How a preferred share redemption illustrates why active management prevails

In mid-April, RBC announced the redemption of a series of preferred shares. There is nothing special about this news, or is there?

At Foyston, Gordon & Payne Inc. (FGP), we view active management as an essential component of successful fixed income investing. To some people, fixed income markets can appear opaque or even fragmented due to the lack of a centralized exchange, but to those willing and able to do the deep dive credit work required to become a well-informed investor, there are ample opportunities to add value to a fixed income strategy. Investors can achieve this added value by generating superior outperformance or by successfully managing the various risks present in the asset class, or, more ideally, a combination of both.

A single corporate or government issuer can have many different forms of fixed income securities outstanding at any given time. These securities can be issued in different currencies, from different parts of the organizational and capital structure and, most certainly, staggered across a variety of different maturities. The risk and return characteristics of each individual fixed income security can therefore vary significantly. Couple these differences with changing regulations and the interpretation of the impact these changes can have on outstanding securities, and we have an ongoing environment where investment performance can diverge greatly between active managers. This divergence is most notable in the fixed income landscape when it comes to bank funding and capital securities.

The AT1 capital bucket

The regulatory and economic landscape is constantly evolving. For example, regulations regarding the Additional Tier 1 (AT1) capital bucket changed significantly in the last decade. These changes force Canada's major banks to frequently adapt their funding and capital strategies.

The AT1 capital bucket currently has a few structures for securities that satisfy several Office of the Superintendent of Financial Institutions (OSFI) guidelines introduced at different points in time. These include $25 par preferred shares (retail and usually traded on an exchange), $1,000 par preferred shares (institutional but not traded on an exchange), Limited Recourse Capital Notes (LRCN - institutional), and AT1 Capital Notes (institutional). These securities all have similar rankings in the overall capital hierarchy with some minor differences based on conversion multipliers and types of recourse assets.

OSFI prefers that only institutional investors hold bank capital securities as these are often quite complex and have important nuances. OSFI has also opined that $25 par preferred shares are considered "retail" instruments. As a result, the banks started redeeming $25 par preferred shares and replacing them with the other forms of AT1 Capital securities considered "institutional" instruments: $1,000 par preferred shares, LRCN, and AT1 Capital Notes. These redemptions paused while interest rates rose because the regulators were concerned about the potential impact of these increases on the housing market and mortgages. However, with the banks weathering these events well and continuing to build up excess capital, the redemptions resumed.

More AT1 Rules

In addition to the types of securities that make up the AT1 bucket, there are rules about the composition of this bucket:

- LRCN is "capped" at the greater of:
  - 50% of the net AT1 capital,
  - 0.75% of Risk-Weighted Assets (RWA), or
  - $150 million.
- However, the "cap" is no longer a constraint if the bank issues enough (floor) non-LRCN capital in an institutional form. This floor is the lesser of:
  - 20% of total AT1, or
  - 0.3% of RWA.

The marketplace confusion with bank capital

There has been considerable debate recently about which capital securities can be redeemed by the banks given new guidelines OSFI created over the last few years. Confusion has centred around the rules by which OSFI will permit the banks to redeem existing AT1 capital securities. The divergent views among market participants stem from various interpretations of the following section of the October 2023 Capital Adequacy Requirements:

> **2.1.2.1 Additional Tier 1 instruments issued by the institution directly**
> 13. e) b. An institution's actions and the terms of the instrument must not create an expectation that the call will be exercised;[17]
>
> Note 17 - An example of an action that would be considered to create an expectation that a call will be exercised is where an institution calls a capital instrument and replaces it with an instrument that is more costly (e.g. a higher credit spread) [Basel framework, CAP 10.11 FAQ8]

The market understood this section to mean that OSFI would only permit a bank to redeem an instrument if the current credit spread based on market pricing is less than the reset spread of the instrument. However, in practice this has not been the case. More likely, OSFI factors in excess capital levels, potential needs for future capital, tax efficiency, regulatory objectives, and other elements when deciding whether to approve a redemption.

The RBC redemption

On April 16th, Royal Bank of Canada (RBC) announced that it would redeem the RY.pr.Z (Series AZ) on May 24th. This is an important development in the $25 par preferred share market as this security had closed at $22.91 immediately prior to the announcement, implying the market had not been expecting the bank to redeem the security given the discount to its par value. This redemption caused an outsized return for holders of this security and of some other preferred shares for which the market revised redemption expectations.

