

National Banking Law Review

• FINANCIAL INSTITUTIONS EXPERIENCE SLOWER ACTIVITY IN CAPITAL MARKETS •

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After unprecedented capital raising in 2008 and 2009,¹ capital market activity for Canadian financial institutions was slow in the first part of this year.² There were a number of reasons for the decreased activity. First, Canadian financial institutions already have capital ratios far in excess of historical norms and the minimum requirements of the Office of the Superintendent of Financial Institutions (“OSFI”).³ Second, significant uncertainty exists about what instruments will qualify for capital in the future as a result of the proposed new capital rules released by the Basel Committee of Banking Supervision in December of last year (known as the “Basel III capital rules”). Third, no significant merger and acquisition activity requiring new capital raising occurred in the first part of the year, partly because of the uncertainty regarding the Basel III capital rules.

The deadline for comments on the Basel III capital rules was April 16, 2010, and more than 250 submissions were received.⁴ Although most of those submissions agreed with the need to increase the quantity and quality of capital, many submissions indicated that the proposals went too far and should be substantially relaxed. In April, Canadian banks provided a quantitative impact study to OSFI on the implications of the proposed changes for individual institutions. And OSFI submitted data from the study to the Basel Committee in mid-May. Although the submission is confidential, we understand that the Basel III capital rules would have a significant negative impact on the existing capital ratios of the Canadian banks; the data will be analyzed, together with the results from other jurisdictions, and the preliminary findings will be presented to the Basel Committee in July. It is then proposed that the Basel III capital rules will be finalized by the end of this year and implemented, depending on economic conditions, by the end of 2012.

We expect that capital market activity will increase later in the year and early in 2011 for several reasons. First, as it becomes clearer what will qualify as capital, institutions may be willing to issue capital before the final rules are released. Second, OSFI has advised financial institutions that any material acquisitions

must be funded with new equity issuances — and the Canadian banks continue to look at a number of opportunities, particularly in the United States, where many sales of troubled banks are supported by the Federal Deposit Insurance Corporation. Third, OSFI has recently confirmed publicly⁵ that non-cumulative dividend reset preferred shares as currently structured in Canada would be compliant with the Basel III capital rules because they do not contain incentives to redeem. In addition, Scotiabank’s recent successful offering of C\$265 million of such preferred shares with a coupon of 3.85 per cent is attractive for Tier 1 capital.⁶ Similarly, CIBC’s recent C\$1.1 billion offering of subordinated debt with a coupon of 4.11 per cent is attractive for Tier 2 capital.⁷ However, as that subordinated debt includes a step-up after year 5, it is unlikely to be compliant with the final Basel III capital rules. As a result, the terms of the offering allow CIBC to call the debt before the fifth-year anniversary⁸ of the issuance upon the occurrence of a “regulatory event” (defined in the prospectus to mean that CIBC has received a notice or advice from OSFI that the instruments no longer qualify as Tier 2 capital).

However, no new offerings of innovative Tier 1 capital will be made because such instruments will not be permitted under the Basel III capital rules.⁹ It is uncertain how long the existing innovative Tier 1 instruments will be grandfathered when the new rules come into force. This is significant, since Canadian financial institutions currently have over C\$20 billion in innovative Tier 1 instruments outstanding and they were products favoured by institutional investors.

Finally, with the uncertainty over the ultimate definition of capital and the quantity of capital that will be required, OSFI has been advising institutions that any material redemption of capital instruments should be funded with new capital issuances. In that regard, the aggregate amount of innovative Tier 1 capital that is scheduled to be redeemed on June 30 or December 31 of this year is C\$2.1 billion.

[Editor’s note: Blair Keefe, a partner at Torys LLP, is head of the firm’s Financial Institutions Group. His

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¹ In 2008, the nine largest Canadian financial institutions raised over C\$21 billion in regulatory capital, and in 2009 those same institutions raised another C\$13.5 billion in capital, according to the FP Infomart deal database.

² As of May 31, approximately C\$2 billion in regulatory capital had been raised, and over half of that came from one offering by CIBC.

³ OSFI has established a minimum of 7 per cent Tier 1 and a minimum of 10 per cent total capital ratio for Canadian banks and a minimum of 150 per cent MCCSR (“Minimum Continuing Capital and Surplus Requirements”) for Canadian life insurance compa-

nies. As of the first quarter ending in 2010, Canadian financial institutions had the following ratios:

RBC: Tier 1 capital is 12.7 per cent and total capital is 13.6 per cent; TD: Tier 1 capital is 11.5 per cent and total capital is 14.8 per cent; Scotia-bank: Tier 1 capital is 11.2 per cent and total capital is 13.5 per cent; BMO: Tier 1 capital is 12.53 per cent and total capital is 14.82 per cent; CIBC: Tier 1 capital is 13.0 per cent and total capital is 17.1 per cent; National Bank Tier 1 capital is 12.5 per cent and total capital is 16.1 per cent; Sun Life: 210 per cent MCCSR; Manulife: 240 per cent MCCSR.

⁴ Submissions have been posted at <www.bis.org>.

⁵ Draft advisory, May 2010 “Interim Treatment of Capital Instruments,” online: <www.osfi-bsif.gc.ca/app/DocRepository/1/eng/guidelines/capital/advisories/ntrcpnstr_e.pdf>.

⁶ Prospectus supplement dated March 31, 2010.

⁷ Prospectus supplement filed on April 27, 2010.

⁸ For the early redemption, investors may receive a premium above par based on the Canada yield price.

⁹ *Supra* note 5.