Analysis of Perpetual Resets

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Spreads on Tier 1 Capital issuance have been ballooning lately…and if you have any idea what that means, you must be a finance geek. So, for all those who harbour ambitions of becoming a finance geek, this month's column will describe the problems now facing bank treasury departments and one bank's successful attempt to meet the challenge.

A bank's common shareholders have the potential to share in all the profits of the bank and, over time, do very well but they also take the "first loss" when things go wrong and, should things go very wrong, have the potential to be wiped out. It is, by and large, in the interest of the common shareholders to take enormous risks, as their losses are limited to the amount invested, with no cap on profits.

Depositors, on the other hand, are looking for safety and convenience. They are willing to pass on the potential for enormous returns next year; they just want to know they can get every dollar of their money back tomorrow, if they need it. By "depositors" in this article, I mean uninsured depositors. The Canada Deposit Insurance Corporation (CDIC, with the website www.cdic.ca) ensures that relatively small depositors may do business with covered institutions without worry (check their website to confirm your coverage!). Depositors prefer institutions that take no risks at all.

The referee in the game is the Office of the Superintendent of Financial Institutions (OSFI, with the website www.osfi-bsif.gc.ca) which sets minimum standards of prudent conduct.

Not everybody is content with a stark choice between the high risk of an investment in common shares and the low returns of a bank deposit. So the banks, in their efforts to diversify and maximize their sources of funds, have created tiers of debt, each with a unique mix of risk and return.

In Table 1, I compare the approximate levels of risk for these various tiers of financing, and provide an indication of how the returns demanded by investors for bearing these risks has changed over the past year as the world's attention has forcibly been refocused on the idea that banking is, indeed, a risky business. The reliance on "Subordination" as a measure of risk is derived from the seniority of each instrument in the event of liquidation. For example, assume that the bank experiences losses equal to 7% of its "Risk Weighted Assets" (RWA). This will wipe out the common shareholders, but the preferred shareholders will get every penny they are due, as will other senior investment holders. A loss equal to 10% of RWA will wipe out the common shareholders, the preferred shareholders and the Innovative Tier 1 Capital (bond) holders, but the holders of subordinated debt won't sustain any damage – and so on.

Table 1 also shows yield spreads against Canada bonds for these issues; the spreads shown are generic, but were developed by reference to dealer quotations for bonds issued by the big 5 banks. Figures for preferred shares were estimated from the interest equivalent yield-to-worst of perpetuals trading at a discount to par on the Toronto Stock Exchange. Those for common shares simply assumed an 8% long-term return, which was converted to its interest equivalent. Very approximate, to be sure, but it's only for illustrative purposes!

TABLE 1 - BANK RISK & RETURN – THEN AND NOW

Instrument	Subordination*	Yield Spread** February 2007	Yield Spread** March 2008
Deposit Note	12%	40bp	180bp
Subordinated Debt	10%	46bp	260bp
Innovative Tier 1 Capital	7%	60bp	290bp
Perpetual Preferred Share	7%	220bp	450bp
Common Equity	0%	700bp	750bp

* "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). RWA includes provisions for off-balance-sheet commitments and other risks; the total is far less than the dollar value of the assets.**Yield Spread is expressed as the yield of the instrument less the yield of a medium-term Canada bond, in basis points (bp; a basis point is 1/100 of a percent). All figures are approximations based on Interest Equivalent Yield (see *Canadian MoneySaver*, February 2007).

There has been a dramatic increase in the extra yield investors require before taking the leap from fully guaranteed Canada bonds to any of the various tiers of bank debt. We can tell that this is not due to a very simple fear of all things corporate, since there is a direct relationship between degrees of subordination and the widening that has occurred. In February 2007, the issues were trading at very similar yields – one bank bond was very much like another, as far as investors were concerned. This is no longer the case.

A changing perception of risk has lead to investors demanding higher returns for Tier 1 Capital. At this time last year, banks could issue perpetual preferreds with a dividend yield of 4.5%. Two recent issues have had to offer dividends of 5.8% (Bank of Montreal) and 6.0% (National Bank) in order to attract investors. These higher rates are cutting into the profit margins. At least one issuer is casting about for a method of paying less money to investors willing to bear the same risk.

The recent issue of the Bank of Nova Scotia Series 18 Preferred was a milestone. It is not clear whether this structure will become common in the future, or whether it will fall by the wayside as an interesting experiment. But we should have a look at it, just to ensure we can tell to a first approximation whether it's rich to other issues or cheap, and, if possible, determine where the cut-off lies. Full details of the issue are available from the System for Electronic Document Analysis and Retrieval at http://www.sedar.com (see the June 2006 edition of *Canadian MoneySaver* for navigation tips if required).

Analysis of this issue depends heavily on "exchange dates". The first is April 25, 2013 with further dates every five years thereafter for as long as the issue exists.

Until the first exchange date, the issue will pay 5.0% dividends. On that date, and every exchange date thereafter unless the issue is called, two things will happen:

- The dividend will be reset to be equal to that of a 5-year Canada bond, plus 2.05%.
- The issue may be exchanged to Series 19 Preferreds, which will pay dividends at a rate of 3-month Treasury bills, plus 2.05%, reset quarterly. These can be re-exchanged for Series 18 on subsequent exchange dates.

The exchangeability of the two issues makes these two issues (of which only one is currently issued) a "strong pair", as defined in the *Canadian MoneySaver* of October 2007.