The most interesting aspect of the RY.pr.Z redemption is the implication for creating an expectation of a call given OSFI's note on the size of the credit spread. As the table shows, the reset spread for RY.pr.Z was +221 basis points, the lowest reset spread of all other outstanding bank preferred shares in Canada. If it is economical to call this preferred share, then it would be hard to argue it is not economical to call the remaining preferred shares if the current market environment persists. This situation should continue to create interesting price moves in the market as investors analyze which banks have sufficient excess capital and are likely to redeem or reset upcoming $25 par preferred share issues.

Recently called and currently outstanding $25 bank preferred shares (as at April 17, 2024)

Recently Called				
Issuer Name	**Ticker**	**Reset Spread**	**Reset Date**	**Call Date**
Toronto-Dominion Bank	TD.PF.K	259	2028-10-30	2023-09-22
Bank of Nova Scotia	BNS.PR.I	243	2024-01-27	2023-12-08
Toronto-Dominion Bank	TD.PF.L	327	2024-04-30	2024-03-12
Canadian Imperial Bank	CM.PR.T	331	2024-04-30	2024-03-21
Royal Bank of Canada	RY.PR.Z	221	2024-05-24	2024-04-16

Outstanding			
Issuer Name	**Ticker**	**Reset Spread**	**Reset Date**
National Bank of Canada	NA.PR.S	240	2024-05-15
Bank of Montreal	BMO.PR.F	351	2024-05-25
Bank of Montreal	BMO.PR.S	233	2024-05-25
Canadian Imperial Bank	CM.PR.O	232	2024-07-31
Canadian Imperial Bank	CM.PR.Y	362	2024-07-31
Toronto-Dominion Bank	TD.PF.B	227	2024-07-31
Toronto-Dominion Bank	TD.PF.M	356	2024-07-31
Royal Bank of Canada	RY.PR.H	226	2024-08-24
Bank of Montreal	BMO.PR.T	224	2024-08-25

Outstanding (continued)			
Issuer Name	**Ticker**	**Reset Spread**	**Reset Date**
Toronto-Dominion Bank	TD.PF.A	224	2024-10-31
Bank of Montreal	BMO.PR.W	222	2024-11-25
Canadian Imperial Bank	CM.PR.P	224	2025-01-31
Toronto-Dominion Bank	TD.PF.C	225	2025-01-31
National Bank of Canada	NA.PR.W	225	2025-02-15
Royal Bank of Canada	RY.PR.J	274	2025-05-24
Canadian Imperial Bank	CM.PR.Q	279	2025-07-31
Toronto-Dominion Bank	TD.PF.D	279	2025-07-31
Bank of Montreal	BMO.PR.Y	271	2025-08-25
Toronto-Dominion Bank	TD.PF.E	287	2025-10-31
Royal Bank of Canada	RY.PR.M	262	2025-12-04
Toronto-Dominion Bank	TD.PF.I	301	2027-10-31
National Bank of Canada	NA.PR.C	343	2027-11-15
Canadian Imperial Bank	CM.PR.S	245	2028-01-31
Toronto-Dominion Bank	TD.PF.J	270	2028-04-30
National Bank of Canada	NA.PR.E	258	2028-05-15
National Bank of Canada	NA.PR.G	277	2028-11-15
Bank of Montreal	BMO.PR.E	268	2028-11-25

Source: Bloomberg

Why active management matters

Economic, regulatory, and market landscapes continue to change. Even though this evolution provides a challenge for some investors, it provides opportunities for other investors. Active management allows for the identification and investment in opportunities that can have a meaningful impact on portfolio performance. In this case, we invested in the RY.pr.Z security on behalf of our clients and, as at April 15, the day before RBC's call announcement, this security was the second largest holding in the FGP Preferred Share Fund and had already generated 17.7% capital appreciation this year*.

*The RY.pr.Z performance is set out to describe the impact of the market's surprise by RBC's announcement given OSFI's guidance. It is not intended to be indicative of current or future performance of the FGP Preferred Share Fund. For context, the FGP Preferred Share Fund had securities with capital appreciation ranging from -1.8% to 53% this year to April 15, 2024. The contents of this paper are provided for general information purposes only and do not constitute an offer to sell or a solicitation or an offer to subscribe or buy any financial instruments in any jurisdiction.

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