Article Title: ARCHIVE | Criteria | Corporates | General: Update On Hybrid Capital Criteria: Step-Ups And Replacement Capital Covenants Data: Standard & Poor's Ratings Services has revised its view of step-up provisions in U.S. bank holding companies' hybrid capital issues in response to a change by the Federal Reserve. We have also refined our approach to replacement capital covenants in issues of both regulated and unregulated issuers. Step-Up Provisions In U.S. Bank Holding Company Issues Step-ups are specifically designed to motivate the calling of the issue. They clearly signal to investors the issuer's initial intention to refinance the issue in time to avoid the step-up. Yet, as long as the extent of the step-up is moderate (100 basis points [bps] being the typical regulatory limit as well as the norm presently in most markets in the current interest rate environment), the issuer could choose to keep the issue in place and not refinance it, if for example, the issuer's financial position or general capital market conditions made it undesirable for the issuer to tap the capital markets. We would be concerned in such a scenario about the possibility of the issuer facing a backlash among investors who had not appropriately taken account of the so-called extension risk. Still, we do not view the time of the call and step-up as an effective maturity. In the regulated financial services sector, the call is typically subject to regulatory approval: from the perspective of analyzing the equity content of the instrument, this neutralizes the potentially weakening effect of the call. Until now, we have made an exception in the case of hybrid capital issues of U.S. bank holding companies, given that the Federal Reserve's regulatory policy has been to reduce to Tier 2 status any Tier 1 issues of such companies with less than five years remaining until a step-up, and to amortize down equity credit during the final five years. Consequently, for U.S. bank holding companies, we have similarly viewed any step-up date in advance of a scheduled maturity or final maturity date as the effective maturity date. (Under our policies, the equity content of any issue with less than 20 years remaining until the effective maturity is reduced to "minimal.") However, the Federal Reserve has now changed its position, and will no longer treat the step-up date as the equivalent of a maturity date, where the step-up date is at least 30 years from the initial issuance date and the step-up is limited to 100 bps. Accordingly, we have decided to cease treating U.S. bank holding companies as exceptional, under our criteria, where the step up is at least 30 years from the initial issuance. So, for example, if a U.S. bank holding company's enhanced trust preferred issue has a 100 bps step-up at year 30 and a scheduled maturity at year 40, we would treat the issue as having "intermediate-strong" equity credit for the first 20 years (assuming our other relevant standards were met), not just for the first 10 years. Replacement Capital Covenants In the case of regulated entities (including, for example, most banks and bank holding companies globally, and European insurance groups), we have not had any requirement that, to qualify for the "intermediate" equity content designation, issues include legally binding replacement capital covenants (RCCs) to offset the effect of step-ups. Still, we have paid close attention to the terms of the RCC, where present, believing the RCC could act as a "roadmap" for management's future actions. Thus, if an RCC expires before the scheduled or final maturity date, or if the covenant, beginning at some point, allows for only partial capital replacement with other hybrid instruments, we have viewed those points in time as defining the effective maturity date. However, we have now reassessed this position, believing we should generally rely on the oversight provided by the regulator and our own understanding of the issuer's financial policies, and not place such emphasis on the terms of RCCs. Thus, going forward, for most regulated entities, we will not automatically view RCC expiration dates or the point at which a reduction in replacement requirements occurs as defining the effective maturity. By contrast, in the case of unregulated entities (including, for example, U.S. insurance holding companies), we continue to believe RCCs are important to offset the risk of the issue being refinanced with debt in the face of a call provision coupled with a step-up. Until now, for instruments to warrant "intermediate" equity credit, we have required RCCs only when there was a call and step-up less than 10 years from the date of issuance; otherwise, we have accepted clearly articulated formal statements of management's intentions regarding the refinancing of the issue: such statements, being included in the terms of the issue, are of dubious enforceability. We had previously stated that this policy could be reassessed. Since the use of RCCs has now become common and widely accepted, in new issues we will require RCCs in all cases where there are calls and step-ups (except in countries where they have no legal basis or are otherwise not practicable). We believe RCCs should provide for issuance of instruments that are at least as equity-like in terms of the flexibility of payments and degree of subordination as the initial instrument. However, the term only needs to extend to the effective maturity date we had assumed with the initial instrument (even if this means that the issue overall would not warrant the "intermediate" equity credit designation). For example, if a corporate issue with a 30-year maturity has a call and step-up at year 15, the RCC needs only stipulate that the replacement security mature no earlier than 30 years from the issuance date of the initial instrument–-not 30 years hence from the time of the refinancing. We continue to believe that issues with step-ups and calls earlier than five years from the date of issuance, or in the case of investment-grade issuers in most markets, with step-ups in excess of 100 bps, do not warrant "intermediate" equity credit.