And finally, we come to a crucial point: redemption provisions. Both the Series 18 and the Series 19 shares are callable on every exchange date at $25.00; the Series 19 shares may also be called at $25.50 at any time. There is no provision whereby investors may force the issuer to return the invested capital. Thus, these shares may be designated as perpetuals, as explained in the *Canadian MoneySaver* of June 2006. A call at par only five years hence is not a good thing; the bank will exercise the option only if redemption is in its own best interest.

The Pick of PrefLetter

After the close on April 11, my monthly newsletter (www.prefletter.com) recommended BAM.PR.B, among others, for long-term, buy-and-hold investors.

Type of Preferred	SplitShare
Quotation (2008-4-11)	$18.20-50
DBRS Rating	Pfd-2(low)
S&P Rating	P-2
Annual Dividend	$0.91875 (pays 70% of prime [now 5.25%] on par value of 25.00)
Yield-to-Worst Scenario	Limit Maturity
Yield-To-Worst	5.09% (based on prime of 5.25% and end value of $18.20)
Modified Duration, YTW	15.38
Pseudo-Convexity, YTW	1.01

BAM.PR.B: Currently redeemable at $25.00. Next ex-date 2008-6-12 (estimated). This issue pays 70% of Canada Prime on the par value as a dividend, and is currently priced at only about 72% of par. Thus, holders will receive nearly Canada Prime on their investment, paid as a dividend – which makes the risk/reward profile of an ordinary floating rate issue much more attractive than has been the case in recent years. BAM.PR.K may be substituted, depending on market conditions – these two issues form a "Weak Pair" as discussed in the October 2007 edition of *Canadian MoneySaver.*

The issue presents analytical difficulties; the benchmarks chosen (five year Canadas and Treasury bills) are unusual and the provision for a fixed spread (rather than a proportion or a range of values within which the reset must be chosen) is highly unusual.

Chart 1 helps explain the choice of benchmark. The issuer can advertise spreads vs. five-year Canadas when these are at a ten-year high, but investors should most certainly not assume that the credit crunch will continue for five years. If we assume that in five years, five-year Canadas will trade to yield 4% (much more reasonable than the current 3% yield), the indicated rate on the BNS issue will be 6.05%. But, if we also assume that the perpetual discount interest-equivalent spreads return to a more normal 3%, then (at an interest equivalency factor of 1.4) most perpetual issues will be trading to yield (Canadas + Spread) / Equivalency = (4 + 3) / 1.4 equal to 5%. In such a case it is prudent to assume that the BNS issue will be called and that the bank will replace the funds with a new issue of perpetuals at the new 5% permanent rate.

Under most plausible scenarios, the reset rate is so high that a prudent investor should assume it is called and that the mouth-watering spreads to Canadas will not be achieved in more normal times. In the absence of other considerations, the 5% dividend for five years seems reasonable, but the redemption is not mandatory. BNS is not obligated to redeem the issue.

It must never be forgotten that buying a perpetual issue, even one that is "almost certain" to be called, or one that will adjust its dividends to account for changing market conditions, represents exposure to the chance that the issuer will get into trouble and that with perpetuals there is no opportunity to simply let the dubious debt mature. In such a case, the high reset rate could even work against the holder, if the bank is persuaded that the benefit of suspending dividends outweighs the hazard to its reputation.

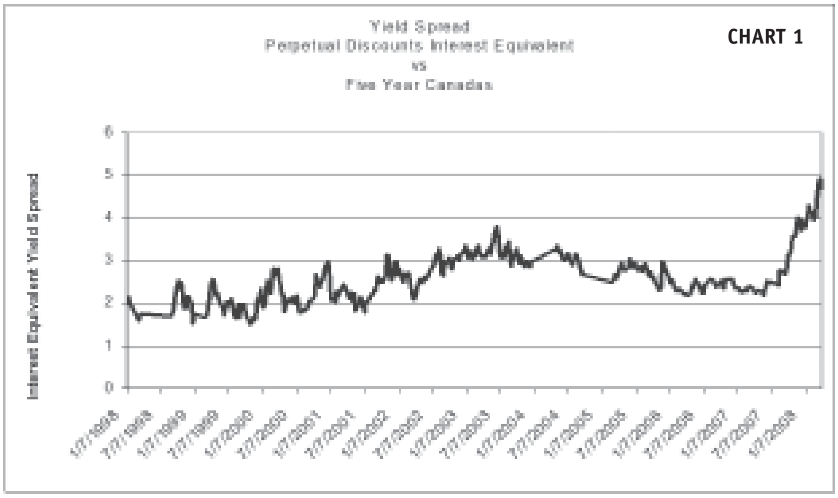

CHART 1

The fund I manage did not purchase any of this issue. When I lend money on a perpetual basis, I want to get perpetual rates of return. Those willing to lend on a five-year basis should invest in issues that will actually mature in five years. In the long term, investors in perpetual preferred shares should be more worried by issues of credit quality than interest rate spreads. While I most definitely should not be construed as impugning the credit quality of Scotiabank, it should be recognized that lightning can strike at any time.

My disdain has not been shared by the market in general. The issue, trading as BNS.PR.P on the Toronto Stock Exchange, had a very successful underwriting and strong secondary demand. But I worry that many investors will have bought this with the assumption, probably valid in most cases but not certain, that the issue will be called in five years. It is the pretense that borrowers can access long-term funds from borrowers assuming short-term risks that, after all, caused the credit crisis in the first place.

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