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Canada Pushes Embedded Contingent Capital

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Canadian officials have been promoting embedded contingent capital as the best alternative for dealing with systemically important financial institutions (SIFIs), or banks that are "Too Big to Fail," as they have historically been referred to. On April 9, the Office of the Superintendent of Financial Institutions (OSFI) had its article advocating the concept published in London's *Financial Times*. On April 13, Canada's Minister of Finance wrote a letter to his G-20 colleagues with the same message. Earlier this month several federal ministers spoke out against the concept of a bank tax as the appropriate response for dealing with SIFIs. It is expected that Canada will push the concept of embedded contingent capital when it hosts the G-20 meeting in June.

What Is Embedded Contingent Capital?

Neither OSFI nor any international regulators have released specific proposals. Different forms of contingent capital have been raised by the Lloyds Banking Group and Rabobank in the last six months or so, but recent speeches suggest that OSFI's concept is different and more pervasive.

Essentially, OSFI would require all new non-common Tier 1 (perpetual preferred shares) and Tier 2 capital (subordinated debt) to contain features that would convert these instruments into common share equity when the bank is in serious financial trouble, instantly increasing the common share equity capital of the bank without the use of taxpayer money. For this concept to be effective, OSFI believes that all the preferred shares and subordinated debt instruments issued in the future would need to contain the conversion feature; if the amount of contingent capital is not fairly large, it would not have the necessary effect. Conversion would occur following the hierarchy of subordination of the various capital instruments in an attempt to effectively simulate an insolvency without the attendant costs or disruption.

The theory is that in an insolvency of a bank, subordinated debt holders would likely receive only a portion of the par value of their instruments, and preferred shareholders would receive less and possibly nothing. The concept would be that on the eve of insolvency, just before the government made an emergency government capital investment or the supervisor closed or took control of the bank, the conversion feature would be triggered. Given the deep financial trouble of the bank at that time, it is likely that preferred shares and subordinated debt would be trading below the face amount of the security. However, for a number of reasons, preferred shares would be converted at the prevailing market value of common shares using the par value (not the market value) of the preferred shares; in that way the preferred shareholders arguably receive some benefit over the common shareholders, preserving their position in the hierarchy of subordination. Similarly, subordinated debt holders would have a two-stage conversion, which would be virtually simultaneous. The subordinated debt would be "notionally" exchanged for the number of preferred shares on the basis of the prevailing market value of the preferred shares at that time using the face amount of

the subordinated debt. Then immediately thereafter, those preferred shares would be converted at their face value into the number of common shares on the basis of the current trading price of the common shares (to eliminate anomalies, the current market price of the shares would likely be based on average trading prices over some number of days before the conversion date). Most important, OSFI would view the triggering of the conversion feature as a necessary precondition to any emergency financial support for the bank from any government authority.

Contingent capital would also make Tier 2 capital more meaningful in the capital structure. The financial crisis has made international regulators suspicious of the quality of subordinated debt as a form of capital because it is only useful in an insolvency situation and the Basel III proposals released in December significantly decrease its importance in the capital structure. Contingent capital can restore the credibility of subordinated debt as a legitimate and important form of capital in the capital structure.

What Are the Benefits?

The biggest benefit of contingent capital is that it is likely better than any other proposal that has been put forward internationally – such as the use of bank taxes, the creation of systemic risk funds and capital surcharges for SIFIs. At the same time, contingent capital should also strengthen market discipline, since one of the greatest concerns resulting from the financial crisis is the implicit government support that the markets and rating agencies now provide to SIFIs. That support allows these banks to raise funds more cheaply than competitors that do not benefit from an implicit government guarantee; it also creates a moral hazard because creditors have no incentive to insist on strong risk management if at the end of the day they will receive a hundred cents on the dollar by virtue of the government's stepping in to bail out the troubled bank.

The theory, although never tested in practice, is that the holders of subordinated debt and preferred shares with mandatory conversion features will insist on stronger risk-management practices; if there is a perception that a particular bank does not have strong risk management, investors will require a risk premium in the form of a higher yield to purchase securities of the bank, thereby creating market discipline for the bank to have strengthened risk management. In that way, contingent capital should reduce moral hazard without the difficulty of defining or developing the special administrative and regulatory processes necessary to manage or regulate any bank considered to be a SIFI: all banks would be required to hold contingent capital.

What Are the Concerns?

A number of concerns arise with the use of embedded contingent capital.

First, it is likely that the conversion itself could cause a "run" on the troubled bank: effectively, the conversion means that the bank is on the eve of insolvency and the conversion does not create any additional capital; it merely improves the quality of the capital. As a practical matter, it will likely be essential for the government to immediately provide funding to the bank; however, with the former holders of subordinated debt and preferred shares being converted into holders of common shares, the government could replenish the subordinated debt rather than being required to replenish the Tier 1 capital, which occurred in the financial crisis. Therefore, it should be less likely that the government would suffer a financial loss.

Second, it will likely be more difficult for banks that are experiencing some financial difficulties (but that are still a long way from being on the eve of insolvency) to raise capital because the holders of that new capital would effectively be facing unlimited dilution. In 2008 and 2009, the nine largest Canadian

financial institutions raised $21 billion and $13.5 billion in capital instruments respectively, an amount that may be more difficult to raise if the contingent capital proposals are adopted. Similarly, the so-called Sovereign Wealth Funds provided the first wave of recapitalization internationally but, given the losses they incurred, they may not be willing to provide the capital next time.

Third, the cost of capital could increase significantly for banks, particularly if the new capital instruments are viewed as equity – given their conversions in times of financial difficulty to common share equity – rather than debt instruments. OSFI is sensitive to this concern and is the reason why OSFI is advocating a trigger that occurs on the eve of insolvency (rather than earlier in the process) when the holders of subordinated debt and preferred shares would anticipate incurring losses in any event. CIBC recently raised approximately $1.1 billion of subordinated debt, with an interest rate of 4.11% and Scotiabank raised $265 million of perpetual preferred shares with a coupon of 3.85%. Would investors require a significantly higher interest or dividend coupon if either of those instruments contained mandatory conversion into common shares? Innovative tier 1 capital instruments always carried the risk of conversion into perpetual preferred shares, but they accounted for no more than 15% of the bank's net Tier 1 capital.

Fourth, there is also concern about how earnings per share would be calculated under the international financial reporting standards when adopted; the subordinated debt and preferred shares create the potential for almost unlimited dilution.

Fifth, another concern relates to the depth of the capital markets to absorb this new form of capital. Fixed-income investors may be unable or unwilling to purchase such instruments if they could end up holding common shares in the bank. However, as OSFI has noted, banks have historically shown an uncanny ability to structure and sell capital instruments, and investors could always sell their investment either before or after the conversion.

Sixth, it is uncertain how the concept would be applied to banks that are not public (e.g., foreign subsidiaries, which can be quite large) and for any banks that would otherwise not have publicly traded preferred shares or subordinated debt in their capital structure.

Seventh, if the embedded contingent capital proposals are adopted, how will those requirements need to be reflected in the Basel III capital proposals? Similarly, what treatment will rating agencies give to contingent capital? If the triggering event is considered remote, rating agencies may not give "equity" credit treatment for the instruments.

Finally, with any change of this nature, market participants worry about the unexpected consequences: Will hedge funds or other market participants be able to "game" the system? Will the conversion features create more instability for a bank experiencing some financial difficulty? Could the conversion create a death spiral of dilution? and so on.

While the concept of embedded contingent capital has more appeal than the other alternatives that have been put forward, there remain a number of concerns that have not been fully addressed. T