COMMENTARY – SPECIAL TOPICS

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Canadian Banks and Upcoming Ratings Changes, Explained

Editor's Note: Earlier this year, the Canadian government adopted new banking regulations in the wake of the last financial crisis with the goal of creating a plan to preserve financial stability and ensure creditors and shareholders of the nation's systemically important banks bear the losses in the event of an institution's default. The following paper by our senior credit analyst for Canadian banks discusses the new regime and how it is being viewed by the rating agencies.

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Canada's Bail-In Regime

Following the lead of regulators in the United States and the European Union, the Canadian Department of Finance published a consultation paper in August 2014 on the Taxpayer Protection and Bank Recapitalization Regime (bail-in regime). After a lengthy consultation period and required legislative changes, the Canadian government published the final rules and guidelines regarding its bail-in regime in April 2018. The bail-in regime applies to Canada's domestic systemically important banks (D-SIB banks) which include Bank of Montreal (BMO), Bank of Nova Scotia (BNS), Canadian Imperial Bank of Canada (CM), National Bank of Canada (NA), Royal Bank of Canada (RY) and Toronto-Dominion Bank (TD).

The primary objective of the bail-in regime is to provide authorities with the ability to restore a financial institution to viability in the unlikely event that it should fail, without disrupting the financial system and without using taxpayer funds. A bail-in is intended to rescue a failing bank by making creditors and shareholders bear the cost of recapitalization through conversion of eligible debt into common shares, as needed, to restore key capital measures. This conversion would occur at the time the Office of the Superintendent of Financial Institutions (OSFI) determines a bank is at the point of non-viability and after all common shareholder equity has been reduced to zero and preferred share and subordinated debt positions have been converted into new equity.

Under the bail-in regime, losses are absorbed in the following creditor hierarchy until the bank is adequately recapitalized:

- Common shareholder equity
- Preferred shares
- Subordinated debt
- Eligible debt

The final bail-in rules require that Canadian D-SIB banks maintain a minimum level of total loss-absorbing capacity (TLAC) at 21.5% of risk-weighted assets. We expect the D-SIB banks will be required to hold buffers above these required levels. Necessary TLAC will be made up of a bank's combined capital position plus bail-in debt. OSFI requires the D-SIB banks to reach these minimum TLAC levels by November 1, 2021.

Eligible debt for bail-in conversion will be senior unsecured debt with an original maturity greater than 400 days that is tradable and transferable and issued by a D-SIB bank beginning September 23, 2018 (the implementation date).

Securities ***ineligible*** for bail-in include consumer deposits, senior unsecured debt with an original maturity of less than 400 days, structured notes and secured debt. Additionally, the bail-in regulations are not retroactive, as senior unsecured debt issued prior to the implementation date (legacy debt) will also be ineligible for bail-in. As a result, we view eligible debt as structurally subordinate to ineligible debt – including legacy debt – in the event a bank is determined to be non-viable.

Issuance Implications

The D-SIB banks will be required to issue a significant amount of eligible debt by November 2021 to achieve the new TLAC requirements. However, we do not expect overall debt levels at the banks to increase, as the current maturity schedules of the banks should allow them to meet their capital requirements through reissuance of existing debt at maturity over the transition period.

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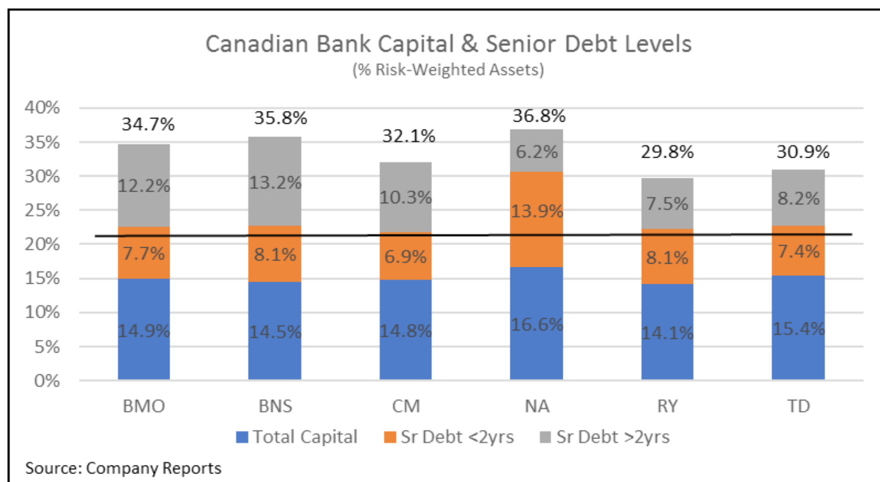
The chart below displays the total capital levels for each D-SIB bank as of July 31, 2018 and current outstanding senior unsecured debt (by maturity) as a percentage of risk-weighted assets. By simply re-issuing all maturities over the next two years with new eligible debt, all the D-SIB banks would comfortably achieve the new TLAC requirement of 21.5%. While we do not expect all new issuance from the banks over the next three years to have maturity dates greater than 400 days, the table highlights the current strong capital positions of the D-SIB banks and reflects no need for any material increase in overall debt levels to achieve the new requirements.



