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How bail-in works

Canada

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How Bail-in Works

Rationale for the bail-in power

The 2008 global financial crisis highlighted that some banks are "systemically important," that is, they are so important to the functioning of the financial system and economy that they cannot be wound down under a conventional bankruptcy and liquidation process without imposing unacceptable costs on the economy. These institutions are commonly labelled as "too big to fail" (see International Context).

Faced with inadequate tools to deal with failed global banks, authorities in other jurisdictions have been forced to rely on taxpayer-funded capital injections to support these banks in the interest of broader financial and economic stability. These are commonly referred to as "bailouts."

In addition to the direct costs to taxpayers associated with these bailouts, the expectation of a bailout if the bank were to fail gives bank managers an incentive to take on excessive risk, as they receive all of the potential benefits, but bear only some of the potential costs.

The expectation of a bailout also allows domestic systemically important banks (D-SIBs) to borrow on more favourable terms, as creditors view the bank's debt as implicitly guaranteed by taxpayers. By contrast, small and medium-sized banks do not benefit from this implicit subsidy in the form of lower funding costs, as there is less of an expectation that they would be bailed out should they fail.

In contrast to a bailout, a "bail-in" is intended to rescue a failing bank by making its creditors and shareholders bear the cost of recapitalizing the bank through conversion of some or all of the bank's bail-in debt into common shares.

The bail-in power gives CDIC the authority to recapitalize D-SIBs from within, by converting some or all of a failing D-SIB's bail-in debt into common shares in order to help restore it to viability.

The Canadian financial system remained resilient throughout the 2008 global financial crisis, with no Canadian bank failures. The strength of the Canadian financial sector should not be taken for granted, however. The bail-in tool is a recommended international standard (see International Context) and gives CDIC another tool to resolve D-SIBs.

Objectives of the bail-in regime

The objectives of the bail-in regime are to:

- **preserve financial stability** and minimize disruptions to the financial system;
- **reduce taxpayer exposure;** and
- **increase market discipline** and reduce incentives for D-SIBs to take on excessive risk.

In the unlikely event of D-SIB failure, the bail-in power achieves those objectives by:

- restoring the D-SIB to viability;
- allowing the D-SIB to remain open and operating and to maintain the critical services it provides to its customers; and
- ensuring that D-SIB creditors and shareholders are the ones who bear losses rather than taxpayers.

Use of the bail-in power

In the unlikely event of the non-viability of a D-SIB, CDIC would take control of the bank using its *Enhanced Financial Institution Restructuring Provisions* (E-FIRP) and restore it to viability by "bailing in" some of the bank's debt, which is converted into common shares.

International context

Canada has been an active participant in the G20's financial sector reform agenda aimed at addressing the factors that contributed to the financial crisis. This includes international efforts to address the potential risks to the financial system and broader economy posed by institutions perceived as "too big to fail."

Following the global financial crisis that began in 2008, the Financial Stability Board (FSB) set out the responsibilities and powers that countries should have in place to resolve systemically important financial institutions. These responsibilities and powers are known as the *Key Attributes of Effective Resolution Regimes for Financial Institutions* (PDF, 830 KB) (Key Attributes). The objective of the Key Attributes is to make it possible for authorities to resolve a D-SIB in a manner that protects deposits, maintains critical financial services, protects the economy, and minimizes risk to taxpayers. The key attributes were endorsed by Canada and other G20 countries in 2011.

Having the power to carry out a bail-in resolution is an important component of the Key Attributes.

A number of jurisdictions have already incorporated bail-in (or equivalent) powers into their own bank resolution regimes. Examples include the United States, Switzerland, and all EU member states (including the United Kingdom) via the European Union Bank Recovery and Resolution Directive (or BRRD).

The Canadian bail-in regime is broadly consistent with the international standards endorsed by the G20 and the best practices of other jurisdictions.

In 2017, the FSB published a consultative document on principles to assist authorities in making the bail-in tool operational. The way CDIC would implement a bail-in is broadly consistent with these principles.

Bail-in framework – Key attributes

The bail-in framework consists of a number of key attributes:

- **Legislation:** the *CDIC Act* provides CDIC with bail-in powers.
- **Regulations**: The bail-in regulations provide details on various aspects of the bail-in regime, including what is subject to bail-in, what factors CDIC must consider in exercising its bail-in power, and the requirements D-SIBs have to follow when issuing bail-in debt.
- **TLAC Guidance**: D-SIBs need to have sufficient regulatory capital and bail-in debt in the event of a failure, to absorb and withstand severe, but plausible losses and be restored to viability. The TLAC (or Total Loss-Absorbing Capacity) guidance sets out the minimum total loss-absorbing capacity that D-SIBs must have (see Bail-in example).

Bail-in power

The *CDIC Act* provides CDIC with the legal power to undertake a bail-in. In addition, the Bank Recapitalization (Bail-in) Conversion Regulations and the Bank Recapitalization (Bail-in) Issuance Regulations provide details on various aspects of the bail-in regime[1].

