Shifting Sands – Basel III and the Impact for Canadian Fixed Income Markets

Marisa Jones, CFA, Senior Credit Analyst, shared with us her analysis of regulatory changes affecting the Canadian fixed income markets. As part of CIBC Asset Management’s credit research team, Marisa is responsible for credit research on Financials.

Executive Summary

During the financial crisis of 2007-2009, many global bank securities which incorporated features that were intended to convert to capital during a distressed scenario, failed to work in the expected way. This failure reflected, in some cases, the inability to convert these instruments to capital quickly enough to be effective. The question that emerged post-crisis was how to address capital structure weaknesses going forward.

In response, the Basel Committee on Banking Supervision put forward an enhanced set of regulatory guidelines in December 2009. These guidelines, termed Basel III, addressed regulatory shortfalls in the areas of capital, liquidity and leverage.

Changes to capital requirements were the first to be implemented by global banking regulators. Basel III guidelines included higher capital levels and an increase of the “Tangible Common Equity” component of Tier 1 capital. This meant not only would banks be required to hold more capital, but the composition of the capital would be higher quality.

These changes in regulatory capital guidelines required an overhaul of bank capital instruments. New features would be needed in regulatory capital instruments to allow them to more efficiently play a role in recapitalizing a failing financial institution. Securities that did not qualify to meet Basel III’s more stringent requirements were recommended to be phased out. In Canada, non-qualifying instruments included Tier 2 subordinated debt issued before June 2010 and Innovative Tier 1 hybrids. Further, to qualify for capital treatment, instruments would have to include a mechanism to convert into common equity. Banks, investors and regulators have worked together to structure new fixed income instruments to meet the stricter Basel III guidelines.

This paper addresses the introduction of preferred share Non-Viability Contegent Capital (NVCC) and Tier 2 NVCC subordinated debt by the Canadian banks and the impact this has had on institutional clients investing in the Canadian debt capital markets. We also look at the introduction of a potential Bail-in regime in Canada and possible changes in the senior unsecured ‘deposit note’ market.

CIBC Asset Management’s Client Relations and Credit Research teams have worked to determine the impact these new securities have and how these new securities fit within plan sponsor’s existing investment policies. The impact of Basel III was seen in both the ratings of Canadian bank instruments as well as in their composition. The introduction of the Basel III regime resulted in downgrades of many bank securities as the ratings agencies removed assumptions of government support from their grading criteria. This meant many plan sponsors had to revisit their investment policy quality constraints and determine whether these securities still met their credit requirements. As well, plans restricting the purchase of fixed income securities that contain a convertibility mechanism were forced to re-evaluate this policy constraint in light of NVCC and Bail-in frameworks which could result in conversion to common equity. We strive to work with clients to ensure they understand the new features of these securities and how they should behave in the market.

We believe a full and up-to-date understanding of changing bank regulation continues to be important for our clients. In many instances these changes have direct impacts on how institutional investors construct or revise their investment policies and may have further implications on their portfolios. The understanding of regulatory changes has become even more crucial to ensuring institutional investors maintain the quality and composition they require of their fixed income allocations.