LIMITED RECOURSE CAPITAL NOTES: A NEW INSTRUMENT IN THE CANADIAN BOND MARKET

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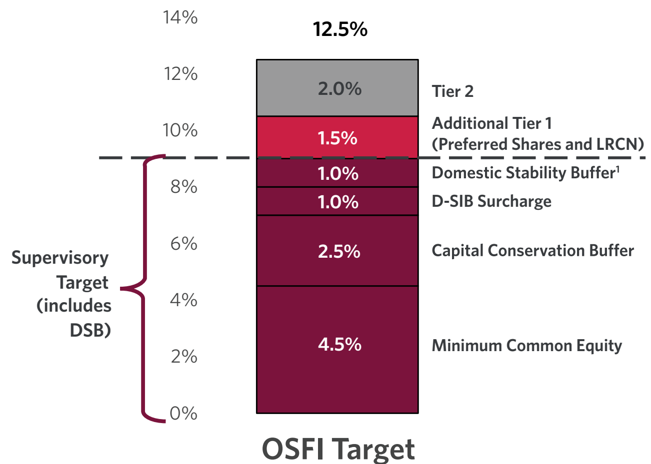
1. Summary

- Inaugural Limited Recourse Capital Note (LRCN) issued in July 2020
- Security is a bond but capital structure ranking like preferred shares
- Must be an institutional investor to purchase
- After consultation with investment community, FTSE Russell ruled at this time not to include LRCNs in the FTSE Bond Indices
- Attractive yields currently for bond investors but comes with unique risk considerations

Figure 1: OSFI required capital buckets



Source: CIBC World Markets . D-SIB = Domestic Systemically Important Bank.

2.1 Introduction

On July 21, 2020 RBC issued the first Limited Recourse Capital Note (LRCN) in Canada, a new hybrid security that is classified as a bond but ranks pari passu with preferred shares in the bank capital structure. This classification means LRCNs count as Additional Tier-1 (AT-1) capital, impacting both the Canadian bond and preferred share markets. The Office of the Superintendent of Financial Institutions (OSFI) has approved the issuance of LRCNs by federally regulated financial institutions to fulfil up to 50% of their AT-1 capital bucket.

Financial regulation requires regulated banks and insurance companies to maintain certain capital requirements. These minimum capital levels are fulfilled by a variety of financial instruments including common equity, preferred shares, subordinated debt, and senior debt. After the Great Financial Crisis in 2007/2008, several new forms of bank capital were established with conversion features that kick in at the discretion of the regulators if and when the viability of a systemically important financial insitution comes into question. In 2013, Non-viability Contingent Capital (NVCC) was introduced as a new loss-absorbing form of preferred share and subordinated debt, and in 2018 bail-in bonds were introduced resulting in the phasing out of legacy bank senior debt. LRCNs mark the next phase of bank regulatory capital instruments.

Figure 2: Regulatory capital evolution

Source: CIBC World Markets

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Typically, AT-1 capital is sourced from the preferred share market. However, for the issuer, preferred shares have their drawbacks; namely its primarily a retail market with limited liquidity, and preferred share dividends are not tax deductible.

Treasury departments of banks are always striving to reduce the cost of capital, improve liquidity and diversify their investor base. The LRCN is the result of years of discussion between regulators and issuers to try and balance both issuer and stakeholder needs. The new tax-deductible structure provides the banks with additional flexibility and diversification options to shore up their Tier 1 capital and institutional investors get a new form of bonds to invest in with potentially attractive return potential. The instrument is also expected to draw interest from international investors as there is no associated withholding tax.

