

Government of Canada Publishes Bail-In Regulations

AUTHORS



Blair W. Keefe



Thomas H. Yeo



David A. Seville



Eli Monas

On June 16, 2017, the Government of Canada published in draft for public comment regulations under the *Canada Deposit Insurance Corporation Act* (the **CDIC Act**) and the *Bank Act* providing the final details of the conversion, issuance and compensation regulations relating to bail-in instruments issued by domestic systemically important banks (**D-SIBs**) (collectively referred to as the **Bail-In Regulations**). The Bail-In Regulations represent the final step in the implementation of the bank recapitalization (bail-in) regime that will allow for the expedient conversion of certain bank instruments into regulatory capital in the highly unlikely event that a D-SIB becomes non-viable (see our April 2016 bulletin [here](#), which discusses the bail-in regime). In connection with the publication of the Bail-In Regulations, the Office of the Superintendent of Financial Institutions (**OSFI**) also published for public comment its draft Total Loss Absorbing Capacity Guideline (the **TLAC Guideline**), which is meant to ensure that D-SIBs have sufficient loss absorbing capacity to support the recapitalization of a non-viable D-SIB.

D-SIBs are expected to have 180 days following the publication of the final versions of the Bail-In Regulations (which we expect will be published before the end of the year) to prepare for the first issuances of bail-in-able instruments, and going forward each D-SIB will be required to maintain a minimum capacity to absorb losses consisting of regulatory capital and debt which is subject to the conversion power. This bulletin summarizes the salient provisions of each of the Bail-In Regulations and the TLAC Guideline.

What You Need To Know

- The Bail-in Regulations are expected to come into force 180 days after the regulations are finalized. An instrument issued before that time will not be subject to the regime even if the terms of the instrument issued would otherwise qualify (unless such instrument is amended or extended per ss. 2(3)(b) of the Conversion Regulations). The D-SIBs must disclose whether a particular instrument is subject to the bail-in regime in a prospectus, information circular, other offering memorandum or similar document related to that instrument.
- In general, any instrument with an initial term to maturity greater than 400 days that is unsecured and has been assigned a CUSIP or ISIN number will be subject to the bail-in regime. Covered bonds, derivatives, structured notes and certain other liabilities are explicitly excluded from the bail-in regime. Deposits (other than deposit notes) with the D-SIB will also not be subject to the bail-in regime.
- If a conversion of the bail-in debt occurs, the holders of the bail-in debt are required to receive more common shares per dollar of claim than the holders of subordinated debt and preferred shares consistent with prior claims in the hierarchy of claims.

- The CDIC Act provides that any shareholders or creditors who are in a worse financial position than they would have been if the D-SIB had been subject to a resolution power of CDIC made pursuant to ss. 39.13(1) of the CDIC Act are entitled to compensation from CDIC.
- Commencing in the first fiscal quarter of 2022 (i.e. November 1, 2021), D-SIBs are required to maintain a TLAC (comprised of eligible capital instruments and eligible bail-in-able debt) ratio of at least 21.5% of risk weighed assets and a minimum TLAC leverage ratio of 6.75%.

Bank Recapitalization (Bail-in) Conversion Regulations (CDIC Act)

The draft *Bank Recapitalization (Bail-in) Conversion Regulations* under the CDIC Act (the **Conversion Regulations**) define the scope and conditions for conversion of bail-in-able instruments. Specifically, the following instruments issued by D-SIBs on or after the day on which the Conversion Regulations come into force¹ will be bail-in-able:

1. any debt obligation (other than subordinated indebtedness) that:
 - a. is perpetual, has an original or amended term to maturity of more than 400 days, has one or more explicit or embedded options that, if exercised by or on behalf of the issuer, could result in a maturity date that is more than 400 days from the date of issuance of the debt obligation or has an explicit or embedded option that, if exercised by or on behalf of the holder, could by itself result in a maturity date that is more than 400 days from the maturity date that would apply if the option were not exercised;
 - b. is unsecured or is only partially secured at the time of issuance²; and
 - c. has been assigned a Committee on Uniform Security Identification Procedures (CUSIP) number, International Securities Identification Number (ISIN) or other similar designation that identifies a specific security in order to facilitate its trading and settlement.
2. any share or subordinated debt that is neither a common share nor non-viability contingent capital.

