

Structured Notes

Recommendations to
Municipalities



Summary

A structured note is a hybrid debt security that typically combines a bond with derivative features to create customized risk-return profiles linked to an underlying asset, index, or interest rate.

These products can offer benefits such as varying levels of principal protection, market diversification, access to otherwise hard-to-reach asset classes, enhanced growth or income potential, customization, and eligibility for certain registered plans, all while carrying the credit rating of the issuing institution.

However, they also present significant risks including issuer risk of association with creditors' credit rating, ill-performing underlying assets, inability to liquidate assets at a high return, reinvestment uncertainty, a complex tax treatment, and the absence of CDIC insurance. These aspects present challenges for municipalities that must stay within the confines of the *Municipal Government Act* (MGA).

Smaller municipalities with limited financial flexibility should be especially cautious, investing only funds that can remain untouched for the full term and avoiding assumptions of full payout at maturity, as many notes require specific performance conditions before returns are realized.

Larger municipalities that have significant financial security – if they choose to use structured notes as an investment option – should choose structured notes carefully to gain most return on investment.

Overview

What is a Structured Note?

A structured note is a hybrid debt security issued by a financial institution that combines elements of multiple financial instruments – typically inclusive of a bond and a derivative. These products are designed to offer customized risk and return profiles that are linked to the performance of an underlying asset, index, or interest rate.

A bond is a fixed-income investment product – commonly available through brokerage platforms – in which an investor lends money to a government, corporation, or other entity at a specified interest rate for a predetermined period. In return, the issuer repays the investor the face value (“par value”) of the bond at maturity, along with periodic interest payments.

A derivative is a type of financial contract whose value is derived from an underlying asset, a group of assets, or a benchmark. These assets may include stocks, bonds, commodities, currencies, interest rates, or market indexes. Derivatives are agreements between two or more parties and can be traded either on organized exchanges or over-the-counter (“OTC”). Derivatives effectively transfer risk between market participants for the listed functions, shifting exposure from those seeking protection to those willing to take on risk in pursuit of higher returns

The bond component of a structured note generally provides principal protection and may offer periodic or final interest payments at maturity. The derivative component adjusts the note's overall payoff, potentially enhancing returns if certain market conditions are met. While the bond's returns are often fixed or contractually determined, the derivative's returns are market-based making the total return inherently uncertain.

Structured notes are considered complex and illiquid investments (cannot be easily sold, traded, or converted into cash without significant loss in value), and their performance depends heavily on the issuer’s creditworthiness and the behavior of the underlying asset. Importantly, banks and other issuers are typically reluctant to enter into these agreements unless they anticipate a financial advantage – either through structuring fees, market movements in their favor, or embedded conditions that reduce their overall exposure.

MGA Considerations

Municipalities are granted a significant degree of autonomy in selecting their investments, provided those investments meet high- or prime-quality standards.

Under the MGA, authorized investments encompass a broad category of defined “securities,” including bonds, debentures, trust certificates, guaranteed investment certificates or receipts, deposit certificates or receipts, bills, notes, and mortgages on real estate or leaseholds. The MGA grants municipalities access to a fairly wide variety of relatively secure and familiar financial instruments, while also constraining municipal decision-making to within a controlled framework.

Municipalities may engage in more complex instruments – such as exchange agreements, futures agreements, option agreements, or rate agreements – but only when these products are linked to an authorized security or used specifically to hedge against potential losses. This ensures that derivative-based strategies serve a protective function rather than a speculative one.

Investment options are otherwise limited to securities issued or guaranteed by the Crown (federal or provincial); school divisions, hospitals, provincial health agencies, or regional health authorities; or financial institutions such as banks, treasury branches, credit unions, or trust corporations.

Municipalities may invest in the shares of a company if the municipality receives explicit approval from the Minister. To maintain strong credit quality, securities issued by Canadian corporations must hold a minimum rating of R-1 or A- (or equivalent), with investments maturing in under one year permitted at A- and those with longer maturities requiring the higher standard.

The MGA prohibits municipalities from owning securities issued by “controlled corporations” – entities operated for profit and controlled by one or more municipalities. This is done in an effort to prevent conflicts of interest or excessive financial entanglement. However, perhaps reflecting a policy intent to support community-oriented entities without exposing public funds to undue risk, municipalities are permitted to acquire shares in non-profit organizations.

Benefits and Risks

Benefits

Structured notes provide the owner several significant benefits, including:

- ◆ *Principal Protection*: Depending on the build, structured notes may offer full, partial, or contingent protection of the original investment when held to maturity.
- ◆ *Diversification and Market Access*: Structured notes can provide exposure to a wide range of asset classes many of which may otherwise be difficult for individual investors to access.

- ◆ *Growth and Income Potential:* Depending on the structured note's design, investors may benefit from enhanced income distributions or growth-linked returns based on the performance of the underlying market or index.
- ◆ *Customization and Flexibility:* Structured notes can be tailored to suit different risk profiles and market views, and may offer the opportunity to sell prior to maturity through a secondary market maintained by the issuer.
- ◆ *Issuer Stability:* Structured notes carry the same credit rating as the financial institution that issues them.
- ◆ *Account Eligibility:* Many structured notes are eligible for registered plans such as RRSPs, RRIFs, RESPs, and TFSAs.

Risks

However, there are several risks that are directly associated with investment in structured notes that municipalities must be aware of or attempt to mitigate. These include:

- ◆ *Credit Risk:* Repayment of principal and any income payments depend on the credit rating of the issuer. Banks are typically safer, but this should be assessed prior to establishment.
- ◆ *Market Risk:* Returns are linked to the performance of the underlying asset(s). Poor market performance may result in reduced or no returns and – in some cases – loss on the principal
- ◆ *Liquidity Risk:* Although issuers generally aim to maintain a secondary market for early redemption, there is no guarantee that such a market will exist or that investors will receive full value if selling prior to maturity.
- ◆ *Reinvestment Risk:* Structured notes may be redeemed early by the issuer or automatically called based on market performance, potentially forcing reinvestment at lower rates.
- ◆ *Tax Considerations:* The tax treatment of returns on structured notes can vary. Investors should consult a qualified tax professional.
- ◆ *CDIC Coverage:* Structured Notes are not insured by the Canadian Deposit Insurance Corporation.

Recommendations

While municipalities are granted notable discretion in choosing their investments under the MGA, this discretion should be exercised with prudence when considering complex financial instruments such as structured notes.

Structured notes, while generally complete with the authorized securities requirement under the MIR, remain hybrid debt instruments that combine a bond with a derivative component – **they should be broached in a conservative fashion.**

These products often carry illiquidity, credit, and market risks, and their returns depend on the performance of an underlying asset or index rather than a fixed rate. Further, financial institutions are generally unwilling to issue structured notes unless they expect to profit from the arrangement, which can further disadvantage investors.

For these reasons, **municipalities should approach structured notes cautiously**. This is especially true for smaller municipalities with limited financial flexibility.

Funds invested should be those the municipality can afford to leave untouched for the full maturity period. Smaller municipalities operating with tight budgets or limited cash reserves should avoid these instruments altogether. Moreover, it is unwise to assume that a structured note will pay out fully at maturity, as most agreements require certain performance thresholds to be met before any interest or principal gains are realized.

For more information visit: rhalberta.com

Ian Profiri

Policy & Research Analyst

825.319.2352

ian@rhalberta.com