CDIC has the power to undertake a bail-in conversion by converting specified debt of a failing D-SIB into common shares to recapitalize the D-SIB and allow it to remain open and operating[2]. The *CDIC*

[1] Please note that there were also amendments to the CDIC Act to implement a new compensation regime for shareholders and creditors affected by CDIC's actions to resolve a non-viable member institution.
[2] CDIC must be directed by the Governor-in-Council (i.e., the federal Cabinet) to undertake a bail-in conversion.

Act provides CDIC with the flexibility to determine the amount of bail-in debt to be converted into common shares, as well as the timing of conversion, including whether the conversion will take place in a single step or over a period of time.

The bail-in power cannot be used unless CDIC has taken temporary control or ownership of the D-SIB. Under the *CDIC Act*, CDIC can take temporary control of a bank in one of two ways: by owning the bank's share or controlling the bank's assets. This gives it the ability to seek and carry out a transaction in order to restructure the bank.

CDIC's powers were enhanced when the bail-in power was introduced, to allow for a longer period of CDIC ownership or control (one year with up to four one-year extensions, for a total of five years). These enhanced powers, referred to as E-FIRP (Enhanced Financial Institution Restructuring Provisions), can only be used in respect of D-SIBs[3].

CDIC temporary control or ownership of the D-SIBs is necessary as bail-in conversion would likely be accompanied by other steps to return the D-SIB to viability. These could include, for example, replacing the directors of the D-SIB, using the D-SIB's existing employees and contractors to ensure that essential services are maintained, and restructuring the D-SIB as necessary, such as by selling off troubled assets or subsidiaries. Through these powers, CDIC also can impose losses on existing shareholders, either by having the shares transferred to CDIC or by diluting their ownership through a bail-in conversion.

Writing-down bail-in debt without providing common shares in exchange is not permitted under the bail-in power.

What is included?

The bail-in regulations set out which instruments are eligible for bail-in. The bail-in power applies only to the following instruments:

- **Long-term (i.e., an original term to maturity of more than 400 days) unsecured senior debt that is tradable, transferable, and issued by D-SIBs**
    - Instruments are considered tradable and transferable if they have a Committee on Uniform Securities Identification Procedures (CUSIP) number, International Securities Identification Number (ISIN) or other similar identification.

[3] CDIC may take temporary control or ownership of a D-SIB through E-FIRP for up to one year, but the Government may grant up to four extensions of one year each upon GIC approval, up to a maximum of five years. At the end of the five years, the D-SIB is returned to the private sector.

- **Preferred shares and subordinated debt that are not Non-Viability Contingent Capital (NVCC)**
    - In practice, D-SIBs are not expected to issue any such instruments, as preferred shares and subordinated debt are almost exclusively issued by D-SIBs in the form of NVCC to count towards the regulatory capital requirements set by the Office of the Superintendent of Financial Institutions (OSFI).

The bail-in power is not retroactive. This means that only instruments that are issued or amended to increase their principal value or extend their term to maturity, on or after September 23, 2018, are eligible for bail-in. The bail-in power does not apply to instruments that meet the above eligibility criteria but were in existence before that date.

What is excluded?

The following are **not** eligible for a bail-in:

- Deposits (including chequing accounts, savings accounts and term deposits such as GICs)
- Secured liabilities (e.g., covered bonds)
- Eligible financial contracts (e.g., derivatives)
- Most structured notes[4]

While they are not subject to conversion under the bail-in regime, NVCC instruments are subject to conversion pursuant to their contractual terms and fully convert into common shares prior to the bail-in conversion of senior debt into common shares.

Ability to impose losses on other instruments

As noted above, the bail-in regime does not apply retroactively. This means that capital instruments (that is, preferred shares and subordinated debt) that were issued prior to September 23, 2018, and that do not contain contractual conversion features, also referred to as NVCC,[5] are not eligible for conversion under the bail-in regime.

[4] Structured notes are debt obligations whose returns are based on such things as equity indexes, a single equity security, a basket of equity securities, interest rates, commodities, and/or foreign currencies.
[5] Since January 1, 2013, OSFI has required all non-common regulatory capital instruments (for example, subordinated debt and preferred shares) issued by banks to contain contractual terms that allow for their automatic conversion into common shares (or writedown of the instrument) if the bank becomes non-viable.

However, these instruments could be subject to losses through the exercise of CDIC's powers. Under the *CDIC Act*, CDIC has a variety of options available in terms of how to treat these instruments; CDIC could choose to wipe them out completely or treat them the same as equally ranking NVCC instruments.

For example, in cases where CDIC takes control through ownership of shares, legacy subordinated debt and legacy preferred shares could be transferred to CDIC by the Governor in Council, and CDIC could provide shares or cash to the original holders in return. In those circumstances, holders of these instruments could expect to:

- bear losses before more senior instruments; and
- receive equal or less favourable treatment than equally ranking NVCC instruments.

