ADDENDA CAPITAL

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A first Canadian bank moves ahead with OTC preferred shares

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For months, rumor had it that a Canadian bank would eventually issue an institutional, or over the counter (OTC), preferred share. That scenario finally played out on October 21st, when Royal Bank of Canada filed a prospectus that signaled a shift in the market. This development could be of interest for investors that are seeking higher returns from a fixed income-like asset class.

Why is this Happening?

To understand the rationale behind OTC preferred shares, we first need to look at an instrument that entered the financial market last year: the limited recourse capital note (LRCN).

RBC was the first bank to issue an LRCN in mid-2020 after the proposed instrument received approval from the Office of the Superintendent of Financial Institutions (OSFI). The independent federal agency determined that LRCNs could be counted as regulatory bank capital in their requirements. Specifically, OSFI authorized LRCNs to be considered as Additional Tier 1 capital (AT1). They can only be issued to institutional investors.

So far, Canadian banks have seen strong demand and issued $11.2 billion in LRCNs, which are tax deductible for issuers. As for the instrument itself, the LRCN is a 60-year debt security (callable every 5 years), which has recourse to a trust holding preferred shares. These shares, which act as collateral, are delivered only in case of non-payment or default.

There is a ceiling, as OSFI pointed out in its July 2020 ruling: LRCNs issued by a federally regulated bank can only fill up 50% of its AT1 bucket. By issuing OTC preferred shares, banks gain the ability to issue more LRCNs. Our understanding of the market's thinking is that once OSFI is comfortable that there is an established OTC preferred share market, it will raise the LRCN limits.

In essence, the banks are moving regulatory capital from retail investors (i.e. exchange-traded preferred shares) to institutional investors. In our view, OSFI is interested in seeing an established OTC preferred share market in the event that those LRCNs would be converted to preferred shares.

Details

The prospectus issued by RBC is for non-cumulative 5-Year fixed rate reset preferred shares (non-viability contingent capital, or NVCC). The initial dividend rate was set at 4.20% per annum. Here are a few features that distinguish the OTC shares vs exchange-traded shares:

- The par value is $1,000 per share, which means it is aimed at institutional investors, as opposed to exchange-traded shares which have a par value of $25.00;

- The dividend is non-cumulative and pays semi-annually, whereas an exchange-traded share would be paid quarterly;
- The dividend is tax-deductible for the holders;
- Shares are pari passu with limited recourse capital notes (LRCN);
- Current exchange-traded bank fixed resets give the holder the option to convert to a floating rate preferred share, whereas this new security does not;
- The new OTC preferred shares will reset every 5 years (the rate will be the Government of Canada 5-year bond rate plus spread) or can be called by the issuer.

What Does this Mean for the Current Exchange-traded Preferred Share Market?

Will institutional investors establish an OTC preferred share market? We believe so. But other questions remain. Just how deep is the LRCN market? Currently, there are $16B in outstanding exchange-traded bank preferred shares. Are LRCN buyers ready to digest a larger chunk of that at current spread levels? Is the market properly pricing in the reset optionality of the LRCN security?

Each bank manages its regulatory capital differently and we do not expect an immediate flurry of new OTC preferred shares. We do anticipate, however, that there could be more over the coming quarters and years.