For clarity, the Conversion Regulations also specify that the following, as well as any liabilities that arise from any of them, are not bail-in-able instruments:

1. any covered bond³;
2. any eligible financial contract⁴;
3. any structured note⁵;
4. any conversion or exchange privilege that is convertible at any time into shares;
5. any option or right to acquire shares or any privilege referred to in paragraph 4 above; and
6. any share of a series that was created before January 1, 2013 and issued as a result of the exercise of a conversion privilege under the terms attached to another series of shares that was created prior to January 1, 2013⁶.

In the event that the Superintendent of Financial Institutions (**Superintendent**) determines that a D-SIB has ceased, or is about to cease, to be viable and the viability of the D-SIB cannot be restored or preserved by the exercise of the Superintendent's power under the *Bank Act*, it must report such D-SIB to the Canada Deposit Insurance Corporation (**CDIC**). On receipt of such a report, the CDIC may request the Minister of Finance to recommend that an order be made to carry out a conversion under the CDIC Act, and upon such recommendation, the Governor in Council may direct the CDIC to carry out the conversion. The CDIC must use its best efforts to ensure that a senior bail-in-able instrument is converted into common shares only if all subordinate bail-in-able instruments and any subordinate non-viability contingent capital have previously been converted or are converted at the same time. With respect to priority, (a) holders of senior bail-in instruments must receive a greater number of common shares per dollar of the converted

part of the liquidation entitlement⁷ of their shares, or the converted part of the principal amount and accrued and unpaid interest of their liabilities, than the holders of subordinate bail-in instruments or non-viability contingent capital that are converted during the same restructuring period⁸, (b) holders of bail-in-able shares or liabilities of equal rank that are converted during the same restructuring period must receive the same number of common shares per dollar of the converted part of the liquidation entitlement of their shares or the converted part of the principal amount and accrued and unpaid interest of their liabilities, and (c) the holders of bail-in-able shares or liabilities must receive, if any non-viability contingent capital of equal rank to the shares or liabilities is converted during the same restructuring period, a number of common shares per dollar of the converted part of the liquidation entitlement of their shares, or the converted part of the principal amount and accrued and unpaid interest of their liabilities, that is equal to the largest number of common shares received by any holder of the non-viability contingent capital per dollar of that capital.

Compensation Regulations (CDIC Act)

The CDIC Act provides that any shareholders or creditors who are in a worse financial position than they would have been had a federal member institution (including a D-SIB) been subject to a resolution power of CDIC made pursuant to ss. 39.13(1) of the CDIC Act are entitled to be paid compensation by CDIC. The draft *Compensation Regulations* under the CDIC Act (the **Compensation Regulations**) provide the framework for determining the compensation, if any, to which a prescribed person under the regulations is entitled.⁹

In particular, "prescribed persons" include those persons who, immediately before the making of an order under ss. 39.13(1) of the CDIC Act, own directly or through an intermediary, any of the following: (a) shares of the federal member institution, (b) liabilities of the federal member institution that are converted in whole or in part into common shares (under the CDIC Act or in accordance with the contractual terms of the liabilities), (c) subordinated debt of the federal member institution that is vested in CDIC; (d) liabilities of the federal member institution (other than liabilities that are assigned to or assumed by a bridge institution or third party) if a winding-up order is made under the WURA with respect to the federal member institution, (e) liabilities of the federal member institution that are assigned to or assumed by a subsidiary corporation incorporated by CDIC under ss. 10(2) of the CDIC Act and that is then liquidated, during a period in which a majority of the subsidiary corporation's voting shares are held by, on behalf of or in trust for the CDIC (other than liabilities that, after being assigned to or assumed by that corporation, are assigned to or assumed by a third party), and (f) liabilities of the federal member institution that are assigned to or assumed by a bridge institution (other than liabilities that, after being assigned to or assumed by the bridge institution, are assigned to or assumed by a third party) if a winding up order is made under the WURA with respect to the bridge institution.

Bank Recapitalization (Bail-in) Issuance Regulations (Bank Act)

Pursuant to the *Bank Recapitalization (Bail-in) Issuance Regulations* under the *Bank Act* (the **Issuance Regulations**), a D-SIB must ensure that a bail-in-able liability issued by the bank includes each of the following in its terms: (a) the holder of the liability is bound, in respect of that liability, by the CDIC Act (including the conversion of the liability into common shares under the CDIC Act and the variation or extinguishment of the liability in consequence) and by the applicability of the laws of Canada or of a province of Canada in respect of the operation of the CDIC Act with respect to the liability; (b) the holder of the liability attorns to the jurisdiction of courts in Canada with respect to the CDIC Act and those laws; and (c) the terms referred to in (a) and (b) above are binding on the holder of the liability despite any other terms of the liability, any other law that governs the liability and any other agreement, arrangement or understanding between the parties with respect to the liability. In addition, a D-SIB must ensure that the terms attached to a bail-in-able share issued by the bank provide that the share is subject to conversion into common shares under the CDIC Act. Finally, a D-SIB is required to disclose in a prospectus, information circular, other offering memorandum or similar document related to the share or liability, that the share or liability is subject to conversion into common shares under ss. 39.2(2.3) of the CDIC Act.

