

Novel hybrid debt issuances by Canadian banks

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Hybrid debt is debt with embedded equity features that are added to meet requirements imposed by a regulator, rating agency or some other third party having oversight of an issuer's capital structure. The creation of a new form of hybrid instrument that satisfies the strict capital requirements applicable to Canadian federally-regulated financial institutions meant that 2020 was a milestone year for the development of hybrid debt in Canada. Osler was pleased to play a key role in pioneering the new alternative tier 1 capital note structure.

Regulatory capital requirements for banks

Effective January 1, 2013, the Office of the Superintendent of Financial Institutions (OSFI), the regulator having oversight of capital issued by Canadian banks, adopted an agreed set of rules developed by the Basel Committee on Banking Supervision in response to the 2008 financial crisis. These measures, called Basel III, are intended to strengthen the regulation, supervision and risk management of banks. They impose detailed requirements for the type of capital that may be issued by financial institutions to their investors.

These measures include requirements for so-called additional Tier 1 (AT1) capital. AT1 capital is capital that qualifies as Tier 1 capital for purposes of the Basel III capital adequacy rules, but that is not common equity or non-cumulative perpetual preferred shares. At the same time, OSFI introduced a requirement that each non-common share capital instrument issued by a Canadian bank after January 1, 2013 must contain a feature which requires the instrument to convert into common share equity if the applicable bank ceases to be viable (non-viability contingent capital (NVCC) conversion). Any capital instruments that were outstanding on January 1, 2013 and do not have NVCC features are required to be phased out over 10 years.

As a result of these regulatory capital developments, the market for AT1 capital of Canadian domestic banks decreased and Canadian banks sought to develop new capital instruments that could satisfy the revised AT1 capital requirements.

AT1 Limited Recourse Capital Notes

In July 2020, OSFI ruled that AT1 Limited Recourse Capital Notes, a new form of hybrid debt instrument pioneered by Royal Bank of Canada (RBC) and Osler, qualify as AT1 capital. RBC completed the inaugural offering of this new instrument with a deal size of \$1.75 billion.

AT1 Limited Recourse Capital Notes are structured as a subordinated debt instrument issued

directly by a bank. In ordinary circumstances, the bank pays, and holders receive, an interest coupon on the notes. In circumstances of financial stress affecting the bank, however, noteholders do not have recourse against the general assets of the bank. They instead have recourse only to a pool of the bank's preferred shares. If these preferred shares are delivered to noteholders, the claims of the noteholders under the subordinated debt are extinguished and they become equity holders in the bank.

As a result of these features, OSFI determined that the AT1 Limited Recourse Capital Notes comply with Basel III guidelines requiring AT1 investors to rank as equity holders of the issuing bank, rather than creditors, in times of financial stress. Under the OSFI ruling, AT1 Limited Recourse Capital Notes may only be issued to institutional investors.

The introduction of the AT1 Limited Recourse Capital Note structure has rapidly changed the market for AT1 capital of Canadian domestic banks. The RBC AT1 hybrid debt offering was quickly followed by offerings by other Canadian banks, including National Bank of Canada and The Bank of Montreal. Since RBC's initial offering of this novel capital instrument in July 2020, nearly \$6 billion of AT1 Limited Recourse Capital Notes have been issued by Canadian banks. Other federally regulated financial institutions, such as insurance companies, are expected to follow suit.

This new form of AT1 capital is also expected to help foster a more global institutional market for Canadian bank AT1 capital than currently exists. Unlike dividends on common shares and preferred shares, where withholding tax is payable, no withholding tax is payable on interest payments on the notes. This makes the structure competitive with instruments issued by Canadian banks' international peers. Market participants expect that over the coming years, Canadian banks will replace their outstanding preferred shares with AT1 Limited Recourse Capital Notes. This will have the effect of shifting the existing domestic, retail investor base for preferred shares to a global institutional investor base for AT1 Limited Recourse Capital Notes.

Osler has long been an innovator in the hybrid debt market. In 2016, Osler developed a form of hybrid note for Canadian energy and services company, Emera Inc. Emera Inc. issued US\$1.2 billion of notes as part of an acquisition financing package. They provide 50% equity credit for rating agency purposes and have a deductible coupon that does not attract Canadian withholding tax. These hybrid notes continue to be issued by other Canadian corporations and provided the structural foundation upon which the Basel III-compliant AT1 Limited Recourse Capital Notes were developed by Osler for Canadian financial institutions.