How Extension Risk is Impacting Preferred Shares

One risk of investing in rate reset preferred shares is the potential for extension risk. Extension risk occurs when the preferred share reaches its call date and rather than being redeemed at the typical $25 call price, the institution offering the preferred share opts to extend the security. This extension into another five-year term will typically reduce the capital value of the preferred share since it won’t be redeemed at $25, and it immediately increases the duration of the security, since the potential call date gets pushed out another five years. As interest rates rise rapidly, it’s quite possible that a lot more rate reset preferred shares become subject to being extended rather than called, since the reset coupon is more attractive than what would be earned by offering a new issue.

As the note below highlights, this risk is really issuer-dependent and there is no real consensus on what issues may be called and what issues might be redeemed. However, the recent extension of a TD preferred share issue has surprised the market, which had been pricing in a call, suggesting this is a risk that will likely have a bigger impact on preferred shares going forward.

Comments from Nicolas Normandeau, Vice President and Portfolio Manager with Fiera Capital’s Integrated Fixed Income Team:

“TD surprised the market on Monday by extending their TD FI preferred with a reset of 301bps. The preferred share market was under more pressure on Tuesday, as a result, bank-issued preferred shares with resets below 300bps were negatively impacted as the market prices were in a higher probability of extension risk.

TD is doing some important acquisitions at the moment, which they are looking for additional financing for, as is BMO. However, the two banks have taken different approaches on similarly yielding preferred share issuances. As a reminder, BMO redeemed a $25 preferred share issue last August with a reset of 317bps two days after printing an institutional preferred with a reset of 425bps. Two Canadian banks, two different strategies.

This particular extension seems specific to TD as they want to maintain a pro-forma conservative capital level because they are anticipating a challenging environment ahead. Or should we now expect banks to redeem their $25 preferred share issue only when it makes economic sense? It is difficult to answer right now.

Limited Recourse Capital Notes (LRCN) and institutional preferred share market are currently under important pressure and a new issue for TD or RBC could be in the area of 440bps reset, if not wider. TD, for example, is printing an LRCN in the US on October 6, 2022, with a big reset level and will have one of the highest tier 1 capital ratios of all
Canadian banks. We think the economics [a lot of higher rate reset LRCNs] mostly drove TD’s decision to extend the TD FI issue since that is at a lower spread.

National Bank will be next to announce a call or an extension at the latest on October 15, 2022. With a reset of 343 bps, we think it would make economic sense to extend but this will likely be a close call. Would they follow BMO or TD? As OSFI accepted, we have no other option but to think that National Bank would do what is best for all its stakeholders.

As for the Horizons Active Preferred Share ETF (HPR) and the Horizons Active Hybrid Bond and Preferred Share ETF (HYBR), TD’s decision to extend TD FI will have negative performance implications on the net asset value of the ETFs. We are underweight banks that reset over the next 18 months, including TD FI (we thought they were expensive if extended) but we are overweight the banks that reset late in 2024 and in 2025 which were already pricing some extension risk and downside should be limited following TD FI extension.

The current yield for these banks if extended would be in the 7.2%-7.5% area if the 5yr Canada rate stays at 3.25% on the reset date, which we believe is attractive. If you believe that the 5yr Canada would decrease toward the neutral rate of 2.5% over time, the next current yield on these would be in the 6.3%-6.6% range.

Over the last few months, we increased our allocation into LRCN and institutional preferred shares with a big reset level and with coupons above 7%. We think these issues should benefit over time as supply could be limited (outside M&A) if other banks follow TD and take a pause in redeeming their $25 preferred share issues.

We are still expecting banks to redeem some (not all) of their $25 preferred shares. However, the tone on LRCN and institutional preferred shares will need to improve substantially from current levels. More patience would be needed and it will also depend on how much LRCN room banks have.”

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