

## Opportunities in Preferred Securities:

### *An Evolving Asset Class in an Era of Financial Reform*

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For many years, investors have turned to preferred securities for their equity-like characteristics and high fixed or variable rates—among the highest in the investment grade market. At the same time, these issues have played a unique role in the capital structure of banks, as a cost-effective source of Tier 1 regulatory capital. But this role is changing as sweeping global financial reforms take shape. These reforms will have a profound effect on the market for existing preferred securities, and could usher in unusual opportunities for investors.

- Under the Dodd-Frank Act<sup>(1)</sup>, the Tier 1 capital status of debt-structured hybrid preferred securities will be phased out for U.S. banks with more than \$15 billion in assets. As the Tier 1 benefits diminish over time, banks might perceive these instruments as expensive forms of debt, rather than cost-effective sources of equity capital. Consequently, many may be refinanced in some form. More than 30% of U.S. dollar-denominated preferred securities, totaling about \$150 billion, will be affected.
- If adopted globally, the so-called Basel III<sup>(1)</sup> accords could impact the preferred securities market even more profoundly than Dodd-Frank. More stringent capital requirements could give rise to more complex forms of preferred bank capital instruments, opening the door to unusual investment opportunity.
- Although successor formats are still being refined, many regulators are advocating the use of contingent convertible capital securities, dubbed CoCos. While satisfying bank capital requirements, CoCos provide an attractively priced form of equity-like capital to companies and offer high income/total return potential to investors. (Please refer to Cohen & Steers' February 2011 publication, *The Evolving Opportunities in CoCos* for more information.)
- For now, many regulatory and ratings agencies remain on the sidelines until more clarity comes out of the Basel III accords and Dodd-Frank. While the appeal of debt-structured hybrid preferred securities to bank and non-bank issuers has been reduced, the lack of new issuance and anticipated levels of refinancing could drive scarcity value, keeping this high income asset class well bid.
- These evolving regulatory changes are likely to be phased in over several years. But since the market is already reacting to these events, timely investment action makes sense. With much still uncertain, navigating the investment waters will require ongoing, active management.

(1) Dodd-Frank is the Dodd-Frank Wall Street Reform and Consumer Protection Act; Basel III proposed by the Basel Committee on Banking Supervision.

The Basel III proposals, if adopted, would have an even more profound impact on the preferred securities market than those mandated by the Collins Amendment.

### **Collins Amendment Impacts Trust Preferreds**

The Collins Amendment is part of the Dodd-Frank Wall Street Reform and Consumer Protection Act, signed into law in July 2010. This far-reaching overhaul of the U.S. financial system broadens regulatory oversight, addresses bank liquidation, places limits on risky activities, calls for greater transparency of the derivatives markets and tightens capital requirements.

Beginning in 2013, the Collins Amendment eliminates the inclusion of debt-structured hybrid preferred securities (often known as trust preferreds) in Tier 1 regulatory capital for banks with \$15 billion or more in assets. Tier 1 capital is the most expensive form of regulatory capital and generally consists of “equity sources” only. However, as subordinated debt instruments, debt-structured hybrid preferred securities will retain Tier 2 regulatory capital treatment, which is a lesser form of regulatory capital with less prominence under new regulations.

### **Basel III—Potential for More Profound Impact on Preferred Securities**

The Basel Committee on Banking Supervision, a group of central bankers from around the globe, has been addressing the need to reform worldwide bank capital requirements since 2009. The final text of their recommendations, commonly known as “Basel III,” was released in December 2010, after being endorsed the previous month by G20 nations. If adopted globally, they could have an even more profound impact on the preferred securities market than those mandated by the Collins Amendment. Under the current proposal, only perpetual preferred securities with 1) no incentive to call, and 2) special loss absorption features, would qualify as Tier 1 regulatory capital.

What are these loss absorption features?

The Basel proposal contemplates that such securities would include a mandatory principal writedown and/or conversion into equity upon breaching pre-determined triggers. If this becomes a requirement, nearly every existing bank preferred would eventually lose Tier 1 status, potentially setting up a much greater wave of refinancing activity.

