FTSE Canada Bond Indexes – Market Consultation on Index Eligibility of New Coupon Structure for Non-Financial Hybrid Capital Securities

FTSE fixed income indexes must keep pace with the evolving markets they measure, however its index methodologies cannot anticipate or codify every eventuality. In such circumstances, FTSE Russell will seek to determine the appropriate treatment by reference to the guiding principles set out in its Statement of Principles, which also summarizes the ethos underlying our approach to index construction.

As announced on 5 March 2021, FTSE Russell is formally opening a market consultation to solicit feedback on the index eligibility of a new coupon reset structure of recently issued non-financial hybrid capital securities in the FTSE Canada Bond Index Series. Historically, fixed-to-floating rate non-financial hybrid capital securities have been included in FTSE Canada Bond Indexes provided they meet other inclusion criteria. While the eligibility of fixed-to-floating rate securities is codified in the FTSE Canada Bond Index rules, the eligibility of non-financial hybrid capital securities as an asset class is not stated.

This consultation will also seek feedback on the appropriate exit timing for index-eligible structures that have an optional reset to a coupon that is not pre-determined at issuance; this is currently one year prior to the reset date.

FTSE Russell acknowledges the distinction between financial hybrid capital securities and non-financial hybrid capital securities and affirms the previously announced exclusion of Limited Recourse Capital Notes (LRCNs) from the FTSE Canada Universe Bond Index and FTSE Canada High Yield Bond Index.

Background

According to the Ground Rules for fixed-rate indexes in the FTSE Canada Bond Index Series, including the FTSE Canada Universe Bond Index and the FTSE Canada High Yield Bond Index, the following coupon types are eligible for index inclusion:

- Fixed-rate;
- Fixed-to-floating rate with a stated legal maturity; and
- Fixed-rate with a step-up coupon schedule with fixed-rates that are predetermined at issuance.

Both hybrid capital and non-hybrid capital securities with a coupon that is fixed-rate for a predetermined length of time followed by an optional conversion to floating-rate at a future date are currently eligible for the index during their fixed-rate period only. These fixed-to-floating rate securities are treated as bullet bonds for analytics purposes with an effective

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1 For purposes of defining financial hybrid capital securities, financial entities are those regulated by the Canadian Office of the Superintendent of Financial Institutions (OSFI). This does not include entities that operate in the financial services sector which are not required to meet bank regulatory capital requirements.
maturity set to the first date at which their coupon may be converted to floating-rate. The rationale for this handling, from an index perspective, is that their floating-rate coupons make them ineligible for a fixed-rate index after their optional reset date.

Several recently issued non-financial hybrid capital securities have a coupon structure that allows for an initial fixed-rate period, followed by an optional conversion to a rate that is not predetermined at issuance and is based on the prevailing Government of Canada 5-year yield at a future date. The subsequent multi-year periods during which the reset fixed-rate coupons of these instruments are paid are longer than the one-year minimum time to maturity for inclusion in most FTSE Canada Bond Indexes. This coupon structure is comparable to the coupon reset structure of Limited Resource Capital Notes (LRCNs), which are an explicit exclusion from FTSE Canada Bond Indexes. Other features, however, are structurally similar to existing index-eligible fixed-to-floating rate non-financial hybrid capital securities.

FTSE Russell acknowledges that two recently issued non-financial hybrid capital securities with this new coupon structure\(^2\) were recently included in the FTSE Canada High Yield Bond Index prior to this broad market consultation and a comprehensive review of the new structure with market participants. FTSE Russell will consider an appropriate way forward for these securities in the light of the responses received to this consultation.

Consultation Approach

Market stakeholders are encouraged to submit their responses to a questionnaire online at: https://www.surveymonkey.co.uk/r/8RLKJT6

All responses will be treated as confidential, however, FTSE Russell may publish a summary of the results in the interest of transparency of process for any ultimate decision it takes. No individual responses will be published and no respondents will be named, however, a summary of responses by stakeholder group may also be made available.

The consultation will close on 2 April 2021, and FTSE Russell will target to communicate its decision the following week commencing 5 April 2021. The exact timing of the announcement will also be published to market participants in advance of its release.

During the consultation period, any new issuance with similarities to the new coupon structure described in this consultation will not be added to the FTSE Canada Bond Indexes, including both the FTSE Canada Universe Bond Index and the FTSE Canada High Yield Bond Index.

Any questions or feedback may also be submitted through the online link.

\(^2\) Gibson Energy Inc. 5.25% 2080 (374825AJ) and Pembina Pipeline Corp. 4.80% 2081 (706327AK).
Consultation Questions

1. While eligibility of fixed-to-floating rate securities is codified in FTSE Canada Bond Index rules, specific reference to the eligibility of non-financial hybrid capital is not referenced outright. Historically, fixed-to-floating rate non-financial hybrid capital bonds have been included in FTSE Canada Bond Indexes provided they meet other inclusion criteria.

For index inclusion purposes, FTSE Russell proposes to define non-financial hybrid capital securities as “a bond that allows for any option (other than principal redemption) to be exercised by the issuer at the earliest opportunity”. Do you agree with this definition?

- Yes
- No
- Please state your reasons

2. Should ALL non-financial hybrid capital securities, regardless of their coupon reset structure, be eligible for inclusion in the FTSE Canada Universe Bond Index?

- Yes
- No
- It depends on the coupon reset structure after the first call date. Please provide further details in the comments.
- Please state your reasons

3. If all coupon reset structures are deemed index-eligible for non-financial hybrid capital securities, when should they exit FTSE Canada Bond Indexes?

- One year prior to their reset date (in line with the treatment of existing fixed-to-float securities) regardless of the coupon structure thereafter
- At their first call date
- It depends based on cash flow projections and / or call probability
- Please state your reasons

4. Do you believe that the approach taken in the FTSE Canada Universe Bond Index should also apply to the FTSE Canada High Yield Bond Index?

- Yes
- No
- Please state your reasons

5. Please submit any other feedback you would like FTSE Russell to take into consideration.