This would result in senior bail-in debtholders being better off than holders of more junior-ranking instruments, which would respect the creditor hierarchy.

In a similar fashion, common shares outstanding prior to the D-SIB's failure could also be transferred to CDIC by the Governor in Council. In such a case, the holders of these common shares would likely not receive anything in return, although they could be entitled to compensation.

Bail-in conversion

While CDIC has flexibility with respect to the amount and timing of conversion, the bail-in regulations set out certain conversion parameters that CDIC must follow in determining the conversion terms for bail-in debt. These parameters are aimed at clarifying that the purpose of a bail-in conversion is to recapitalize the institution to a level that supports market confidence and to ensure that relative creditor hierarchy is preserved.

CDIC must set the terms and conditions of a bail-in conversion in accordance with the following parameters:

- **Adequate recapitalization** – in carrying out a bail-in, CDIC must take into consideration the requirement in the *Bank Act* for banks to maintain adequate capital.
  - The intent of this requirement is to ensure that the D-SIB emerges from the bail-in conversion appropriately recapitalized, with a buffer, to restore the D-SIB to viability and market confidence.
- **Order of conversion** – CDIC may only convert bail-in eligible instruments if all subordinate-ranking bail-in-eligible and NVCC instruments have been converted.

- **Treatment of equally ranking instruments** – all equally ranking bail-in-eligible instruments must be converted in the same proportion (pro rata) and receive the same number of common shares per dollar of the claim that is converted.
    - Conversion is on a pro rata basis. This means that CDIC does not have the discretion to choose to convert certain debt by type of debtholder or location of debtholder. CDIC must also convert all of a D-SIB's equally ranking bail-in debt at the same rate (i.e., CDIC could not convert 100% of a certain debt instrument and 50% of another equally ranking instrument).
- **Relative creditor hierarchy** – holders of bail-in eligible instruments must receive more common shares per dollar of their claims converted than holders of subordinate ranking bail-in-eligible instruments and NVCC instruments.
    - Bail-ins follow relative creditor hierarchy, meaning that holders of more senior bail-in-eligible instruments must be better off than holders of subordinate ranking bail-in-eligible instruments and NVCC instruments. Bail-in does not change the hierarchy of claims, but instead ensure that the losses that led to the failure of the D-SIB are borne by investors based on their creditor ranking.

The bail-in regulations do not include a fixed conversion rate setting out how many common shares bail-in debtholders must receive for each dollar of debt converted. This provides CDIC with discretion to set appropriate conversion terms based on circumstances.

Issuance requirements

The bail-in regulations set out requirements that D-SIBs must follow when issuing bail-in-eligible debt. The regulations seek to ensure that:

- **Investors have clarity on which debt is subject to the bail-in power.** The bail-in regulations require D-SIBs to provide investors with a prospectus or other relevant offering or disclosure document, and to disclose to investors in that document whether the instrument is subject to bail-in conversion. This disclosure requirement is in addition to, and not in lieu of, any other disclosure requirements. Also, to ensure investors can easily distinguish between debt that is subject to bail-in and debt that is not, the bail-in regulations prohibit D-SIBs from referring to bail-in debt as a deposit in their advertising and other promotional efforts in Canada.
- **CDIC's bail-in power can be exercised in respect of all bail-in-eligible instruments, even where instruments are governed by foreign law.** The bail-in regulations require that the contractual terms of instruments subject to bail-in specify that the holder is bound by the *CDIC Act*, including conversion of the instrument into common shares in the event of a bail-

in. The bail-in regulations state that the provisions relating to bail-in conversion are governed by Canadian law, even where the rest of the contract is governed by foreign law. These provisions are important since Canadian D-SIBs issue significant amounts of debt outside of Canada.

D-SIB designation and Total-Loss Absorbing Capacity (TLAC)

The Office of the Superintendent of Financial Institutions (OSFI) has identified Canada's six largest banks as being D-SIBs, recognizing that the disorderly failure of these banks could have a detrimental impact on the Canadian financial system and economy. In addition, the FSB has designated Royal Bank of Canada (RBC) and the Toronto-Dominion Bank as global systemically important banks (G-SIBs).