Preferred securities with specific loss absorption characteristics exist in some countries, but they are relatively uncommon. Even the provision that precludes the incentive to call is likely to result in large refinancings for foreign bank issuers. Many banks use so-called “innovative capital” instruments, which are structured with coupon “step-ups” that incentivize the issuer to call them. However, these recommendations are still subject to revision, and the decisions of the Basel Committee may not be adopted in every member country.

### **Basel III vs. the Collins Amendment**

Both Basel III and the Collins Amendment eliminate Tier 1 capital treatment for trust preferred securities; however, there are a number of differences:

- The Collins Amendment requires U.S. depository institutions to phase out trust preferred securities issued before May 19, 2010 from Tier 1 capital over a period of three years, beginning on January 1, 2013. The phase-in period under Basel III is ten years.
- The Collins Amendment grandfathers trust preferred securities issued before May 19, 2010 held by institutions with assets of less than US\$15 billion. Basel III has no such exemption.

### **Potential for Significant Refinancing Activity**

As certain preferred securities lose Tier 1 status—by way of the Collins Amendment or Basel III—issuers are likely to view them as expensive forms of debt. Hence, these changes are likely to result in a significant amount of refinancing activity both inside and outside the United States.

Par calls offer one potential option for issuers. Many preferred securities are governed by legal documents that enable issuers to call them at par in the event of a change in their regulatory capital treatment. As a result, those trading at premiums may be at risk of loss if called at par; however, those trading at discounts may experience a gain if called at par.

One recent example of a par call occurred in May 2011, when Fifth Third Bank exercised par regulatory calls on three hybrid securities trading at a premium. These calls were unexpected by the market, and they occurred somewhat earlier than we might have anticipated. But as the new standards are adopted and codified, we expect more securities to be called.

As an alternative to par calls, some issuers with securities below par may choose buybacks, exchanges or tenders instead. This would enable them to realize gains as they pay less than par for their liabilities. From an investment standpoint, even this activity is likely to be positive for holders, as companies will almost certainly need to offer more than the market price to garner holder participation.

While we await such activity in the future, it is likely that little will materialize in the very near term. Banks are likely to wait until the regulatory environment is more certain. What is

more, debt-structured hybrid preferred securities used in the U.S. are generally the cheapest form of Tier 1 capital for issuers, largely owing to the fact that they pay interest (rather than dividends), which is tax deductible to the issuers. Hence, issuers are likely to want to keep them outstanding while Tier 1 status is intact.

It is also important to note that issuers might decide to leave certain issues outstanding as Tier 2 capital. An issuer's decision relative to takeout and new issuance activity will be influenced by a number of factors, including the issuer's net tax-effected cost for refinancing phased-out preferred structures.

Other considerations include the percentage of debt-structured hybrid preferred securities within the issuer's capital structure, and any remaining regulatory benefits of the issues; changes in its risk-weighted assets (which influence demand for Tier 1 capital); and the relative attractiveness of generating regulatory capital via other means.

### **Positive Fundamentals and Issuance Trends**

On the whole, bank fundamentals are on an improving trajectory. In recent quarters many banks have significantly improved capital via equity raises, asset sales and other means.

Also vital, recent earnings reports largely show diminishing asset quality problems after many quarters of heavy loss provisioning, writedowns and charge-offs.

This trend was confirmed in the first quarter of 2011, when the Federal Reserve announced the results of stress tests conducted on the largest U.S. financial institutions. Goldman Sachs was given the “green light” to repay the \$5 billion investment made by Warren Buffett during the

We view the current supply and demand balance positively due to the very low interest-rate environment and improving bank fundamentals.

CoCos offer promise as an alternative source of equity-like capital.

financial crisis. SunTrust and KeyCorp<sup>0</sup> raised equity to repay taxpayer bailouts. Based on significantly improving capital levels, 19 banks were allowed to raise dividends, buy back shares or repay bailouts. JP Morgan Chase, Wells Fargo and U.S. Bancorp have already announced plans to boost their quarterly dividends.

Sustained profitability is returning, and this will likely lift the ratings of many preferred issues that were downgraded in recent quarters. In fact, over one-third of the preferred securities that fell to below-investment-grade during the financial crisis have returned to investment-grade status since the beginning of 2011. We also believe that over time new regulations that limit non-traditional banking activities and mandate improved bank capitalization and funding will further reduce the risks creditors routinely attribute to banks.

