Why Canadian banks were immune to recent market stress

Few people in Canada had ever heard of Silicon Valley Bank prior to March 2023. But after the collapse of this U.S. bank, many Canadians wondered how financial institutions north of the border would be affected. In this paper, we explain the factors that make Canada's banking system stable and sound.

Persistent inflation and high interest rates were once again a major part of market conversations throughout the volatile first quarter of 2023. In March, news of trouble at a handful of U.S. regional banks - Silicon Valley Bank and Signature Bank, to name just two - dominated the headlines. The news media was quick to point to the recent aggressive increase in interest rates as the culprit and implied other banks would have similar fates. However, the failures were the result of mismanagement and lack of proper risk controls that amplified pre-existing nervousness towards the general health of the global financial system and translated into "runs" on selective U.S. regional banks.

It wasn't just regional banks in the U.S. that were having liquidity issues. In Switzerland, Credit Suisse Group AG, a very large bank with more than its fair share of troubles in recent years, finally lost the confidence of depositors and financial market participants and was on a path to non-viability when regulators intervened. In a government-sponsored resolution, Credit Suisse was acquired by fellow Swiss bank UBS Group AG for approximately USD 3 billion, thereby keeping some residual value in equity holders' hands.

Part of this resolution was a requirement to immediately increase capital, so the Swiss regulator imposed a complete write-off of all Additional Tier 1 (AT1) bonds issued by Credit Suisse. Globally this move was quite unique because a class of bondholders lost everything while modest value remained for equity holders. While not the typical path expected in most jurisdictions, a complete flip of the capital hierarchy should have been understood as a possibility given the unique contractual features of Credit Suisse's AT1s.

Understandably, these developments raised many questions and concerns about Canadian banks and the securities they have issued in the Canadian market - AT1s included. Canada has a fundamentally stable and sound banking system. There are four main reasons for this strength:

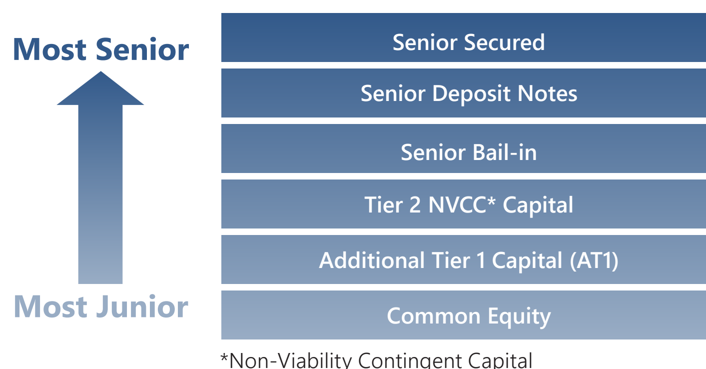
- Most Canadian banks are systemically important and therefore have higher capital requirements.
- These banks are subject to stringent liquidity requirements which necessitate prudent management.
- They are highly diversified across business lines and funding sources.
- The bank capital regime in Canada is clear and concise compared with other jurisdictions as the capital hierarchy is well-defined in a robust framework laid out by the Office of the Superintendent of Financial Institutions (OSFI).

What is bank capital and why is it important?

First, a bank is a levered entity. Simplistically, this means that it accomplishes its mandate of being a deposit-taking institution and a lender by using deposits, various forms of debt, debt/equity hybrid instruments, and common equity (shares) to fund loan activity. These instruments create a bank's capital structure.

Second, the amount and characteristics of the capital structure determine how useful it will be in ensuring the long-term viability of a bank.

Below is a simplified diagram highlighting the principal layers of a Canadian bank's capital structure.



*Non-Viability Contingent Capital

At the bottom is the most junior/subordinated component of the capital structure. As we move upwards, the securities have an increasingly senior claim on a bank's assets.

Starting at the bottom is Common Equity, which is the most junior layer of the capital structure and would absorb losses first in times of acute stress.

Next are the AT1s mentioned earlier. These securities must be approved by OSFI and be compliant with international rules called Basel III. Currently, there are several approved AT1 structures in Canada:

- Limited Resource Capital Notes (LRCNs) - first issued in July 2020.
- AT1 Capital Notes - used in very limited instances.
- $1,000 par value preferred shares - a relatively new security targeted at institutional investors.
- Legacy $25 par value preferred shares.

None of these AT1s are eligible for index inclusion in the FTSE Canada Universe Bond Index, the main Canadian fixed income benchmark.

The next layer up is Tier 2 NVCC Capital also known as NVCC Subordinated Debt or simply NVCC. These securities were first issued in the Canadian market in July 2014 and are well known and frequently traded. They currently constitute approximately 1.5% of the FTSE Canada Universe Bond Index.

Next up in the capital structure is Senior Bail-in. These securities were first issued in September 2018 and make up the majority of bank issuance in Canadian credit markets. They currently constitute approximately 5.5% of the FTSE Canada Universe Bond Index and are the most actively traded corporate credit securities in the Canadian market today.

The last two levels (Senior Deposit Notes and Senior Secured) are the highest in the capital structure but consist of relatively few securities that are traded in the Canadian market. These are mainly legacy deposit notes from a previous regulatory regime, covered bonds, and some asset-backed securities.

This simplified capital structure is implemented in a consistent manner by the major Canadian banks, and the individual securities within each specific regulatory capital layer have very similar characteristics.

The most important of these characteristics, and one that makes the Canadian market clear and concise relative to many other global jurisdictions, is specific language in the issuance documents about the convertibility to equity. At times of acute stress, bank bondholders are converted to an equity position rather than losing everything outright, the situation experienced in Switzerland with Credit Suisse. The Canadian regime is far superior for bondholders as it upholds the hierarchy of the capital stack by ensuring a senior instrument receives a relatively better outcome from any restructuring event.

This convertibility of capital instruments only happens as a result of a decision by the regulator (OSFI) that a bank is no longer viable without exceptional support. OSFI then determines how much capital must be converted to ensure the bank's viability given known information. The conversion is carried out subject to the terms of each security's issuance documents.

These documents uphold the capital hierarchy through a multiplier (see table) at each specific seniority level, ensuring that each dollar of debt gets more equity on conversion depending on the seniority of the layer held - the higher up in the capital structure diagram, the better off the investor will be in a time of stress.

Capital Structure Layer	Conversion Multiplier
Bail-in	> 1.5
Tier 2 NVCC Capital	1.5
AT1 Capital Notes	1.25
LRCNs & preferreds	1.0

Summary

Canada has a fundamentally stable and sound banking system, with well-defined capital structures. Financially, the Canadian banks continue to perform quite consistently and effectively when compared to many of their global peers. Investments in Canadian banks are supported by a robust capital regime with clearly defined rules in their issuance documents that are intended to uphold the capital hierarchy.

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