# NVCCs and the new “bail-in” regime

## Key Messages

- A new form of senior bank deposit notes will enter Canadian capital markets in the near future – “bail-in” bonds. This follows the addition of NVCC subordinated debt in 2014,
- NVCC subordinated debt, preferred shares and “bail-in” bonds all have a contractual clause that allows the regulator to convert these securities to common equity in a scenario where the regulator determines a bank to be non-viable and in need of additional capital,
- Newly issued NVCC bonds became eligible for the FTSE TMX Canada Universe Bond Index on July 1, 2017; however, NVCC bonds issued prior to July 1, 2017 will not be immediately added to the index. Bail-in bonds will also be eligible for inclusion once issuance commences which could begin as early as January 2018,
- TDAM continues to assess the impact of these changes; most importantly we view the probability of non-viability, and hence conversion of debt into equity in any of the Big 6 Canadian banks, as very low.

In response to the global financial crisis of 2008/2009, the regulatory environment has evolved in hopes of strengthening bank capital adequacy. In 2010/2011, the Basel Committee on Banking Supervision enacted a framework for an enhanced set of voluntary regulatory guidelines, termed Basel III Accord, which attempted to resolve the financial weaknesses that were exposed during the global financial crisis, by establishing stricter minimal capital thresholds for banks.

During the crisis, many non-Canadian banks were rescued with funds or “bailouts” from the public sector. In other words, bond and equity holders did not absorb losses that many institutions incurred, instead taxpayers effectively bailed out large global financial institutions. Under the new international guidelines, Basel III Accord, banks were directed to ensure they had loss absorbing instruments.

## New reforms announced

Against this backdrop, The Department of Finance Canada has recently introduced new debt structures for financial institutions, two of which will be replacing typical Canadian bank debt instruments - Non-Viable Contingent Capital (NVCC) and the more recent introduction of Bail-in bonds.

The main attribute of these two types of securities is that they contain a contractual clause in which they can be converted into common equity in a scenario where a bank is determined by The Office of the Superintendent of Financial Institutions (OSFI) to be non-viable and in need of additional capital. In addition, bail-in bonds will replace existing unsecured senior debt (often referred to as deposit notes), which currently rank senior to other forms of bank debt and are some of the most widely held bonds by Canadian investors. Existing Canadian subordinated debt has already begun to be replaced by NVCCs, and banking debt issuance moving forward will carry this feature of convertibility into common shares which is executable only by the regulator.

## Background - why do Canadian financial institutions issue NVCC bonds?

NVCC bonds were first issued in Canada in 2014, and today total approximately $22 billion with $16 billion of issuance in Canadian dollars*. Since 2014, there have been ongoing debates surrounding the inclusion of NVCC bonds in the broad Canadian Bond Index; with the main discussion around the hybrid nature of the bonds as they have both debt- and equity-like features. The critical issue relates to the regulator's ability to convert these instruments into common shares at the point of non-viability. In other words, if OSFI deems a NVCC issuer non-viable, they can equitize debt holders.

### Impact on the index

The FTSE Russell conducted an extensive market consultation to determine what should be done with respect to this significant and growing portion of the Canadian fixed-income landscape. On June 5, 2017, FTSE Russell announced that NVCCs would be eligible for index inclusion in order to ensure that the "flagship FTSE Russell benchmarks remain suitable and representative measures of the Canadian domestic fixed income market". The announcement included the following:

- Newly issued (settled on or after July 1, 2017) NVCC bonds **will become eligible** for the FTSE TMX Canada Universe Bond Index effective July 1, 2017,
- NVCC bonds issued prior to July 1, 2017 **will not be immediately** added to the FTSE TMX Canada Universe Bond Index as a result of this announcement,
- A further market consultation on if/how to integrate the remaining $16 billion currently outstanding in the marketplace is underway with a final decision expected by July 30, 2017.