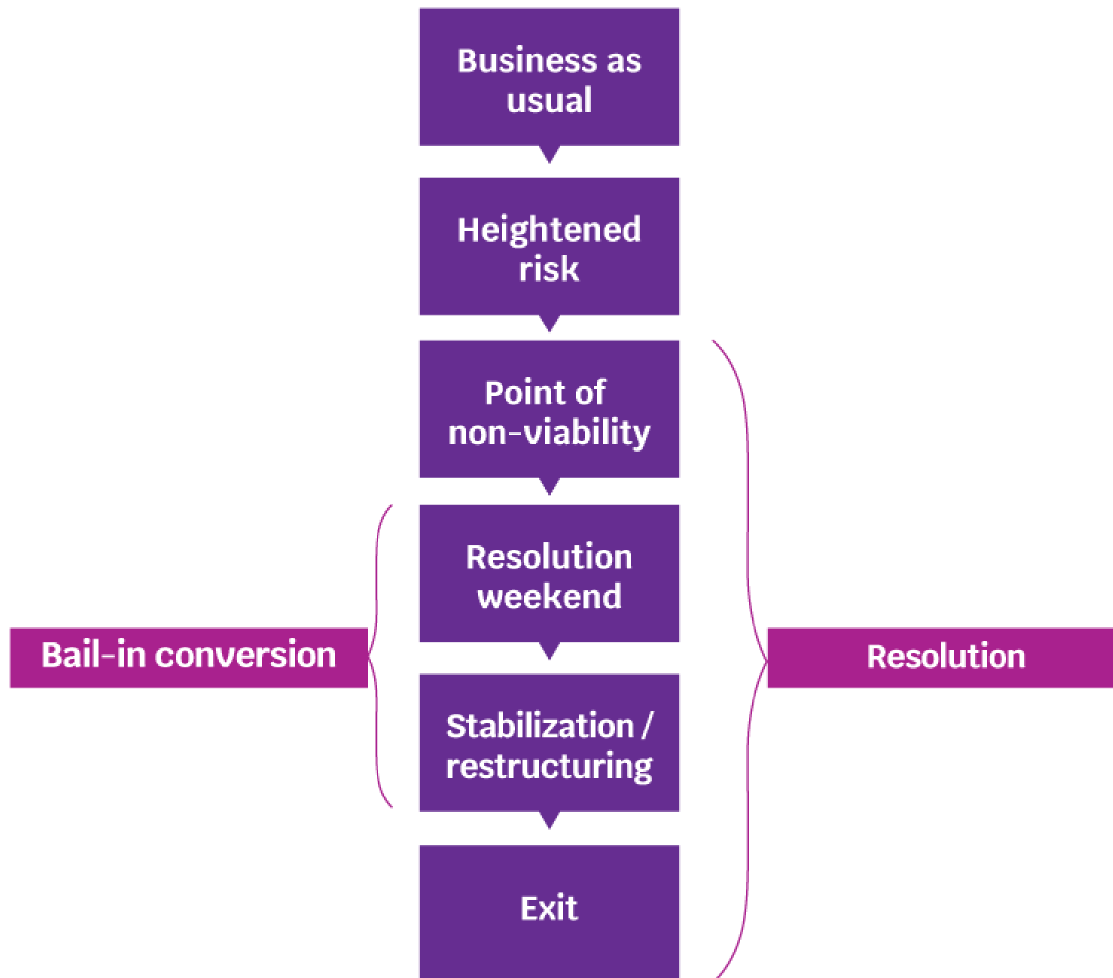
To ensure D-SIBs have the capacity to withstand severe but plausible losses and emerge from a bail-in well-capitalized, the legislative framework of the bail-in regime includes a requirement in the *Bank Act* for Canada's D-SIBs to maintain a minimum capacity to absorb losses, which is set and enforced by the Superintendent of Financial Institutions.

The Superintendent of Financial Institutions has issued orders to each D-SIB specifying the minimum amount of total loss-absorbing capacity (TLAC) they must hold. More specifically, D-SIBs are required 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%, pursuant to orders issued to each D-SIB by the Superintendent. This requirement is broadly consistent with the FSB TLAC standard. [6]

Resolution stages

D-SIB resolution involves a number of key phases. Below is an illustrative timeline that details these various stages together with the actions and events that might take place at each stage.[7]

[6] TLAC, or Total Loss-Absorbing Capacity, is a standard applicable to global systemically important banks. This standard was finalized by the Financial Stability Board in late 2015 and endorsed by the G20.
[7] For the purposes of this backgrounder, we have assumed that immediately after CDIC takes control, the Superintendent of Financial Institutions would announce that the conditions for conversion of any NVCC instruments have been met, triggering automatic conversion of all such instruments into common shares in accordance with their contractual terms.



1. **Business as usual:** during this period, the D-SIB is in good financial health.

2. **Heightened risk:** during this period, the D-SIB faces severe financial difficulties that may lead up to resolution if they are not addressed.
   - During this stage, the D-SIB may implement recovery plan actions under OSFI's oversight, while CDIC may monitor and undertake any necessary preparatory activities.[8]
   - There could be a general lack of market confidence in the D-SIB. The D-SIB could experience credit rating downgrades and challenges raising capital and/or funding.

[8] The coordination mechanism in place between OSFI and CDIC during the recovery stage is described in the Guide to Intervention for Federally Regulated Deposit-Taking Institutions.