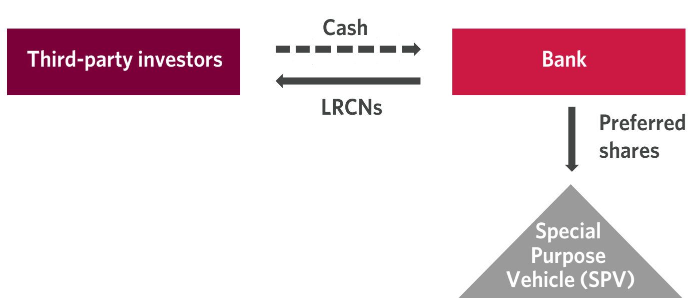
A number of banks have already issued LRCNs and insurance companies are expected to take advantage of this structure as well to retire higher cost issues of outstanding preferred shares.

2.2 LRCN key features

LRCNs are bonds with risk profiles much closer to preferred shares than traditional fixed income. They have a par value of $1,000 similar to traditional bonds but are potentially perpetual, pricing off a 5-year Canada bond yield plus a spread, reset every five years, similar to some preferred shares.

Overall, LRCNs have a complex structure and are deeply subordindated. They also have embedded call features which favour the issuer; as such, active monitoring is key to investing in this new segment of the bond market. However, these securities are currently offering attrative yields and broaden the opportunity set for skilled managers.

Figure 3: LRCN issuance structure



Source: OSFI

2.3 Portfolio implications

After consultation with market participants, the FTSE Canada Fixed Income Advisory Committee decided to exclude LRCN from its FTSE Canada Universe Bond Index or other FTSE Canada fixed-rate indexes. To arrive at this decision, the Index collected external feedback from OSFI, Debt Capital Markets desks and issued a broad market consultation. CIBC Asset Management participated in the market consultation and recommended at this time that LRCNs be excluded from the index.

Given the unique nature of LRCN, the structure doesn't align with existing FTSE index rules for the following reasons:

- Perpetual nature with a call feature makes it difficult to determine the likely maturity date; therefore the duration of the instrument is not known.
- Given coupon payments are reset every 5 years at the prevailing Government of Canada 5-Year bond yield + initial deal spread, it is not possible to precisely determine future interest payments.

However, the history of the FTSE Indices does include instances of evolving index inclusion criteria. NVCC subordinated-debt was introduced to the market in 2014 and the decision to include it in the Index was not made until 2017. Perpetual instruments are included in other global bond indices so there is precedent for inclusion. Given the advantages of LRCN for issuers and greater investment breadth it provides institutional investors, we expect this market to grow over time and for index-inclusion of LCRNs to be potentially revisted by FTSE Russell as the market matures. Another alternative would be for FTSE to create a LRCN index similar to the current FTSE Maple Bond Index.

Increased LRCN issuance will also result in less preferred share issuance by financial institutions, shifting sectors concentrations as the financial sector weight will shrink overtime.

2.4 Scenario analysis

To better undertand some of the underlying LRCN features, we analyzed how the instrument behaves under three different market scenarios.

i. Normal market environment

- Coupon resets every five years at the prevailing 5-year Government of Canada yield plus initial spread
- Security potentially remains outstanding perpetually and investors collect interest semi-annually or be called at reset date
- LRCN interest rate volatility is expected to be highly correlated to the 5-year Government of Canada rate

ii. Special events

- If there is regulatory call or a tax call
- Another special event to consider is if the bank chooses to utilize its discretion to deliver preferred shares held in a Special Purpose Vehicle (SPV) to LRCN holders in lieu of principal, unpaid and accrued interest. After the delivery of preferred shares LRCN would be cancelled. This would not be considered an event of default

iii. Stress events

- In the event of non-payment or insolvency the preferred shares held in SPV are delivered to LRCN holders
- If NVCC is triggered, preferred shares are converted to common shares one for one

Non-Viability Contingent Capital (NVCC)

NVCC securities are meant to be loss absorbing instruments which convert into common equity at the point of non-viability. Non-viability is determined as the point where OFSI has deemed the bank to be non-viable and the government has decied to inject capital. The proposed benefit of NVCC is it provides an additional capital cushion while the bank is operating and removes the obligation to pay fixed coupons upon conversion to common equity, thereby improving financial flexibility.

