BUDGET 2016: INTRODUCTION OF A BAIL-IN REGIME

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On March 22, 2016, the federal Liberal Government released its 2016 budget, which includes a plan to implement a bail-in regime for Canada's six domestic systemically important banks. The bail-in regime holds shareholders and bondholders responsible for a bank's risk in the event of failure, rather than taxpayers. The bail-in regime would convert eligible long-term debt into common shares in order to recapitalize the bank and allow it to remain viable and operating.

Bail-Ins: A Response to the Financial Crisis

The bail-in regime aims to protect Canadians in the event of big bank failure. Concerns about such failure stem from the 2008 global financial crisis, when some banks that had previously been considered "too-big-to-fail" needed to be bailed-out by their government. While none of these banks were Canadian, the bail-outs raised concerns about Canadian taxpayers having to fund the rescue of big banks in the future.

The 2016 budget notes that implementing the regime will strengthen the bank resolution toolkit in Canada and ensure Canadian banking practices are consistent with international best practices endorsed by the G20.

Previous Attempts to Introduce a Bail-In Regime

This year is not the first time that a Canadian federal government has proposed implementing a bail-in regime. The Conservative Government's 2013 Budget also included a bail-in regime proposal which was further developed in its 2014 consultation paper. The consultation paper outlined a plan to introduce a statutory conversion power that would allow the government to convert long-term eligible liabilities of big banks into common shares.[1] The proposed regime excluded depositors, distinguishing itself from the bail-in approach in Cyprus.[2] Ultimately, no legislation was introduced before the election was called and thus the bail-in regime was not implemented.

Non-Viable Contingent Capital

Since January 1, 2013, the Office of the Superintendent of Financial Institutions has required deposit-taking institutions issuing preferred shares or subordinated debt to provide a mechanism to convert these instruments into common shares, or to fully write-down the instrument if the institution was no longer viable.

Instruments containing these mechanisms are called non-viable contingent capitals (**NVCCs**).

Since NVCCs serve the same purpose as the proposed bail-in regime, it is difficult to know how the two regimes will interact with one another once both are in place, including whether both regimes would or could be triggered at the same time.

The Conservative Government's 2014 consultation paper contemplated that the bail-in regime would be incorporated into the existing resolution framework, including NVCCs, but provided few specifics with respect to how this would be done. The details that were provided included that the bail-in conversion power would only be executed following certain events, one of which was that there had been a full conversion of all the bank's NVCC instruments. It also proposed linking conversion terms for the bail-in with the terms of outstanding NVCC instruments. Whether or not the Liberal Government's bail-in regime will follow the form provided for by the Conservative Government in the 2014 consultation paper remains to be seen.

Concerns with a Bail-in Model

When the Conservative Government proposed the bail-in regime in its 2014 consulting paper, Moody's cut its rating on Canadian banks from stable to negative, citing concerns with the global trend of moving to bail-in regimes rather than bail-out regimes. However, Moody's stated at the time that the negative rating was not expected to have any impact on the credit ratings for the seven biggest banks.[3] The outlook remained at 'negative' for 2016, with one explanation cited as being the potential introduction of a bail-in regime.[4]

Concerns voiced in the press include whether consumer deposits will be considered to be part of the eligible debt responsible for bailing-in a bank. It remains to be seen whether the Liberal Government will opt to follow a similar approach to that of the Conservative Government in excluding depositors from the bail-in regime. Presumably this would be a feature of the proposed regime so that taxpayers who are deposit-holders and who are purportedly being protected by moving away from a bail-out model would not still be required to shoulder some burden in the event of a bank failure.

Next Steps

The government intends to publish regulations and guidelines setting out a more detailed bail-in regime, which will provide stakeholders with an opportunity to provide comments. How the proposed regime will interact with the existing NVCC framework and whether consumer deposits will be considered part of eligible debt are just a few areas that will remain uncertain until more information is published about how the Liberal Government intends the bail-in regime to work.

by Pat Forgione, Sean Brandreth, Darcy Ammerman and Jennifer Allman, Student-at-Law

1 "Taxpayer Protection and Bank Recapitalization Regime: Consultation Paper", Department of Finance Canada – Financial Sector Policy Branch (1 August 2014).

2 "Bank 'bail-in' plan shouldn't worry Canadians, Carney says", The Canadian Press (18 August 2013).

3 "Moody's cuts bank outlook to 'negative' on Ottawa's bail-in rule", CBC News (8 July 2014).

4 David Berman, "Moody's sticks with 'negative' outlook for Canadian banks in 2016", The Globe and Mail (8 December, 2015).

A Cautionary Note

The foregoing provides only an overview and does not constitute legal advice. Readers are cautioned against making any decisions based on this material alone. Rather, specific legal advice should be obtained.