Canadian banks expected to face higher costs to raise funds amid volatility

JAMESON BERKOW CAPITAL MARKETS REPORTER

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Canadian banks are expected to face a more expensive fundraising environment as the consequences of Credit Suisse Group AG CSGKF -5.64% decrease being hurriedly acquired by UBS Group AG UBS-N -3.14% decreasecontinue to ripple through the global financial system.

In brokering the emergency takeover, Swiss regulators deemed roughly US$17-billion worth of Credit Suisse additional Tier 1 (AT1) debt worthless, while positioning the bank's shareholders to receive US$3.25-billion in UBS stock. The decision upended credit markets, as holders of common equity are usually the first to absorb losses because compensating lenders is considered a higher priority.

As a result, experts warn that financial institutions issuing that riskier type of debt – including Canada's largest banks and insurance companies – will need to pay higher interest rates to convince investors to keep buying.

"I think we will see some widening of AT1 spreads for some time given the perception of risk following the Credit Suisse situation, [because] the perception of this particular instrument has changed, despite the messages from regulators that nothing really has changed," said Marcos Alvarez, the global head of insurance credit ratings at DBRS Morningstar, in an interview from Madrid.

"For the Canadian market in particular, this will also impact limited resource capital notes [LRCNs] as pricing already was high. It might become more expensive for banks and insurers in Canada to issue LRCNs, at least for the next few months."

AT1 debt, more commonly known in Canada as LRCNs, were first introduced in the wake of the 2008 financial crisis as a way for banks to raise money without government bailouts. Since LRCNs first became available in Canada in 2020, they have consistently attracted investors drawn to their tax benefits – AT1 bond interest payments are not subject to the same withholding tax as traditional dividend payments – and interest in the 7-per-cent to 8-per-cent range.

In exchange, investors risk a similar outcome to what Credit Suisse AT1 holders just experienced, though potentially less severe given the differences between Swiss and Canadian regulations.

Canada's six largest banks have issued more than $20-billion of those bonds over the past three years, according to data from iA Capital Markets – almost a fifth of all the debt they issued.

"They are becoming more and more popular" among both institutional and retail investors, said Christian Pouliot, the head of fixed income investments at iA, in an interview from Quebec City. "They are primarily issued by the Big Six banks, but smaller banks and insurance companies have issued some as well."

Canadian Western Bank and Laurentian Bank, for example, have respectively issued $325-million and $125-million worth of LRCNs. And insurers Manulife, Sun Life and Great West Life have collectively issued almost $7-billion worth of AT1-style debt.

Mr. Pouliot expects between $2-billion and $4-billion worth of LRCNs to be issued this year, with investors likely to ask for higher interest payments in light of recent events.

"Maybe investors will ask for 10 or 15 basis points more of a risk premium," he said. "That is not impossible, just because of the increase in uncertainty at the moment."

Rules governing AT1 structures differ by market, and while Swiss regulations allow for shareholders to be prioritized above certain lenders in some circumstances, Canadian authorities have been quick to stress the same thing could not happen here.

Should a Canadian bank fail, LRCN holders would receive "a more favourable economic outcome than existing common shareholders, who would be the first to suffer losses," the Office of the Superintendent of Financial Institutions said this week.

The current state of the AT1 market is similar to what happens with catastrophe bonds issued by insurers in the wake of natural disasters, according to Korey Pasch, a PhD candidate at Queen's University in Kingston whose research focuses on catastrophic financial risk. Those bonds are often deemed worthless after a major earthquake, hurricane or hailstorm, he said in an interview, as those lenders are among the first to absorb an insurance company's losses.

"I see a lot of similarities between catastrophe bonds and AT1s," he said. "They are essentially the same mechanism, just applied to a different scenario."

In the natural-disaster scenario, insurers often have to wait months or even years before investors will willingly purchase more catastrophe bonds at predisaster interest rates, Mr. Pasch said. Usually, once the perception of risk has been heightened – either by a recent natural disaster, in the case of catastrophe bonds, or a bank failure in the case of AT1 bonds – investors need extra incentive to accept that risk.

“Then they have to look at pricing and they have to increase the coupon rate in order to get investors interested again,” Mr. Pasch said. “For me, it looks like the [AT1] mechanism is operating the way it is supposed to, so of course it is going to get more expensive to get investors to carry that risk. You just had a major event that is making people more leery of sitting on that risk.”

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