2.5 Our view

When thinking about investment policy guidelines for investment managers, we believe LRCNs issued by Canadian banks should be viewed as deeply subordinated debt instruments. This deep subordination has resulted so far in a mix of investment grade and high yield public ratings across issuers. The instrument is expected to experience higher volatility than other bank debt due to the uncertainty around term length and lower credit rating than senior and less subordinated debt. As discussed earlier, LRCNs are currently excluded from the main Canadian bond indices and therefore are not investable for passive mandates. However, despite the index exclusion and higher risks, we feel in-depth credit research and skilled portfolio management capabilites provide a framework for determining the appropriate risk-reward balance of these instruments versus higher ranking tranches of capital. There will be times where they are attractive to hold and times where they are not as attractive; active managers should have the discretion to make these determinations on their investors behalf.

We recommend active core and corporate bond mandates allow portfolio manager discretion to invest in investment-grade rated LRCN as out-of-benchmark securities and Core Plus strategies allow both high yield and investment grade-rated LRCN, also as out of benchmark holdings. LCRNs must be evaluated against how they affect total portfolio risk for all types of mandates and should be viewed as opportunistic holdings.

In the low yield environment of 2020, this instrument adds another lever for active managers to utilize to enhance portfolio returns. Currently, investors have the opportunity to hold Canadian bank investment-grade debt with coupons north of 4% at a time when 5-year Government of Canada bonds yield well below 1% and the average BBB corporate bond is yielding 2.2%.[2] Investors are being offered high-yield spreads for investment-grade rated bonds, of course, with some crucuial differences that we have already outlined.

2.6 Conclusion

Limited Recourse Capital Notes are a new capital instrument for the Canadian market and we anticipate meaningful issuance in the coming years. LRCNs offer institutional fixed income investors an alternative to traditional bonds with currently attractive yields but also a unique risk proile. Fundamental credit research and skilled portfolio management will be key to properly evaluating the risk-reward profile of these securities over time and should be considered for inclusion in actively managed investment policies.

Let's connect

Should you have any questions about this report or anything else, please do not hesitate to connect:

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[2] FTSE Corporate Universe Bond Index yield as of November 30, 2020

2.7 Appendix

The following items are the critical structural elements of an LRCN:

1. Maximum allowable issuance per financial institution to be 0.75% of Risk Weighted Assets (~50% of AT1 bucket).
2. Can only be purchased by institutional investors.
3. Must have a minimum term to maturity at issuance of 60 years, which is required to allow these instruments to fall into the "perpetual" capital bucket.
4. Coupon to be reset every five years at the then-prevailing 5-year Government of Canada yield plus the original credit spread.
5. OSFI's ruling prohibits redemption unless the instrument has higher carry cost than a replacement (or if no longer needed has been replaced with better quality capital like common equity or retained earnings which would generally be much more expensive for the issuer).
6. Six month coupons, fixed every 5 years, non-deferrable.
7. At issuance two underlying instruments are created (a) LRCN and (b) preferred shares. The (a) LRCN are sold to investors and (b) preferred shares are issued and held in a special purpose vehicle (SPV). In certain situations, the preferred shares will be delivered to LRCN investors. The recourse instrument, in this case preferred shares, are issued at the onset to avoid any problems which may arise if they were created in a stress environment.
8. The SPV is essentially a trust that holds the preferred shares on behalf of the bondholders and will deliver those preferred shares in exchange for the bonds under certain predetermined stress scenarios.
9. These preferred shares have the same distribution rate (although a dividend, not coupon) and other details except maturity date, as the LRCN.
10. The LRCN effectively ranks pari passu with preferred shares because there are no situations under which the rank matters where investors will still be holding the LRCN bonds.
11. Both the notes (LRCN) and the preferred shares must have a minimum par or stated value of C$1000, unlike regular preferred shares which have a stated par value of $25.
12. Allows for tax deductibility by the issuer as opposed to dividends on preferred shares which are paid with after-tax dollars.

All data as at December 15, 2020.

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