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Canada Implements Basel III Contingent Capital Requirements

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On August 16, 2011, the Office of the Superintendent of Financial Institutions Canada (OSFI) became the first banking regulatory authority to issue detailed guidance on its expectations regarding the implementation of the non-viability contingent capital (NVCC) requirements of Basel III.[1] These rules will require all non-common capital instruments to contain features that require them to be converted into common shares if the institution becomes non-viable. The OSFI advisory sets out the NVCC criteria that the capital of Canadian banks, bank holding companies and trust and loan companies (collectively, deposit-taking institutions, or DTIs) must meet for it to qualify as capital for regulatory purposes.[2] While it is still uncertain whether or to what extent the U.S. regulatory authorities will apply the Basel III rules,[3] the OSFI advisory is particularly noteworthy in that its application extends to Canadian banking subsidiaries of non-Canadian banks (including U.S. banks). Thus, given the potential relevance to U.S. financial institutions, it is important to understand and appreciate the Basel III capital rules and the NVCC advisory produced by OSFI. This article provides a basic summary of the NVCC requirements and OSFI's guidelines, in addition to a discussion about some of the concerns and implications of these new rules.

Basel III NVCC Requirements

On January 13, 2011, in an annex to the Basel III rules text that was published in December 2010, the Basel Committee on Banking Supervision outlined the minimum requirements to ensure loss absorbency at the point of non-viability.[4] The rules require that all non-common capital instruments (generally preferred shares and subordinated debt) issued by an internationally active bank[5] contain features that require these instruments to convert into common equity tier 1 capital if the bank becomes non-viable.

These provisions are meant to protect the public from paying for bailouts of failing banks before investors fully absorb bank losses. According to the rules, the NVCC requirements would be triggered by a decision from a relevant authority that either a write-off of the non-common

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[1] The Australian Prudential Regulation Authority (APRA) recently became the second international regulator to provide comments on the NVCC requirements. Australian Prudential Regulation Authority, "Discussion Paper: Implementing Basel III capital reforms in Australia" (September 6, 2011). See pages 18 and 19 specifically for a discussion of the implementation of the NVCC requirements.

[2] Office of the Superintendent of Financial Institutions Canada, "Advisory: Non-Viability Contingent Capital," August 2011.

[3] For example, in a recent speech at the International Monetary Conference, Treasury Secretary Tim Geithner advocated for a requirement that the largest firms (e.g., the firms whose failure could cause the greatest damage to the economy) hold more capital relative to risk than smaller institutions, in the form of a common equity surcharge, as opposed to implementing contingent capital instruments. "Remarks by Treasury Secretary Tim Geithner to the International Monetary Conference" (June 6, 2011), online: U.S. Department of the Treasury <http://www.treasury.gov/press-center/press-releases/Pages/tg1202.aspx>.

[4] Bank for International Settlements, Press Release, "Basel Committee Issues Final Elements of the Reforms to Raise the Quality of Regulatory Capital" (January 13, 2011).

[5] Although the Basel III rules apply only to internationally active banks, OSFI has determined to apply the NVCC requirements to all DTIs incorporated in Canada.

capital instrument or a public sector injection of capital (a bailout) is necessary because the bank in question would otherwise become non-viable. In either case, the triggering of the NVCC requirements would mean that before public funds are injected to save a bank from failure, all non-common capital instruments must either be written off or be immediately exchanged into common equity capital to absorb the losses. This will shift the costs of bank failure first and foremost onto the shoulders of investors, rather than depositors and taxpayers, because the write-off/conversion must occur *before* any public money is used to bail out the bank. Any publicly owned capital issued for a bailout would therefore be protected from being diluted by the newly converted common equity capital. Under Basel III, all non-common capital instruments issued after January 1, 2013, must include NVCC features. Non-common capital instruments without NVCC features will be phased out according to the timeline detailed in annex 4 to Basel III.