3. **Point of non-viability:** this is when the Superintendent of Financial Institutions determines that the D-SIB has ceased or is about to cease to be viable.
    - The Superintendent concludes that the D-SIB is about to become or is no longer viable, after providing the D-SIB with an opportunity to make representations. The Superintendent reports this to the CDIC board of directors but does not make it public.
    - If the CDIC board of directors determines that a bail-in is necessary, it informs the Minister of Finance and suggests a resolution approach that includes the use of bail-in powers.
    - If the Minister of Finance agrees, they recommend this approach to the Governor in Council (GIC) (i.e., the federal Cabinet).
    - If the GIC agrees, it makes an order (GIC order) authorizing CDIC to take temporary control or ownership of the non-viable D-SIB[9] and directing CDIC to carry out a bail-in conversion to recapitalize the D-SIB.

4. **Resolution weekend**: this is the initial period during which CDIC takes temporary control or ownership of the D-SIB, upon the GIC order being issued.
    - In most cases, a GIC order would be issued after the markets close on a Friday, so that CDIC can take control or ownership of the D-SIB that night.
    - CDIC makes a public announcement to inform market participants and the public that the D-SIB has entered resolution, that CDIC has temporary control or ownership of the bank, and that a bail-in will be used as part of the strategy to restore the D-SIB to viability.
    - CDIC (and potentially other federal authorities) take all necessary actions to ensure that the D-SIB can reopen and continue its operations on the Monday morning. For example, depending on the circumstances, authorities may need to provide liquidity funding to the D-SIB until it restores its market funding channels.
    - Voting rights of existing and new common shares are suspended during the time that CDIC controls or owns the D-SIB.

5. **Stabilization/restructuring:** during this stage, CDIC undertakes any necessary restructuring measures (e.g., selling off troubled assets or subsidiaries) to address the underlying cause of failure and return a viable D-SIB to the private sector. It is during this period that bail-in debt is converted.

[9] CDIC control or ownership of the D-SIB through E-FIRP is a necessary precondition for bail-in to be used.

Bail-in conversion

- CDIC determines the portion of bail-in debt to be converted into common shares, as well as the timing of conversion.,
  - For example, CDIC could choose to convert bail-in debt into common shares over the resolution weekend, or later during the stabilization period.
  - CDIC could also choose to convert bail-in debt into interim instruments, before subsequently converting the interim instruments into common shares.
- CDIC determines the amount of bail-in debt to be converted to restore the D-SIB's capital levels to an adequate level with a buffer for market confidence and determines the number of shares that bail-in debtholders are to receive in exchange for their debt.
- Bail-in debt is fully or partially converted into new common shares.

Other restructuring actions

- Bail-in conversions are used as part of a suite of measures to return D-SIBs to viability.
- The restructuring actions during this stage are generally in keeping with the D-SIB's resolution plan, although they also very much depend on the circumstances facing the D-SIB at the time of resolution.
- One course of action that CDIC may choose is to replace the D-SIB's board of directors and senior management.
- CDIC's goal is to return the D-SIB to private control as soon as possible, although the GIC may authorize CDIC to be in control for up to five years.

Exit: After completion of the bail-in conversion and other necessary restructuring measures, CDIC returns the D-SIB to private control.

- Once the D-SIB is stabilized, it is returned to the private sector.
- Common shareholders regain full control and voting rights.

Bail-in implementation

Introduction

The *CDIC Act* provides CDIC with the legal power to use bail-in (i.e., convert bail-in debt of a Domestic Systemically Important Bank (D-SIB)). The details are set out in the relevant regulations.

While every bail-in situation is unique, this section outlines how CDIC implements bail-in during the various resolution stages.

Business as usual

Through their resolution planning, D-SIBs are expected to demonstrate that they can be resolved in an orderly manner without impact on their continued delivery of critical financial services. This means that D-SIBs must be operationally ready to implement a bail-in conversion, including having up-to-date information on all bail-in debt (such as the relevant CUSIP/ISIN numbers[10] or similar identifiers and other instrument-specific information).

CDIC works with the D-SIBs to ensure these plans are realistic, credible, and implementable.

Heightened risk

Whenever a D-SIB faces severe financial difficulties, CDIC prepares for a potential resolution by undertaking any necessary preparatory activities, as outlined in the Guide to Intervention for Federally Regulated Deposit-Taking Institutions.

[10] In order to be eligible for bail-in conversion, bail-in debt needs to have a Committee on Uniform Security Identification Procedures (CUSIP) number, an International Securities Identification Number (ISIN), or other similar identifier that facilitates its trading and settlement (see Bail-In – What is Included?).

