Wealth Management

Hybrid preferreds and the “float” rate

Hybrid preferred securities combine characteristics of debt and equity instruments and they have often been issued to take advantage of favorable accounting, tax, and capital treatment.

While there is considerable variability between individual issues, most hybrid preferreds share some common features:

- **Maturity date:** Hybrids are typically perpetual securities, with no fixed maturity date; for those hybrids that do specify a maturity, it is usually very far in the future.
- **Fixed coupon period:** Coupons are initially paid at a fixed rate for a set time period, often five years.
- **Float coupon period:** Hybrids are almost always callable at the end of the fixed coupon period and are frequently designed to be called at that time. If the issuer does not call the bond at the first opportunity, the coupon changes to a floating or variable rate. Floaters, as they are sometimes known, pay a coupon calculated by adding a fixed spread to a market interest rate, often 3-month London Interbank Offer Rates (LIBOR). The frequency with which the coupon changes is often linked to the chosen reference rate, so a coupon based on a 3-month interest rate will usually be recalculated quarterly, while a coupon linked to an annual rate may be fixed for a year.
- **Additional calls:** Hybrids are callable at par throughout the floating rate period; some are continuously callable during that time, while others can only be called when rates reset or on other specified dates.

Historically, the most common reference rate was 3-month LIBOR, but with that rate’s scheduled termination, many new issues are linked to 5- or 10-year Constant Maturity Treasury (CMT) rates.

Given the market’s relatively recent adoption of CMT yields, we wanted to highlight the move and discuss some of the investment implications. We focus our discussion on hybrids linked to the 5-year CMT rate, but the same principles apply to the bonds issued with a 10-year CMT reference rate.

What is a CMT rate?

The 5-year CMT rate is designed to reflect the current market yield on a Treasury bond maturing in exactly five years. Since there is usually not a bond outstanding with that exact maturity, the Fed uses a mix of auction data and daily price information to calculate a best estimate of the yield. These rates are then published on each bond market trading day.

Benefits of the CMT rate

Investors enjoy several potential benefits from the move to use CMT rates as a reference for floating rate coupons.

- **Higher average yields:** Since the yield curve typically slopes upward, a 5-year CMT yield will usually be higher than a 3-month money market yield. For any given fixed spread, therefore, investors will typically receive a higher coupon during the float period. This is not always the case, of course, and the fixed spread will tend to adjust for expected differences in the reference rate. But in an environment with an upsloping yield curve, 5-year reference rates should lead to higher coupons for hybrid investors.
- **Typically higher fixed spreads over the reference rate:** When deciding what spread will be added to the 5-year CMT rate on each reset date, issuers typically use the difference between the fixed coupon and the 5-year swap rate near the day of issuance. This calculation is currently favorable for investors: the 5-year swap rate is near historical lows and is 1.5% below the average rate since 2015. Lower swap rates translate into higher spreads being added to future CMT yields. The result is that investors benefit from either a higher call probability during the shift to floating rates or higher income if the issuer does not call the bonds during the floating rate period.

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For important disclosures see page 3.

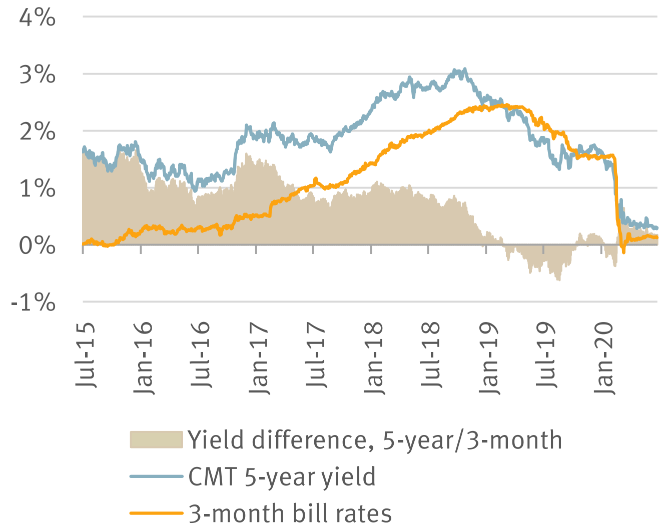
- **Fewer reset dates:** The frequency of coupon recalculation for a floating rate bond is often linked to the length of the underlying reference rate; a bond linked to 3-month LIBOR recalculates the coupon rate quarterly in most cases. Hybrids that link to the 5-year CMT rate and adopt a 5-year reset calendar will have fewer resets relative to LIBOR-based floaters and will therefore give investors greater cash flow predictability.
- **Fewer call dates:** Issuers almost always have the right—but not the obligation—to call hybrid preferreds when they switch from fixed to floating coupons. Call schedules after that vary between individual issues, but call dates are sometimes aligned with coupon reset dates. Since 5-year CMT-linked bonds reset less frequently, they are often subject to less frequent calls as well, reducing uncertainty for investors.
- **Potentially greater likelihood of initial call:** Financial institutions are heavy issuers of hybrid preferreds and they usually have more exposure to short-term rates than long-term rates; working capital loans, for example, are usually for less than a year and corporate loans frequently adjust with some money market reference rate such as LIBOR. For these institutions, having an outstanding liability that references a 5-year rate tends to be expensive and creates problematic asset-liability mismatches, giving these issuers more reason to call the security. Higher call predictability tends to provide investors with more certainty regarding cash flows.
- **Stability:** Since the U.S. government is likely to have debt outstanding for the foreseeable future, the 5-year CMT rate should, unlike LIBOR, be calculable into the future. Many of the new issues contain provisions if the Fed were unable or unwilling to provide the 5-year CMT rate in the future.

Overall, the 5-year CMT rate offers investors a greater chance for higher yields and greater predictability of both cash flow streams and call dates relative to reference rates with shorter maturities. Since most investors buy fixed income to get known cash flows for a set period of time, 5-year CMT-linked hybrids have a potentially significant advantage relative to 3-month LIBOR.

Additional considerations

Investors should be aware of a few other aspects regarding the mechanics of the 5-year CMT.

Comparison of historical yields on 5-year and 3-month government securities



Source - RBC Wealth Management, Bloomberg; data range 7/15/15–7/10/20

First, as CMT bonds typically reset less frequently than LIBOR bonds, they have a greater sensitivity to interest rates during the floating period. Since CMT bonds are potentially more likely to be called, this factor may never be relevant.

In addition, since the CMT is based on Treasury bonds, there is no credit component to the yield; it is simply compensation for the time until repayment. Many short-term rates, such as LIBOR, do have a small credit component. This difference becomes most relevant if there were to be a significant credit blowout near a reset date. In that case, Treasury yields would typically be low as investors shifted into low-risk assets, while credit premiums could spike and push LIBOR or other credit-sensitive rates higher.

A healthy change

As the hybrid preferred market shifts away from LIBOR-based coupons, investors will more frequently be confronted with securities linked to CMT rates. Overall, we believe this change is healthy for investors, as the longer-term reference rate will tend to provide greater stability, potentially higher yields, and greater consistency in coupon payments relative to the current predilection for 3-month LIBOR-linked coupons.

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