OSFI Advisory Providing Additional Guidance on NVCC Requirements

In its August 2011 advisory, referred to above, OSFI set out 10 principles governing the inclusion of NVCC instruments in regulatory capital and described the process under which OSFI will assess whether such instruments qualify as additional tier 1 or tier 2 capital that meets the NVCC requirements. In addition, the advisory outlines some of the criteria to be considered by the Superintendent prior to triggering conversion.

Among the principles set out in the advisory is that the contractual terms of all qualifying non-common capital instruments must include a clause requiring full and permanent conversion into common shares on the occurrence of a trigger event. In addition, each capital instrument must contain clauses that include, at a minimum, the following two trigger events:

1. The Superintendent publicly announcing that the DTI has been advised in writing that the Superintendent is of the opinion that the DTI has ceased or is about to cease to be viable, and that after the conversion of all contingent instruments and taking into account any other factors or circumstances that are considered relevant or appropriate, it is reasonably likely that the viability of the DTI will be restored or maintained; and

2. A federal or provincial government in Canada publicly announcing that the DTI has accepted or agreed to accept a capital injection without which the Superintendent would have determined the DTI to be non-viable.

Although the Basel III NVCC requirements provide each country with discretion to require all non-common capital instruments to either be written off or be exchanged into common shares upon a trigger event, OSFI determined that a conversion to common shares was more consistent with traditional insolvency consequences and therefore will not permit a write-off of the capital instrument.[6]

Other principles emanating from the OSFI advisory are that the conversion terms of the new NVCC instruments must reflect the market value of the common equity of the bank before the date of the trigger event and that the conversion method must also put a limit or a cap on the number of shares issued upon a trigger event. Furthermore, the method of the conversion should

[6] By contrast, APRA will allow the flexibility to write off the instrument rather than requiring it to be converted into common shares, *supra* note 1.

take into account priorities in an insolvency. Former debtholders should receive economic entitlements greater than those given to former preferred shareholders; former preferred shareholders should receive economic entitlements greater than those given to pre-existing common shareholders; and common shareholders will have their ownership interest substantially diluted. The issuing DTI must also ensure that there are no impediments to conversion, so that the conversion will be automatic and immediate, and the DTI must make all commercially reasonable efforts to ensure that the conversion is not an event of default under any other contract entered into by the DTI. In addition, the issuing DTI must provide procedures or mechanisms for dealing with the issuance of common shares to persons who are prohibited from owning shares in the bank.

OSFI has also indicated that in the case of a DTI that is a subsidiary of a non-Canadian financial institution that is subject to Basel III's capital adequacy requirements, the NVCC instruments that the DTI issues must be convertible into shares in the DTI and not in the parent or affiliate without the prior consent of OSFI. In addition, the trigger events must not occur at the discretion of a non-Canadian regulator or be based on non-Canadian events applicable to the affiliate. If the DTI has a non-Canadian subsidiary subject to Basel III requirements, the DTI may include the NVCC issued by non-Canadian subsidiaries in its consolidated regulatory capital to the extent allowed by the Basel III rules. NVCC instruments issued by non-Canadian subsidiaries must contain triggers that are equivalent to those specified by OSFI. OSFI will activate those triggers only after consulting with the host authority if the subsidiary is non-viable or if the parent is non-viable as a result of an injection of capital or similar support into the subsidiary. In triggering conversion, OSFI will be informed by its interactions with the Financial Institutions Supervisory Committee,[7] as well as by the Minister of Finance. Other public sector interventions will likely need to be used in tandem with NVCC measures.[8]

Benefits and Concerns

As with any new regulatory requirements, there are both supporters and critics of the new Basel III rules. Proponents of the NVCC requirements argue that contingent capital should strengthen market discipline, in light of the serious concern resulting from the recent financial crisis over the implicit government support that the markets and rating agencies ascribe to systemically important financial institutions. Given this support, banks are able to raise funds more cheaply than competitors that do not benefit from an implicit government guarantee. This creates a moral hazard because creditors have no incentive to insist on strong risk management if they can expect to receive a hundred cents on the dollar by virtue of the government's stepping in to bail out the troubled bank. Such proponents theorize that mandatory conversion features will force the holders of subordinated debt and preferred shares to insist on stronger risk management practices, which should reduce the moral hazard. If there is a perception that a bank does not have strong risk management, investors will require a risk premium in the form of a higher yield