Resolution weekend/stabilization/restructuring[11]

Bail-in announcement

CDIC makes a public announcement as soon as possible after the Governor-in-Council (GIC) orders CDIC to undertake a bail-in conversion (see Resolution Stages). At a minimum, CDIC announces the following:[12]

- CDIC's temporary takeover of control or ownership of the D-SIB and intent to carry out a bail-in conversion to recapitalize the D-SIB
- The fact that the D-SIB will remain open and operating and will continue to provide critical financial services to its customers
- The impact on pre-existing shareholders and subordinated debtholders[13], including whether any voting rights of those shares are suspended and whether the shares and subordinated debt of the D-SIB are transferred to CDIC;
- An estimate of the total amount of the D-SIB's bail-in debt available for recapitalization[14]
- The list of the D-SIB's bail-in debt that is eligible for a bail-in conversion (i.e., identified through CUSIP/ISIN numbers)

In some circumstances, CDIC may be able to announce the conversion amount and conversion terms when making this initial public announcement.

Shortly after the GIC order is made, the Superintendent of Financial Institutions also generally announces that the conditions for conversion of any Non-Viability Contingent Capital (NVCC) instruments have been met, triggering automatic conversion of all such instruments into common shares in accordance with their contractual terms.[15]

[11] During resolution, D-SIBs may be subject to other applicable laws, including securities laws.
[12] The items listed focus specifically on bail-in; it is expected that CDIC would make announcements on other topics (e.g., D-SIB governance, details of any financing arrangements, provision of any guarantees, access to payment systems, etc.).
[13] This only applies to preferred shares and subordinated debt without NVCC features issued prior to September 23, 2018 (see Ability to Impose Losses on Other Instruments).
[14] The total amount is not necessarily the amount of the D-SIB's bail-in debt that CDIC decides to convert (conversion amount) (see Timing of Bail-in Conversion).
[15] Alternatively, NVCC instruments may have been subject to conversion prior to the GIC order where a trigger event has occurred.

Impact on trading

The D-SIBs have securities and other financial instruments[16] that are qualified, registered, and traded in multiple jurisdictions. As a result, D-SIBs are subject to continuous and periodic disclosure requirements, which continue to apply in resolution.

D-SIBs are expected to comply with securities law and listing requirements to the extent possible during a bail-in resolution. If securities law requirements and listing requirements are not met, the relevant securities regulators and/or exchanges may halt or suspend trading in the D-SIB's securities or other financial instruments, either on an exchange or over the counter (OTC). In that case, trading would likely not resume until the D-SIB can meet securities law and listing requirements.

Throughout the resolution process, CDIC maintains regular contact with market authorities and coordinates actions to the extent possible.

Timing of bail-in conversion

While the bail-in regulations set out certain conversion parameters that CDIC must follow when effecting a bail-in conversion, CDIC has the flexibility to determine the portion of bail-in debt to be converted as well as the timing of conversion.

CDIC seeks to make these decisions as quickly as possible in the circumstances.

To effect a bail-in conversion, CDIC needs to determine:

- how much bail-in debt to convert to absorb the losses that led to the D-SIB entering resolution and ensure that the D-SIB is adequately recapitalized (conversion amount); and
- the number of common shares bail-in debtholders will receive in exchange for their bail-in debt (conversion terms).

To guide these decisions, CDIC conducts various valuations in respect of the D-SIB with the assistance of external valuation experts. Depending on circumstances, valuation work may commence before the D-SIB enters into resolution.

In some cases, CDIC may be able to make these decisions and announce the conversion amount and conversion terms fairly quickly. In others, the timing takes longer as it depends on

[16] This includes, but is not limited to, common shares, NVCC preferred shares, NVCC subordinated debt, non-NVCC preferred shares or subordinated debt, senior debt, covered bonds.

circumstances such as why the D-SIB failed, how much time CDIC had to prepare for resolution, and whether the D-SIB's failure is isolated or part of a larger systemic disruption.

Where CDIC has determined the conversion amount and conversion terms at the time of the initial public announcement or shortly thereafter, it announces these at the same time. Where CDIC has not yet determined the conversion amount or the conversion terms at the time of the initial public announcement, it may provide an estimated range of the amount to be converted and say when it thinks an announcement will be made given the circumstances.

Delivery of common shares

Flexibility

The *CDIC Act* provides CDIC with the flexibility to determine the process of conversion, including whether the conversion takes place in one step or over a period of time.

Process

CDIC leverages existing processes and systems within central securities depositories[17] to deliver common shares in a bail-in conversion. This means that, in most circumstances, bail-in debtholders are not required to come forward to CDIC and provide details before receiving common shares.

For example, CDIC instructs the D-SIB to issue the requisite number of new common shares, based on the conversion terms, and to allocate them to the relevant depositories where bail-in debt is registered. Instructions are also provided for the depositories to:

- write down the bail-in debt (i.e., to zero in the case of a full conversion or to the appropriate proportion in the case of a partial conversion); and
- allocate shares to participants, which results in the bail-in debtholders being allocated their new shares.