If the next two years' maturities are refinanced into eligible debt, the D-SIB banks would eclipse the regulatory minimum TLAC requirement.

Eligible debt will be issued under each bank's existing debt program and will be the only issuing class of medium- and long-term senior unsecured debt after the implementation date. The first eligible debt issuance is expected in late 2018, however the pace of debt issuance isn't expected to increase until sometime in early 2019.

Rating Implications

With the first issuance of eligible debt expected later this year, the primary rating agencies have articulated their expectations for ratings on eligible debt as well as any changes to outstanding legacy debt. Current indications show each agency will be taking a different approach to both classes of debt; however, thematically each agency will view eligible debt to be structurally subordinate to legacy debt.

- S&P Global Ratings (S&P) announced in August it will maintain the current ratings on legacy debt for the D-SIB banks. S&P expects to rate eligible debt one notch below the current stand-alone credit profile which will result in a two- to three-notch difference in the ratings of the two senior debt classes. This rating treatment is consistent with S&P's rating for subordinated debt, which is the viewpoint it is taking on eligible debt given the possibility for equity conversion upon bail-in.
- In July, Moody's Investors Service (Moody's) upgraded the ratings on existing D-SIB legacy debt and deposits by one to two notches and introduced a new debt rating category for eligible debt called "junior senior unsecured" debt. The junior senior unsecured debt ratings for the D-SIB banks will be two to three notches below the newly upgraded ratings for legacy debt, as Moody's will apply its advanced loss-given-failure methodology to the new debt following the introduction of a bank resolution framework (i.e. the bail-in regime).
- Fitch Ratings (Fitch) commented in June that it does not envision any immediate rating changes due to the bail-in regime or TLAC requirements. Initially, Fitch expects to rate eligible debt at the same level as legacy debt. Once sufficient eligible debt has been issued to build an appropriate capital cushion, Fitch has indicated it may upgrade the ratings on any remaining legacy debt by one notch.

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Current Long-term Ratings and Indications
as of September 10th, 2018

	S&P	Moody's	Fitch
Bank of Montreal			
Senior Unsecured	A+	Aa2	AA-
Bail-In Eligible (expected)	A-	A2	AA-
Outlook	Stable	Stable	Stable
Bank of Nova Scotia			
Senior Unsecured	A+	Aa2	AA-
Bail-In Eligible (expected)	A-	A2	AA-
Outlook	Stable	Stable	Stable
Canadian Imperial Bank of Commerce			
Senior Unsecured	A+	Aa2	AA-
Bail-In Eligible (expected)	BBB+	A2	AA-
Outlook	Stable	Stable	Negative
National Bank of Canada			
Senior Unsecured	A	Aa3	A+
Bail-In Eligible (expected)	BBB+	A3	A+
Outlook	Stable	Stable	Stable
Royal Bank of Canada			
Senior Unsecured	AA-	Aa2	AA
Bail-In Eligible (expected)	A	A2	AA
Outlook	Stable	Stable	Stable
Toronto-Dominion Bank			
Senior Unsecured	AA-	Aa1	AA-
Bail-In Eligible (expected)	A	Aa3	AA-
Outlook	Stable	Stable	Stable

Sources: Bloomberg, Rating Agencies

Our Take

Despite the structural subordination to other classes of senior debt, we view eligible debt as presenting minimal credit risk. Additionally, the new bail-in regime does not change our view that the Canadian D-SIB banks remain solid credits with strong levels of capital and liquidity, prudent underwriting standards, and robust asset quality and loss coverage metrics. Still, institutional investors may want to consider whether these changes are reflective of their investment policy risk tolerance intentions.

Author's Bio

Eric Espeseth, Senior Credit Research Analyst, is responsible for credit research within the automotive, oil and gas, utility, media / telecom and Canadian bank sectors. Additionally, he covers the Canadian public sector and any asset-backed issuers related to his sectors. Eric also serves on the Taxable Credit Committee. Eric began his financial industry career at U.S. Bancorp Asset Management in 2004, then became a senior fixed income trader in 2008. In 2012, Eric joined Allianz Life as an associate before returning to U.S. Bancorp Asset Management in 2014. Eric received a B.S. in finance from St. Cloud State University and an M.B.A. from the University of Minnesota - Carlson School of Management.

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