Against a backdrop of improving fundamentals, the new issuance of bank preferred securities has fallen, and it is likely to remain modest until there is more certainty regarding Basel III. This favorable supply and demand balance, combined with improving fundamentals and the low interest rate environment, is positive for preferred securities valuations. Near-term scarcity value in the asset class may grow; and, of course, investors may speculate as to which securities will be taken out at premiums to current trading prices. Issuance is likely to resume as the regulatory environment becomes clear, and particularly as Tier 1 status is phased out for certain structures. However, this issuance may be in the form of new preferred structures—possibly with the “loss absorbing” characteristics proposed by Basel III. This new issuance may

provide scope for value opportunities, as the market will almost certainly demand high premiums for untested and unknown securities.

### **CoCos Are Coming of Age**

At this time, contingent convertible capital securities, also called CoCos, seem to be emerging as a likely source of equity-like capital. CoCos can be structured as debt or preferred equity, but would convert to common stock under certain stress scenarios (such as a bank’s Tier 1 capital ratio falling below a pre-determined level). An alternative version of bank capital that may be compliant with new Basel III standards would write down to less than par value rather than convert to common equity. In general, these securities would fall into two buckets: so-called “going concern” issues would convert or write-down under more mild stress scenarios, while those deemed “gone concern” securities would convert or write-down under more dire circumstances. To compensate investors for the equity conversion or write-down features, CoCos are expected to offer high rates of income.

### **Scarcity Value May Grow for Other Preferreds as Well**

Regulatory changes largely affect bank preferreds. However, if prices on this largest part of the preferred market rise due to scarcity value or other reasons, it is likely to have a broader relative value affect on insurance, utility, REIT and other issues as well.

Scarcity value may also grow for the market as a whole due to changes in ratings agency methodologies that could effect the attractiveness of debt-structured hybrid

preferred securities more broadly. Specifically, Moody's refined its methodology for assigning "equity credit" to these securities as of July 1, 2010. Per these changes, debt-structured hybrid preferred securities will receive less equity credit and therefore be considered more like debt than equity.

In years past, non-financial issuers have used debt-structured hybrid preferred securities for various purposes, including buying back stock without significantly altering debt-to-equity ratios for ratings agency purposes. Therefore, non-bank issuers may find these issues less appealing, and some refinancing activity is possible from them as well. Ultimately, decisions whether to keep existing securities outstanding or to issue new ones will be complex and come down to similar factors being considered by banks, principally the tax-effected cost of these securities relative to the benefits they provide.

### **Our Closing Perspective**

The financial reforms of Basel III and the Dodd-Frank Act are in the early stages of overhauling the global banking system. While questions remain on timelines and country-by-country adoption requirements, financial markets have already begun to react. Accordingly, we think it is important for investors in preferred securities to be in front of this issue, as some securities will grow or hold their value better than others.

Over time, the new regulations are set to diminish the Tier 1 capital status of bank-issued debt-structured hybrid preferred securities. As a result, we expect refinancing activity to rise, as banks weigh the costs relative to the benefits. Once the regulatory environment becomes more certain, some could be subject to calls, buybacks

or tenders, depending on where individual securities are priced.

As a result, we expect that these types of redemptions will drive scarcity value and spur issuance of alternative hybrids like CoCos. This is a developing new asset class that may satisfy Tier 1 capital requirements, while offering high income and total return potential. Given these factors, we expect the market for CoCos to grow exponentially over the next decade. But as this asset class comes of age, we advocate that investors rely on active management by an experienced investment team with deep research resources, given the complex nature of these instruments and the regulatory reforms in progress.

Financial reform could drive scarcity value for existing preferreds, while ushering in new forms of bank capital instruments.

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**Risks of Investing in Preferred Securities**

Investing in any market exposes investors to risks. In general, the risks of investing in preferred securities are similar to those of investing in bonds, including credit risk and interest-rate risk. As nearly all preferred securities have issuer call options, call risk and reinvestment risk are also important considerations. In addition, investors face equity-like risks, such as deferral or omission of distributions, subordination to bonds and other more senior debt, and higher corporate governance risks with limited voting rights.

*This commentary must be accompanied by the most recent Cohen & Steers Preferred Securities and Income Fund fact sheet if used in connection with the sale of mutual fund shares.*



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