[17] Canada (as well as most jurisdictions) relies on an intermediated holding system. When banks issue securities and other financial instruments, they generally create global certificates and register them with the relevant central security depositories. The banks then deposit the global certificates into the depositories, which allocate positions in the global certificates among the depositories' participants based on the banks' instructions. Participants in the depository maintain accounts for their clients, who can be investors or other intermediaries. Given that D-SIBs have securities and other financial instruments that are issued in multiple jurisdictions, they deal with a number of depositories (e.g., CDS Clearing and Depository Services Inc. (CDS) in Canada, the Depository Trust Company (DTC) in the United States, etc.).

The time required depends on a number of factors, including the number and location of instruments affected, and may vary between depositories.

Ownership restrictions[18]

The *Bank Act* prohibits any person from acquiring a significant interest in a bank (more than 10% of a class) unless they first receive the approval of the Minister of Finance.[19, 20] Shareholders are responsible for complying with these ownership restrictions. The *Bank Act* further provides that anyone who breaches the legal ownership restrictions is prohibited from exercising any voting rights in respect of any shares that they beneficially own in the bank.

In the case of a bail-in resolution, CDIC reminds bail-in debtholders of these legal ownership restrictions before and at the time of delivering the common shares, through public communications and through central securities depositories. However, bail-in debtholders who receive shares upon conversion of their bail-in debt (as well as other shareholders) are the ones responsible for verifying their position and complying with the ownership restrictions under the *Bank Act.* CDIC does *not* have the ability to monitor holdings and as a result is not in a position to notify bail-in debtholders in breach of these restrictions.

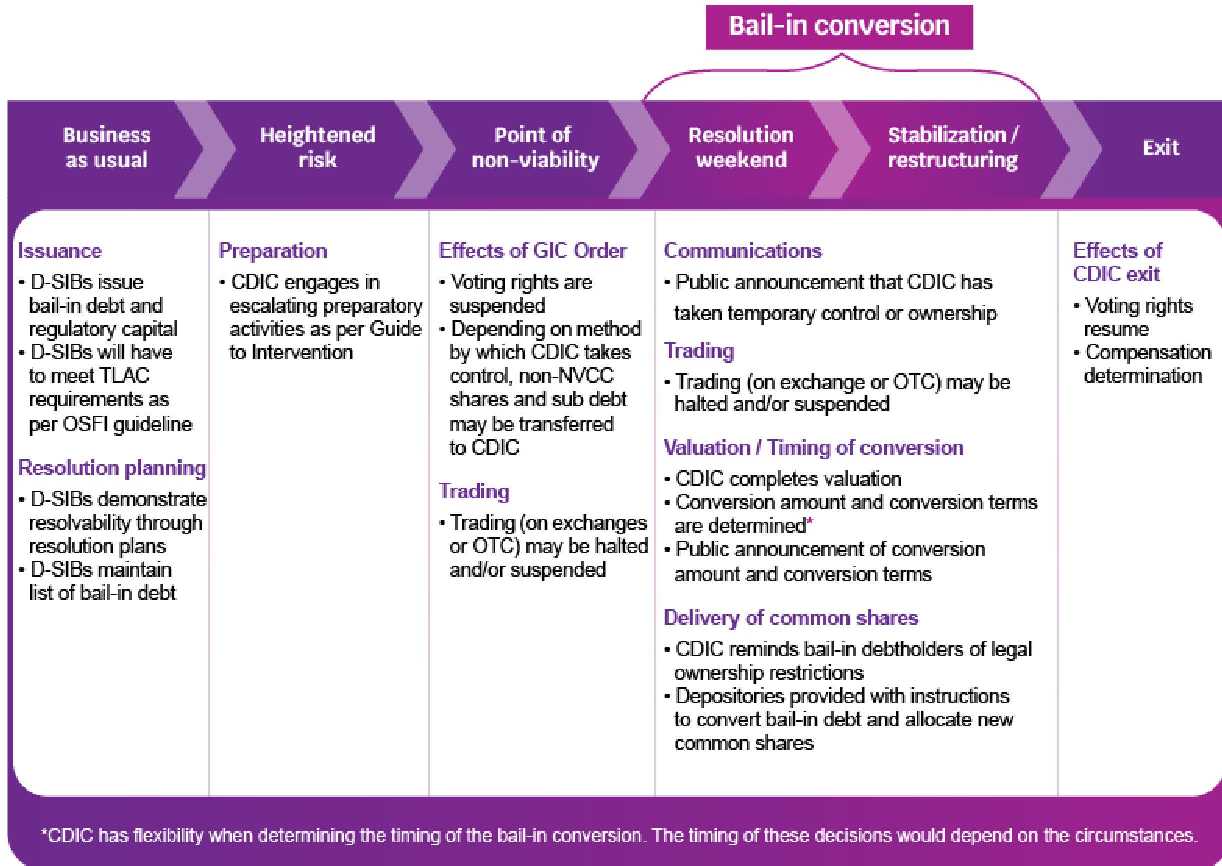
Exit

After completion of the bail-in conversion and other necessary restructuring measures, CDIC returns the bank to private control. Common shareholders regain full control and voting rights. Shareholders and creditors affected by CDIC's actions to resolve the D-SIB may be entitled to compensation.