[7] The Financial Institutions Supervisory Committee (or FISC, as it is commonly referred to) was created in 1987 under section 18(1) of the *Office of the Superintendent of Financial Institutions Act* (Canada). Its membership includes the Superintendent at OSFI, the Governor of the Bank of Canada, the Chairperson of the Canada Deposit Insurance Corporation and the Deputy Minister of Finance.

[8] The OSFI advisory does not specify examples of public sector interventions, but the most likely example would be a government investment in shares of the troubled institution.

to purchase securities of the bank, thereby creating market discipline for the bank to strengthen its risk management.

Critics of the NVCC requirements, however, are chiefly concerned that the capital markets do not have the depth to absorb this new form of capital and that finding investors to invest in such instruments will prove challenging. For example, fixed-income investors may be unable or unwilling to purchase such instruments if they could end up holding common shares in the bank – particularly if the instruments are not eligible for inclusion in bond indices – since the investors are essentially being required to assume equity downside risk without the potential upside of equity investments. In any event, investors will likely require a significantly higher interest or dividend coupon to compensate for the fact that such instruments contain mandatory conversion features. Given that banks in Canada and the United States raise billions of dollars in capital each year, there is a concern that adding additional uncertainties may cause investors to become more reluctant to make investments in banks, which would actually weaken the stability of the financial institutions sector as opposed to strengthening it. Moreover, banks that are not actually on the eve of insolvency (but that may be experiencing some financial difficulties) may find it especially difficult to raise common share equity since the holders of that new capital would effectively be facing significant dilution. This concern becomes amplified significantly if hedge funds or others try to "game" the system. The unintended consequence could be that such struggling banks may end up experiencing even greater financial difficulties (which could eventually lead to insolvency) resulting from the potential inability to raise capital on reasonable terms.[9]

Potential for Exemptive Relief in the United States

As mentioned earlier, it is still unclear whether or to what extent, the U.S. regulatory authorities will apply the Basel III rules. For example, the final Basel III rules contain the possibility that the new requirements will not apply if

1. the governing jurisdiction of the bank has laws that (i) require such tier 1 and tier 2 instruments to be written off upon such event, or (ii) otherwise require these instruments to fully absorb losses before taxpayers are exposed to loss;

2. a peer group review confirms that the jurisdiction conforms with clause (1); and

3. the relevant regulator and issuing bank disclose in future issuance documents that these instruments are subject to loss under clause (1).

Many believe that these provisions were inserted at the request of officials from the United States on the basis that the provisions of the *Dodd-Frank Wall Street Reform and Consumer Protection Act* (Dodd-Frank Act) and other regulatory changes made in the United States will

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[9] When asked whether there is a sufficient market for contingent capital instruments, OSFI Superintendent Julie Dickson remarked that if need be, investment banks will find a way to sell the NVCC securities. Said Dickson: "A sufficient investor base will be a function of the ultimate design, ratings, and other items. Financial institutions have shown an uncanny ability to design instruments for their own use that have found broad market acceptance." "Too-Big-to-Fail and Embedded Contingent Capital: Remarks by Superintendent Julie Dickson, Office of the Superintendent of Financial Institutions Canada (OSFI) to the Financial Services Invitational Forum" (May 6, 2010).

satisfy the requirement. However, to our knowledge, no peer group has been created to conduct the assessment, and it is unclear whether the Dodd-Frank Act will satisfy the requirements of (1). Even if the exemptive relief is not available, it is possible that U.S. regulatory authorities will not fully adopt Basel III, which is not legally binding on any country. However, until more clarity is available on the potential applicability of the NVCC requirements, U.S. banks will need to continue to monitor these developments closely.

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