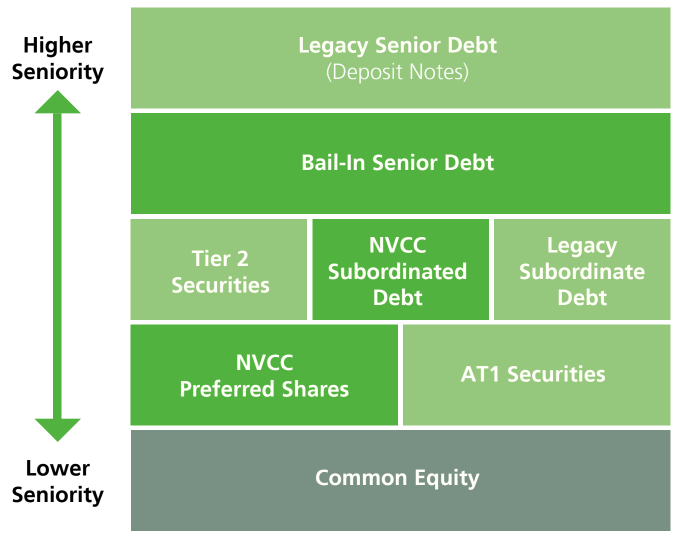
The announcements by FTSE Russell were positive for existing NVCC debt spreads, as there is the potential for greater demand for the debt instrument once included in the broader Canadian index. However, there continues to be an element of uncertainty, around if and when existing NVCC bonds will be included. TDAM continues to participate and monitor developments on the discussion as it has implications for both passive and active investing clients.

## The introduction of the Bail-in regime

In June, The Department of Finance Canada released a long awaited proposal on "Bail-in" regulation that will govern how banks are funded. OSFI followed with a guideline proposal for Total Loss Absorbing Capacity (TLAC), which will set the minimum level of total capital and senior notes available for equity conversion at 21.5% in the event a bank is determined by the regulator to be non-viable. Current secured senior bank debt (chequing/savings accounts, term deposits and secured liabilities) will not be eligible for conversion under the new guidelines. Bail-in regulations allow for issuance of the new debt instrument to commence as early as January 2018 and banks are expected to be in compliance with new TLAC requirements by November 2021.

Bail-in bonds will ultimately replace senior unsecured bank debt within the banking capital structure and therefore will be given preferential treatment in order to maintain priority of seniority. Specifically, all other securities that rank lower in the capital structure will be fully converted before any conversion of bail-in bonds is contemplated. Bail-in bonds would be converted thereafter on a pro-rata basis so that a non-viable bank is ultimately adequately re-capitalized as determined by the regulator. Bail-in bonds would also receive more common equity shares relative to NVCC bonds and preferred shareholders, to maintain the order of the priority of claims. Lastly, Bail-in bonds issued by Canadian financial institutions **will be eligible for** inclusion in the FTSE TMX Canada Universe Bond Index once issued.

Canadian bank capital structure




## Considerations for investors moving forward

**There could be a demand/supply challenge should the current outstanding NVCC bonds be determined as eligible for inclusion in the broad index** - Currently, NVCC bonds are an out-of-benchmark holding, meaning passive and active investors that are benchmark constrained to hold securities in the FTSE TMX Canada indexes, can’t own them. If these bonds are made index eligible, these investors will need to devise trading strategies to buy a large amount of NVCC securities, ultimately increasing demand for the bonds with no new incremental supply. This may result in driving the price of existing NVCC bonds higher for the simple reason that there are more buyers than sellers.

**Potential for higher funding costs (yield on bank debt)** - There are now additional considerations when assessing risk given the removal of the implicit government backing of traditional bank debt and investors may demand compensation for this additional risk. Although we believe a non-viable event trigger is a very unlikely scenario today, we conduct fundamental research on a bank by bank basis to ensure we fully understand these risks. With this possibility in mind, we continue to believe that this possible increase in Canadian banks’ cost of funding will be manageable and have limited impact on profitably.

**The largest component of the Canadian corporate bond market may carry a lower rating** - Bail-in notes are expected to have lower credit ratings than existing unsecured senior debt given the removal of implicit government backing. Senior bank debt is one of the most widely held types of securities among investors. Legacy senior debt will be grandfathered, but will slowly roll out of the index and be replaced entirely by Bail-in bonds. NVCC subordinate-debt, which resides lower in the capital structure, currently is rated A (RBC and TD) or BBB (BNS, BMO, CIBC, NB). The potential inclusion of the current $16 billion of Canadian dollar NVCC debt along with all future new issuances contributes to the downward migration in ratings. There is potential that the overall banking average credit rating may decline as a result of the ratings associated with the new Bail-in instruments and NVCC debt.