[18] Please note that this covers only legal prohibitions, not investors' internal investment policies or mandate restrictions.
[19] With the prior approval of the Minister of Finance, a person or group may acquire up to 20% of the voting shares and 30% of the non-voting shares of a D-SIB.
[20] In addition to these restrictions, subject to certain exceptions and conditions, the Bank Act also prohibits the registration of a transfer or issue of any shares of a bank to any government or governmental agency of Canada or any province of Canada, or to any government of any foreign country, or any political subdivision, or agency of any foreign country.

Bail-in illustrative timeline

The illustrative timeline below outlines the various steps that CDIC may take in a bail-in, as well as potential actions by other stakeholders. Note that this timeline focuses only on the operational aspects of a bail-in conversion, and not on all the other actions that CDIC may be undertaking.



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Example of bail-in conversion

Stylized example – Effect of bail-in conversion on the balance sheet

When a failing D-SIB's bail-in debt is converted into common shares, this is reflected in its balance sheet.

This example depicts the balance sheet of a hypothetical D-SIB to illustrate the effect of a bail-in conversion. This diagram has been simplified to illustrate the effect of the bail-in conversion only; it does not capture the full range of liabilities held on typical D-SIB balance sheets.

The following analysis is based on a hypothetical D-SIB, ABC Bank, which enters resolution after failing. CDIC assumes temporary ownership of the D-SIB[21] and bail-in conversion is used.

Stage 1 – Business as usual

ABC Bank's balance sheet in business as usual is presented in the first column in the diagram below.

Stage 2 – Heightened risk (severe economic downturn – ABC Bank records losses)

A severe economic downturn causes some assets from ABC Bank to come under particular stress and, as a result, ABC Bank records a loss on its assets. This is shown in the second column in the diagram below.

Stages 3 to 5 – Point of non-viability to stabilization/restructuring

ABC Bank suffers a loss in market confidence. The Superintendent of Financial Institutions determines that ABC Bank has ceased or is about to cease to be viable. It is determined by the Governor-in-Council that CDIC should take temporary ownership[22] of ABC Bank, which involves the following steps[23]:

[21] CDIC assumes temporary ownership of the D-SIB through a Share E-FIRP, meaning that the outstanding shares of pre-existing shareholders are transferred to CDIC.
[22] CDIC assumes temporary ownership of the D-SIB through a Share E-FIRP.
[23] In an actual failure scenario, CDIC prepares a valuation of the balance sheet at the point of non-viability to determine the size of actual and expected future losses, to ensure that sufficient liabilities are converted to equity. This example, however, makes the simplifying assumption that there are no additional losses to recognize upon entry into resolution. The purpose of the example is exclusively to demonstrate how bail-in conversion can absorb losses.

- By operation of law, all of the common shares (equity) of ABC Bank are automatically transferred to CDIC,[24] and the pre-existing common shareholders no longer own their common shares or have any rights or entitlement to the shares. They are the first to suffer losses, in keeping with the creditor hierarchy.
- Immediately after CDIC takes temporary ownership, the Superintendent of Financial Institutions announces that the conditions for conversion of any outstanding NVCC instruments have been met, triggering automatic conversion of all such instruments into new common shares in accordance with their contractual terms. This means that NVCC subordinated debt and NVCC preferred shares are written down to zero and common equity is increased by an equivalent amount. This absorbs a portion of ABC Bank's losses, in keeping with the creditor hierarchy where preferred shareholders and subordinated debtholders absorb losses only after common shareholders have been impacted.
- In order to absorb the remaining losses, CDIC determines that a portion of the outstanding bail-in debt must be converted to common equity.[25] This means that a portion of bail-in debt is written down to zero and equity is increased by an equivalent amount on the balance sheet. Senior unsecured (or bail-in) debtholders are the last to absorb losses, in keeping with the creditor hierarchy.
- Liabilities that are not eligible for bail-in conversion, including deposits, remain unchanged as they are insulated from losses by the scope of the bail-in regime.

Following the conversion of NVCC instruments and bail-in debt, the result is a recapitalized balance sheet for ABC Bank. This is shown in the last column in the diagram below.

[24] These pre-existing common shares remain on the balance sheet; they are temporarily owned by CDIC for the duration of the resolution.
[25] In order to restore market confidence, CDIC may choose to convert all of the D-SIBs bail-in debt, or an amount that results in a recapitalization that is greater than the loss. For simplicity, the converted amount of bail-in debt results in a recapitalization that is exactly equal to the loss amount in this example.

Illustration of impact of bail-in conversion on balance sheet