions ("OSFI") in 2013.

[2] In Canada, other efforts include higher capital requirements, enhanced supervision by OSFI, and institution-specific recovery and resolution plans.

[3] Some of these features either build on or adapt existing legislative provisions in sections 39.23 to 39.37 of the CDIC Act.

By

Carol Derk, Stephen J. Redican, Olivier Tardif, Michael Taylor, Jeffrey S. Graham

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BLG Offices

Calgary
Centennial Place, East Tower
520 3rd Avenue S.W.
Calgary, AB, Canada
T2P 0R3
T 403.232.9500
F 403.266.1395

Ottawa
World Exchange Plaza
100 Queen Street
Ottawa, ON, Canada
K1P 1J9
T 613.237.5160
F 613.230.8842

Vancouver
1200 Waterfront Centre
200 Burrard Street
Vancouver, BC, Canada
V7X 1T2
T 604.687.5744
F 604.687.1415

Montréal
1000 De La Gauchetière Street West
Suite 900
Montréal, QC, Canada
H3B 5H4
T 514.954.2555
F 514.879.9015

Toronto
Bay Adelaide Centre, East Tower
22 Adelaide Street West
Toronto, ON, Canada
M5H 4E3
T 416.367.6000
F 416.367.6749

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