**Potential for bank debt to be issued with callable features** - Bail-in and NVCC bonds with less than one year to maturity will not be included in the calculation of TLAC. This provides incentives for banks to issue bonds with a call option. The most likely scenario would be an option to call a bond 1 year prior to maturity, thereby replacing it with debt that remains eligible for TLAC. A simple example of an issue could be a 5- year non-call 4 year bond. As this issue approaches its final year to maturity i.e. a 5-year bond with a call option in 4 years the bank would refinance the debt to a maturity greater than 1-year enabling the debt to meet the TLAC requirements.

## Business as usual at TDAM

NVCC bonds are not new to TD Asset Management (TDAM). In fact, our active fixed income strategies have participated in NVCC bond issuances since 2014. Although new developments are unfolding with respect to NVCC inclusion within the broad Canadian investment grade fixed income index, we have and currently hold positions within these debt instruments. Our assessment is established through our extensive credit research process, helping to ensure we understand the full merits and risk of the underlying securities. Our focus when constructing portfolios is centered on seeking to deliver superior risk-adjusted returns.

*Source: TDAM, FTSE TMX

## Hypothetical change to index composition

Below we show how the FTSE TMX Canada Universe Index would change if the total amount of NVCC bonds currently outstanding in the market were included in the market as of June 30, 2017. Given the current size of the market ($16 billion), the inclusion would have minimal impact on key characteristics when combined with the $1.5 trillion Canadian fixed income market. We observe a similar scenario when isolating for the corporate component of the market. Key observations however are the increase in the amount of short-term securities, which pulls duration down slightly, as well as an increase to the BBB ratings bucket. We stress this is only a hypothetical scenario given the market values as at June 30, 2017, the more important consideration is how the market evolves once full conversion to Bail-in and NVCC bonds has occurred.

| June 30, 2017 | FTSE TMX Canada Universe Bond Index with NVCC | FTSE TMX Canada Universe Bond Index | Difference |
|---|---|---|---|
| Market Value | **$1,570.8** | **$1,554.9** | $15.9 |
| Yield to Maturity | 2.18 | 2.17 | 0.00 |
| Duration (Modified) | 7.52 | 7.56 | -0.04 |
| Coupon | 3.41 | 3.41 | 0.00 |
| Combined Rating | AA- | AA- | |
| Term To Maturity | 10.37 | 10.44 | -0.07 |
| Term | | | |
| 1-5 Yr | 45.77% | 45.31% | 0.46% |
| 5-10 Yr | 22.82% | 22.96% | -0.14% |
| 10-20 Yr | 11.44% | 11.56% | -0.12% |
| 20+ Yr | 19.97% | 20.17% | -0.20% |
| Total | **100.00%** | **100.00%** | 0.00% |
| Ratings | | | |
| AAA | 40.30% | 40.71% | -0.41% |
| AA | 33.79% | 34.14% | -0.35% |
| A | 14.84% | 14.50% | 0.34% |
| BBB | 11.07% | 10.65% | 0.42% |
| Total | **100.00%** | **100.00%** | 0.00% |

| June 30, 2017 | FTSE TMX Canada All Corporate Bond Index with NVCC | FTSE TMX Canada All Corporate Bond Index | Difference |
|---|---|---|---|
| Market Value (Billions) | **$439.6** | **$423.7** | $15.9 |
| Yield to Maturity | 2.67 | 2.68 | -0.01 |
| Duration (Modified) | 6.26 | 6.37 | -0.10 |
| Coupon | 3.84 | 3.86 | -0.02 |
| Combined Rating | A- | A- | |
| Term To Maturity | 9.08 | 9.28 | -0.20 |
| Term | | | |
| 1-5 Yr | 54.45% | 53.08% | 1.37% |
| 5-10 Yr | 19.43% | 19.82% | -0.39% |
| 10-20 Yr | 8.99% | 9.33% | -0.34% |
| 20+ Yr | 17.13% | 17.77% | -0.64% |
| Total | **100.00%** | **100.00%** | 0.00% |
| Ratings | | | |
| AAA | 3.37% | 3.50% | -0.13% |
| AA | 13.67% | 14.18% | -0.51% |
| A | 43.39% | 43.23% | 0.16% |
| BBB | 39.57% | 39.09% | 0.48% |
| Total | **100.00%** | **100.00%** | 0.00% |

Source: TDAM, FTSE TMX. For illustrative purposes only

Please contact your TDAM Relationship Manager for more information.