Total Loss Absorbing Capacity (TLAC) Guideline

Subsection 485(1.1) of the *Bank Act* will require D-SIBs to maintain a minimum capacity to absorb losses. The purpose of the TLAC requirement (which will apply on a consolidated basis to all D-SIBs) is to provide a non-viable D-SIB with sufficient loss absorbing capacity to support its recapitalization (which would, in turn, facilitate an orderly resolution of the D-SIB while minimizing adverse impacts on the stability of the financial sector, ensuring the continuity of critical functions, and minimizing taxpayers' exposure to loss). Under the TLAC Guideline, the Superintendent will establish two minimum standards: (1) the risk-based TLAC ratio, which builds on the risk-based capital ratios described in OSFI's Capital Adequacy Requirements Guideline; and (2) the TLAC Leverage Ratio, which builds on the Basel III Leverage Ratio described in OSFI's Leverage Requirements Guideline. The risk-based TLAC ratio, which will be the primary basis used by OSFI to assess a D-SIB's TLAC, focuses on the risks faced by that institution, and the TLAC Leverage Ratio will provide an overall measure of a D-SIB's TLAC. The elements of each ratio are set forth in more detail in the TLAC Guideline, but the numerator for both will be the "TLAC Measure."

The TLAC Measure will consist of the sum of the D-SIB's TLAC, subject to certain adjustments. The following are eligible to be recognized as TLAC: (a) Tier 1 capital, consisting of Common Equity Tier 1 (CET1) capital and Additional Tier 1 capital, (b) Tier 2 capital, and (c) bail-in-able instruments (as described above under the heading "Bank Recapitalization (Bail-in) Issuance Regulations (Bank Act)") that are subject to conversion—in whole or in part—into common shares pursuant to ss. 39.2(2.3) of the CDIC Act and meet all of the eligibility criteria set out in the TLAC Guideline. The eligibility criteria for the capital elements of the TLAC Measure (i.e., Tier 1 and Tier 2 capital) as well as the various limits, restrictions and regulatory adjustments to which they are subject will be described in Chapter 2 of OSFI's Capital Adequacy Requirements (CAR) Guideline, and additional positive and negative adjustments will be as follows:

- a. Regulatory capital instruments, other than CET1, issued out of subsidiaries to third-parties will only be recognized as TLAC until December 31, 2021. After that date, such interests will only be eligible towards the D-SIB's capital ratios in accordance with OSFI's CAR Guideline,
- b. Regulatory capital instruments issued indirectly by a wholly and directly owned funding entity or via a special purpose vehicle (SPV) will only be recognized as TLAC where they were issued on or before December 31, 2021. Thereafter, such instruments will only be eligible towards the D-SIB's capital ratios in accordance with the CAR Guideline, and
- c. Tier 2 capital instruments that are subject to amortization under OSFI's CAR Guideline may be fully included as TLAC where their residual maturity is greater than 365 days.

The eligibility criteria for bail-in-able instruments to qualify as TLAC are described below:

- a. The instrument is subject to a permanent conversion – in whole or in part – into common shares pursuant to ss. 39.2(2.3) of the CDIC Act.
- b. The instrument is directly issued by the Canadian parent bank (indirect issuances by subsidiaries or through SPVs will not be eligible as TLAC).
- c. The instrument satisfies all of the requirements set out in the Issuance Regulations.
- d. The instrument must be issued and paid for in cash or, with the prior approval of the Superintendent, in property.
- e. Neither the D-SIB nor a related party over which the D-SIB exercises control or significant influence can have purchased the instrument, nor can the D-SIB directly or indirectly have funded the purchase of the instrument.
- f. The instrument is neither fully secured at the time of issuance nor covered by a guarantee of the D-SIB or related party or other arrangement that legally or economically enhances the seniority of the claim vis-à-vis the D-SIB's depositors and/or other general creditors.

