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Outlook On Six Big Canadian Banks Revised To Negative Following Review Of Bail-In Policy Proposal

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TORONTO (Standard & Poor's) Aug. 8, 2014--Standard & Poor's Ratings Services today said that it revised its outlooks to negative from stable on almost all Canadian banks to which we have ascribed ratings uplift for potential extraordinary government support in a crisis. We base this rating action on our view that the announcement of a proposed bail-in policy regime might lead us to lower ratings on the banks within two years. We are revising our outlooks on Royal Bank of Canada (RBC), Toronto-Dominion Bank (TD Bank), The Bank of Nova Scotia (Scotiabank), Bank of Montreal (BMO), Canadian Imperial Bank of Commerce (CIBC), and National Bank of Canada (NBC).

"The outlook revision reflects our expectation of reduced potential for extraordinary government support arising from implementation of the proposed new elements of the resolution framework for Canadian banks," said Standard & Poor's credit analyst Tom Connell.

THE PROPOSED FRAMEWORK

On Aug. 1, the Canadian government issued a consultation paper setting out a possible "bail-in" policy framework for large Canadian banks. The proposed Taxpayer Protection and Bank Recapitalization Regime, which the government first alluded to in its 2013 federal budget, will add to the set of tools available for Canadian officials to respond to the impending failure of a large bank, in a way designed to maintain overall financial system stability

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while reducing the potential need for a taxpayer-funded bailout.

The framework would establish the capacity of authorities to recapitalize a nonviable bank through the conversion of bank liabilities to common equity. Specifically, the proposal creates a mechanism for the conversion of bank senior debt to regulatory capital. It appears that under the proposal, senior and subordinated debt issues outstanding (excluding recently issued regulatory capital instruments) will not be subject to bail-in. Currently, regulations only require that hybrid capital instruments include a provision for their conversion to common equity for a bank that is approaching the point of nonviability. Under the proposal, banks would have to meet a higher loss absorbency (HLA) requirement, consisting of a combination of regulatory capital and senior debt. The government proposes setting a fixed HLA requirement at 17%-23% of risk weighted assets. This pool of potential loss-absorbing capital is intended to allow regulators to position a bank to absorb a meaningful degree of stressed losses and subsequently satisfy a Basel III 11.5% total capital ratio upon reemergence from receivership. We believe the explicit ability for regulators to bail-in senior debt significantly increases the capacity of authorities to stabilize a failing bank through recapitalization.

The consultation paper includes several notable proposals and questions. For instance, although the Canadian institutions all have operating banks as their top-tier parent companies, the proposal states that the federal government welcomes comments on the potential merits of the holding company model, similar to those used in the U.S. and U.K., based on a single point of entry strategy. As well, the government has proposed that the regulator's conversion powers only apply to liabilities that are issued, originated, or renegotiated after an implementation date, as determined by the government. Finally, it's proposed that only senior unsecured debt with an original maturity of more than 400 days be subject to statutory conversion. This varies from other global regimes; for example, the Bank Recovery and Resolution Directive to be implemented in the European Union states that obligations with an original maturity greater than seven days will be subject to conversion. The Canadian government has requested comments on its proposals, and the final rules could vary somewhat from the current proposal.

RATINGS UPLIFT FROM GOVERNMENT SUPPORT

We incorporate the potential for extraordinary government support in our ratings on the seven largest Canadian financial institutions. We evaluate the potential for extraordinary government support through an assessment of a bank's systemic importance, in conjunction with our view of the government's willingness and capacity to support one or more banks during a crisis. We assess seven Canadian financial institutions as having "high" or "moderate" systemic importance. We also assess Canada as being "supportive," which is the middle of three categories in our framework for evaluating the tendency of a government to bail out a financial institution. The issuer credit ratings on the large Canadian financial institutions include either one notch (RBC, TD Bank, Scotiabank, NBC, and Caisse Centrale Desjardins) or two notches (BMO and CIBC) of uplift due to the potential for extraordinary government support.

This notching reflects our belief that the Canadian government, like other governments around the world, would face strong incentives to support a large institution in a crisis to preserve financial market stability. We base this on the size and interconnectedness of these banks, their importance to the economy, and the potential for the failure of one institution to destabilize the system as a whole. We believe there is a moderately high likelihood that the Canadian government would intervene to preempt a large bank's failure.

WHAT OUR ASSESSMENT WILL ENTAIL

In assessing the credit implications of the final bail-in regime, our primary focus would be on how it affects the probability of default of banks' various debt classes (as opposed to recovery or loss-given-default considerations). The effect of the implementation of a bail-in regime could raise a bank's probability of default, in our view, because of reduced likelihood of extraordinary support from the government; and more directly, the bailing-in of senior debt would be a default with respect to those instruments, and for the issuing entity. The impact of a bail-in regime could be partially offset if market discipline prompts banks to strengthen their underlying risk-adjusted capital positions.

