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Expert Analysis

In Canada, a New Preferred-Share Structure for Tier 1 Capital

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Something has happened in Canada that should be of interest to U.S. capital market participants. That something is an innovative and successful investment product that was created in the midst of the recent financial and credit crisis and that almost single-handedly allowed Canadian financial institutions to recapitalize themselves in an efficient manner.

This innovative investment product has been so economically attractive and advantageous to both issuers and investors that by August over CA$17 billion of the product had been issued and sold in Canada. The product is a type of preferred share officially named "perpetual, non-cumulative, fixed/floating, preset five-year rate reset, preferred shares" but simply referred to in Canada as "rate reset prefs."

In 2008 a team from Canada-based investment dealer Desjardins Securities Inc. (the broker-dealer arm of the largest cooperative financial group in Canada and the fourth safest among the top 10 safest banks in North America[1]) and the international business law firm Fasken Martineau DuMoulin LLP created the innovative rate reset pref structure. (*Editor's note:* The authors are attorneys at Fasken Martineau.)

The design challenge was to create an equity security that would be recognized by financial institution regulators as "Tier 1" capital yet would not be dilutive to existing shareholders. The security would also have to be more cost-effective to the issuer as compared with the dividend yields that had historically been demanded by preferred-share investors.

Tier 1 capital is the core measure of a bank's financial strength from a regulator's point of view. It is made up of core capital, which consists primarily of common stock and disclosed reserves (or retained earnings), but may also include non-redeemable, non-cumulative preferred stock as long as such preferred stock has permanence.

To ensure permanence, preferred shares cannot be retracted by the holder, and the bank does not undertake an obligation to redeem them. In addition, the preferred shares cannot be redeemed within the first five years of issuance, and there can be no step-up or change in the dividend yield representing a preset increase such as would give the issuer an inherent incentive to redeem the shares. Lastly, there can be no expiration date for the instrument.

The Desjardins–Fasken Martineau team was able to create a unique structure that achieved the Tier 1 requirements and was approved by the Office of the Superintendent of Financial Institutions. At the same time, the product was attractive to investors.

In the past, when an issuer would offer its preferred shares for sale, it would set the dividend rate at the time of marketing and closing the offering. If the market dividend rate moved up five years later, the issuer would, of course, leave the relatively low-cost shares outstanding. If the market dividend rates were to fall, the issuer would, of course, redeem the relatively high-cost shares and refinance itself at the new, lower market rate. The investor therefore faced the risk of changes in the market dividend rate or yield.

This investment product has been economically attractive and advantageous to both issuers and investors.

Unlike this historic structure, rate reset prefs instead allow the issuer to reset the dividend yield every five years. The investor has the choice to convert its fixed-rate preferred shares to a floating-rate preferred share at the same yield premium over a certain benchmark Canadian government bond, as was the case under the investor's original fixed-rate preferred share.

Under these circumstances, issuers of rate reset prefs will be much less likely to redeem these shares. Issuers would only have an incentive to do so if their own risk profile has improved enough over the past five years such that they could now issue comparable securities with a much lower yield premium over the benchmark Canadian treasury bond.

Because of this innovative structure, investors holding rate reset prefs are not exposed to the same risk as holders of historic preference shares in regard to changes in the fixed-income market. Accordingly, investors have been willing to pay more for these new rate reset preferred shares (or conversely, issuers are able to sell them with a lower dividend yield) as compared with the issuer's historic perpetual preferred-share offerings.

The first offering of rate reset prefs was a CA$345 million prospectus-qualified offering that was completed in March 2008 by the Bank of Nova Scotia (the third safest bank in North America[2]). Desjardins Securities was a co-lead underwriter for this offering, and Fasken Martineau acted as legal counsel for the underwriting syndicate. After the completion of this offering, other Canadian banks soon followed suit with their own offerings of rate reset prefs.

The popularity of these securities quickly spread beyond financial institution issuers. Today rate reset prefs are the most common type of preferred-share offering in Canada, with over 70 percent of new preferred-share issues coming in the form of rate reset preferred shares.

Issuers recognize that these shares are cost-effective. It has been proven that these securities can be issued at a lower effective cost of capital as compared with the direct alternatives. Investors have hungered for these Canadian-issued rate reset prefs because they present an attractive risk-return profile and they are easily understood as compared with other innovative fixed-income products with their often convoluted abstractions of derivatives.

The result is that both issuers and investors believe this investment product is economically advantageous. There continues to be a strong demand by investors and a strong supply by issuers of rate reset prefs in Canada. It seems reasonable to think that U.S. issuers and investors would be just as receptive to embracing rate reset prefs given their eligibility for Tier 1 ranking in Basel Accord member countries and the benefits to both issuer and investor. In regard to recent financial reform activities, nothing in the Sept. 12 announcement of the oversight body of the Basel Committee on Banking Supervision changes the Tier 1 eligibility of the rate reset prefs.[3]

The rate reset prefs have been a tremendous success in Canada, and the bottom line is that they represent a creative, yet easily understood, financing and investment product, and they are something U.S. capital market participants should know about.

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NOTES

1. Global Finance names the World's Safest Banks 2010 in North America, Global Finance, Aug. 30, 2010, available at http://www.gfmag.com/tools/best-banks/10532-worlds-safest-banks-in-north-america-2010.html.

2. Dan Keeler, Global Finance selects the world's safest banks — the 50 institutions with the highest ratings from the leading international credit ratings agencies — and the safest banks in seven regions, Global Finance, October 2010, available at http://www.gfmag.com/archives/130-october-2010/10635-worlds-safest-banks-2010.html#axzz14LN5dXMm.

3. Press Release, Bank for Int'l Settlements, Group of Governors and Heads of Supervision announces higher global minimum capital standards (Sept. 12, 2010), *available at* http://www.bis.org/press/p100912.htm.




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