- g. The instrument is not subject to set-off or netting rights.
- h. Except as provided below, the instrument must not provide the holder with rights to accelerate repayment of principal or interest payments outside of bankruptcy, insolvency, wind-up or liquidation. Events of default relating to the non-payment of scheduled principal and/or interest payments will be permitted where they are subject to a cure period of no less than 30 business days and clearly disclose to investors that:
 - a. acceleration is only permitted where an order has not been made pursuant to ss. 39.13(1) of the CDIC Act in respect of the institution; and that
 - b. notwithstanding any acceleration, the instrument continues to be subject to bail-in prior to its repayment.
- i. The instrument is perpetual or has a residual maturity in excess of 365 days.
- j. The instrument can be called or purchased for cancellation at the initiative of the issuer only and, where the redemption or purchase would lead to a breach of the D-SIB's minimum TLAC requirements, with the prior approval of the Superintendent.
- k. Where an amendment or variance of the instrument's terms and conditions would affect its recognition as TLAC, such amendment or variance will only be permitted with the prior approval of the Superintendent.

Beginning in the first quarter of the D-SIBs' 2022 fiscal year (i.e., November 1, 2021), OSFI anticipates that D-SIBs will be expected to maintain a minimum risk-based TLAC ratio of at least 21.5% of risk-weighted assets and a minimum TLAC Leverage ratio of at least 6.75% (and the Superintendent may subsequently vary the minimum TLAC requirements for individual D-SIBs or groups of D-SIBs). In addition, D-SIBs will also be expected to hold operating buffers above the minimum TLAC ratios. If a D-SIB falls below the minimum TLAC requirements, the Superintendent may take any measures that he or she considers appropriate, including measures described in ss. 485(3.1) of the *Bank Act*.

¹ An instrument issued before the date on which the Conversion Regulations come into force could also become bail-in-able if, on or after that date, the terms of such instrument are amended to increase its principal amount or to extend its term to maturity.

² If a debt obligation, other than subordinated indebtedness, is only partially secured at the time of issuance, only the portion of the principal amount and accrued and unpaid interest of the debt obligation that exceeds the value of the collateral (determined at the time that the debt obligation is issued) is bail-in-able.

³ As defined in s. 21.5 of the *National Housing Act*.

⁴ As defined in ss. 39.15(9) of the CDIC Act.

⁵ A "**Structured Note**" is a debt obligation that (a) specifies that the obligation's stated term to maturity, or a payment to be made by its issuer, is determined in whole or in part by reference to an index or reference points, including (i) the performance or value of an entity or asset, (ii) the market price of a security, commodity, investment fund or financial instrument, (iii) an interest rate, and (iv) the exchange rate between two currencies; or (b) contains any other type of embedded derivative or similar feature. However, the following debt obligations are *not* structured notes: (a) a debt obligation in respect of which the stated term to maturity, or a payment to be made by its issuer, is determined in whole or principally by reference to the performance of a security of that issuer; and (b) a debt obligation that (i) specifies that the return on the debt obligation is determined by a fixed or floating interest rate or a fixed spread above or below a fixed or floating interest rate, regardless of whether the return is subject to a minimum interest rate or whether the interest rate changes between fixed and floating, (ii) has no other terms affecting the stated term to maturity or the return on the debt obligation, with the exception of the right of the issuer to redeem the debt obligation or the right of the holder or issuer to extend its term to maturity, and (iii) is payable in cash.

⁶ This carve-out is meant to capture rate reset preferred shares created prior to January 1, 2013 which contained terms allowing for the conversion of such shares into a separate series of fixed or floating rate shares after a specified number of years (i.e. any such shares converted into the new series following the date of which the

regulations come into force are not bail-in-able).

⁷ "**Liquidation entitlement**" means the amount to which the holder of a share of a D-SIB is entitled to be paid, in the event that the institution is wound up, in priority to any amount to be paid to a holder of a subordinate share.

⁸ Legacy preferred shares and subordinated debt which do not contain any non-viability contingent capital features are not subject to this conversion regime, but we expect that CDIC would seize these shares if the bail-in regime is invoked, and endeavour to ensure that such shares receive the same treatment as preferred shares that did contain non-viability contingent capital features.

⁹ The amount of compensation to which a "prescribed person" is entitled with respect to each share or liability will be determined by the formula A-B-C, where (A) is the estimated liquidation value; (B) is the estimated resolution value; and (C) is (i) if the share or liability is converted in common shares in accordance with the contractual terms of the share or liability, an amount equal to an estimate of losses attributable to that conversion, and (ii) in any other case, zero.

To discuss these issues, please contact the author(s).

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