A Vale of Tiers

Not all bank debt is the same: what investors need to know

BY JAMES HYMAS

In the past year a great deal of criticism has been raised against structured finance. Problems in the U.S. subprime marketplace, in which most individual mortgages were only indirectly tied to, but then split into tranches of differing safety, have focused attention on structured finance – structure being used to denote anything that isn’t plain vanilla.

The implosion of the Canadian Asset Backed Commercial Paper (ABCP) market, another example of structured finance, has given the subject another black eye. Many investors, influenced by the headlines, have retreated quickly from anything too complex, preferring plain vanilla investments, such as bank debt.

Unfortunately, bank debt is highly structured. Every layer has a different degree of credit risk from the others, a fact that is often forgotten when investing in paper issued by a familiar name. In order to better appreciate the types and complexity of bank debt, we first need to differentiate between the various levels of bank debt. These vehicles are, in order of increasing risk (but not necessarily increasing returns):

• Subordinated Debt (Tier 2B)
• Subordinated Debt (Tier 2A)
• Tier 1 Capital

Table 1 helps illustrate types of bank debt and shows the return available on a variety of Royal Bank instruments against the degree of subordination for these instruments. “Subordination,” as defined here, is bank value of the capital structure subordinated to the instrument of interest divided by Risk Weighted Assets (all figures from the 2007 Annual Report).

### Table 1

<table>
<thead>
<tr>
<th>Instrument</th>
<th>Subordination*</th>
<th>Yield</th>
<th>Notes</th>
</tr>
</thead>
<tbody>
<tr>
<td>GIC</td>
<td>infinite</td>
<td>3.00%</td>
<td>5-Year Term, less than $100,000, full CDCI insurance assumed for subordination figure</td>
</tr>
<tr>
<td>4.5-Year Deposit Note</td>
<td>11.54%</td>
<td>4.52%</td>
<td>Subordinated assumes this deposit is uninsured</td>
</tr>
<tr>
<td>Sub-Debt [Call: 3-5 Years]</td>
<td>9.76%</td>
<td>8.49%</td>
<td>Assuming call in 5-7 Years</td>
</tr>
<tr>
<td>Innovation Tier 1 [call: 8 Years]</td>
<td>9.75%</td>
<td>8.49%</td>
<td>Assuming call in 8 Years</td>
</tr>
<tr>
<td>Perpetual Preferred Share [PR]</td>
<td>7.01%</td>
<td>7.32%</td>
<td>Assuming Current Yield of 5.26% and interest equivalency factor of 1.4x</td>
</tr>
<tr>
<td>Common Equity</td>
<td>0%</td>
<td>11.20%</td>
<td>Assuming total return of 8% and interest equivalency factor of 1.4x</td>
</tr>
</tbody>
</table>

* “Subordination” is the degree of protection against losses that may be experienced by the bank without affecting an investor in the instrument, expressed as a percentage of Risk Weighted Assets (RWA) as of October 31, 2007. RWA includes provisions for off-balance sheet commitments and other risks; the total is less than the dollar value of the assets. For example, RBC had over $116 billion of securities on its balance sheet, which given its risk to $15 billion at risk weighting would be $62.1 billion of conventional mortgages became $32.1 billion of RWA.

Note: These figures are presented solely to assist the reader in conceptualizing the spectrum of investment possibilities. They are obviously huge differences between, for instance, a five-year, fully insured GIC and a common equity that cannot be captured in a single table. Yield figures are indications only, as of Feb 6, 2008.

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### Table 1: SPECTRUM OF ROYAL BANK INVESTMENT VEHICLE

**NEED FOR STRUCTURE**

Protection of depositors is considered a social good in many countries, as it enables small retail investors to “put their truncheon safely in the bank,” where their deposits may be invested, directly or indirectly, in a variety of productive schemes. If these depositors were to lose faith regarding the safety of their deposits, the stability of the system would be compromised. For example, during New York’s Panic of 1907 substantial sums were withdrawn from banks considered to be at risk and held as currency. A safe deposit house is all of this at great cost to the economy.

As a result, modern banks have accepted a trade-off. They have direct access to the central bank’s liquidity provision services and can assure their depositors that (within explicit limits) their deposits are safe; in return the banks submit to supervision and regulation of those schemes that has the intent of minimizing the possibility that recourse for lost revenue will be required.

This supervision is quite important. Consider the fact that the U.S. Federal Deposit Insurance Corporation has only about 1.2% of the value of insured balances in its reserve fund. In Canada, the Canadian Deposit Insurance Corporation’s holdings represent only 0.34% of insured deposits, while the British Financial Services Compensation Scheme has a negligible net worth (it’s able to keep the lights on only with the help of a bank overdraft). There’s something quintessentially English about the bank insurer of last resort having to step in to save the bank overdraft.

Deposits must be protected and the best protection is the banks’ own money, but equity capital is very expensive for a bank. Any form of investment is accepted by regulators as protecting deposits if it takes any losses due to insolvency prior to these losses harming depositors, subject to rules that require the common-share-holding decision-makers to bear a significant portion of the risk of loss. Differing investors, however, have differing views on what risk they are prepared to take and what differing buffers should be between themselves and any such losses. A full spectrum of investment possibilities is available; an increased risk, then, should imply an expectation of increased return.

**DEPOSIT NOTES**

Deposit Notes (DNs) may be issued by a bank for any term, although the CDIC will insist such notes only if the initial term to maturity is less than five years. These instruments may also be known as “Guaranteed Investment Certificates” (GICs), or “Term Deposits.” DNs are an important part of the money market; the Bank of Canada accepted DNs with a remaining term not exceeding 180 days as collateral for its December market interventions.

**BANKERS ACCEPTANCES**

Bankers Acceptances (BAs) are loans from the purchaser to an un-specified company that has a facility with the bank. Repayment of this loan is guaranteed (“accepted”) by the bank, which charges the borrower a “stamping fee” for this service. BAs are not insured by the CDIC— as far as the bank is concerned, they are “off balance sheet” instruments—but, as with DNs, are an integral part of the money market and were accepted as collateral in the Bank of Canada’s December interventions.

**SUB DEBT (TIER 2B)**

This is the debt that is the last line of protection for depositors and other creditors such as RA Holders. Most bank debt labelled “Sub Debt” is Tier 2B; OSFI insists that such debt have an initial term to maturity of at least five years and only allows a bank to include a fraction of the debt’s book value as part of its Tier 2 capital if the remaining term is less than this figure.

**SUB DEBT (TIER 2A)**

In order to qualify as Tier 2A capital, even more stringent requirements must be met—such investments are not only subordinated to deposits but they must be:
- Able to absorb losses of the bank without triggering a cessation of ongoing operations or the start of insolvency proceedings,
- Allow defaults of interest or dividend of the bank doesn’t have the money.

Two examples of Tier 2A capital are cumulative perpetual preferred shares and some 99-year debentures; this type of instrument is often referred to as “General Allowances” bookkeeping entries) but TD Bank, for instance, issued over $4 billion in Tier 2A capital in 2007.

**INNOVATIVE TIER 1 INSTRUMENTS**

Put simply, an “Innovative Tier 1 Instrument” is a perpetual preferred share dressed up as a bond to seduce the unwary. OSFI has stated that the following conditions must be met if a particular instrument is to be accepted as Tier 1 Capital for regulatory purposes:

1. The bank is able to absorb losses of the bank without triggering a cessation of ongoing operations or the start of insolvency proceedings.
2. Subordinated to depositors and other (non-subordinated) creditors.
3. The bank must allow for full discretion over the amount and

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Sometimes recoveries don’t make it to the highlight reel.

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