In our ongoing reassessment of the likelihood of extraordinary government support for systemically important banks, we will consider our views of both the government's tendency to support banks in a crisis, and whether the systemic importance of the individual banks has changed due to the evolving framework.

We might reclassify the Canadian government's tendency to support a bank as "uncertain" from the current "supportive" category. We note that taxpayer protection is a primary goal of the bail-in policy, as the consultation document's title reflects. We expect the Canadian government will take a pragmatic approach that balances policy goals and makes use of whatever options are available in the event of an impending bank failure. Canada has not prohibited capital injections to a distressed bank, but does include a capital injection from a federal or provincial government as a trigger event for the conversion of nonviability capital instruments and of bail-in debt. For jurisdictions we view as having an uncertain tendency to support banks, we do not apply any ratings uplift from a bank's stand-alone credit profile, regardless of the bank's systemic importance.

Alternatively, we could reduce our assessment of the systemic importance of some or all Canadian banks, to "moderate" or "low." This could arise if we conclude that the array of resolution tools, including the bail-in option, would have the potential to materially reduce the potential for a bank failure to destabilize the financial system. For banks we view as having low systemic importance, we do not apply any uplift for extraordinary government support. For banks that we believe have moderate systemic importance, we would limit uplift of extraordinary support to one notch at most (assuming we view the government as supportive).

The bail-in proposal would apply directly to institutions designated as domestic systemically important banks (D-SIBs) by the Office of the Superintendent of Financial Institutions (OSFI), which does not include the Desjardins group because it is regulated (and was designated as a D-SIFI) by the Autorite des marches financiers (AMF), a body the Government of Quebec has mandated to regulate the province's financial markets. We will update our expectations for support with respect to the Desjardins ratings taking into account any future regulatory directives. These regulatory D-SIB designations do not determine our assessments of systemic importance or our view of the government's tendency to support banks. In our view, the primary implications of OSFI's designation of D-SIBs include enhanced supervisory and disclosure requirements, a 1% capital surcharge, and being subject to the proposed bail-in policy.

We will base rating actions following from today's outlook revisions on our expectations for the proposal's final form, as well as details concerning scope, timing, and phase-in of related measures. In addition, we will look at the overall credibility of the proposed measures in conjunction with other resolution tools to effectively preserve financial stability in the event that a major institution fails, and the extent to which we believe they will reduce potential pressures on the government to bail out a failing institution. We will continue our assessment of the government's proposal to identify specific elements that might have incrementally positive or negative rating implications considered in isolation.

The negative outlook on the affected banks primarily relates to the issuer credit and senior debt ratings of those institutions. Preliminarily, we do not see immediate or direct implications of the proposed policy for the stand-alone credit profiles (SACPs) of those institutions, or for the instruments notched from the issuer SACPs. However, we do not rule out the possibility of SACP changes if subsequent changes arising from the finalized policy suggest expected responses on the part of the banks themselves or of holders of bank liabilities. These second-order responses could be positive (such as a bank's decision to strengthen its core capital position to reduce the perceived risk of bail-in) or negative (such as a negative impact on the terms or composition of wholesale funding that a bank can access subject to the bail-in regime).

The outlook revision is a response to our view of the general direction of the Canadian policy framework, as well as to the prospects of the introduction of a bail-in regime. Some specific questions we will explore in assessing the bail-in framework include:

- Will the finalized policy inspire confidence that it will materially reduce the need for government bail-outs in crisis situations?
- How will structural changes such as requirements for non-operating holding companies (if adopted) affect bank operating company credit profiles?
- How will senior debt that could be bailed in be positioned relative to other instruments with which senior debt is currently pari passu, such as deposit notes and short-term senior debt?

- How will banks respond to the bail-in policy with respect to relative amounts of loss-absorbing hybrid instruments versus senior debt (with an increasing use of hybrids potentially reducing the default risk of senior debt)?
- How will market reaction to the bail-in policy affect bank funding, and will this prompt changes in bank risk profiles?

RELATED CRITERIA AND RESEARCH

Related Criteria

- How Standard & Poor's Plans To Finalize--And Apply--Its Bank Hybrid Capital Issue Credit Ratings Criteria, July 15, 2014
- Group Rating Methodology, Nov. 19, 2013
- Revised Market Risk Charges For Banks In Our Risk-Adjusted Capital Framework, June 22, 2012
- Banks: Rating Methodology And Assumptions, Nov. 9, 2011
- Banking Industry Country Risk Assessment Methodology And Assumptions, Nov. 9, 2011
- Bank Hybrid Capital Methodology And Assumptions, Nov. 1, 2011
- Bank Capital Methodology And Assumptions, Dec. 6, 2010

Related Research

- U.S. Banks: Government Support Is Fading But Not Gone--Yet, Aug. 4, 2014
- Credit FAQ: The Rating Impact Of Resolution Regimes For European Banks, April 29, 2014
- Banking Industry Country Risk Assessment: Canada, Jan. 27, 2014
- Supplementary Analysis: Canada, Nov. 26, 2013

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