

Article Title: ARCHIVE | Criteria | Corporates | General: Clarification Regarding Step-Ups Used In

Equity Hybrids Data: Many long-dated equity hybrids have a fixed rate for the first 10 years, then convert to a variable rate. If that variable rate incorporates a penalty feature designed to motivate the issuer to call the issue, Standard & Poor's Ratings Services questions the permanence of the issue, which undermines equity content. One example of this is a step-up, where the issuer would have to pay a specified number of basis points over the applicable benchmark rate. Another example of an inherent penalty involves the payment of the highest of various rates that could fluctuate relative to each other. We have accepted some equity hybrids that employ two or three rates tied to points on the yield curve, the highest of which determines the instrument's yield for each dividend period. Since the yield curve is normally upward-sloping, we presume the rates will not fluctuate--rather, that the long-term benchmark will pertain. However, using a long-term benchmark for a security that resets at short intervals would itself be a penalty if not priced appropriately. Any long-term benchmark rate must be modified to make it economically comparable with a more-appropriate short-term benchmark rate, to eliminate the penalty aspect. For example, the applicable rate could be a percentage of the long-term benchmark rate or "x" basis points below the benchmark rate. Recently, the yield curve essentially has been flat, and any penalty involving the use of a long-term benchmark without modification has been modest. Now, however, we are concerned about the effect of a steepening yield curve--especially over a longer time horizon. Accordingly, going forward, we will presume that use of a long-term benchmark, on its own or in combinations, is an inherent penalty rate--unless there is an adequate pricing modification that equates it with the short-term benchmark rates ordinarily used for variable-rate debt. We will individually evaluate securities that incorporate such pricing modifications to a long-term benchmark rate. Our acceptance of the specific modified rate will require a rigorous statistical analysis that the modification is adequate. Such analyses should be provided by the structuring bank. Replacement language--or covenants--can remedy a penalty-rate situation, up to a point. We are sensitive to the size of the penalty involved. If the penalty exceeds 100 basis points, we deny equity credit even where a legally enforceable replacement covenant is in place. Because of the difficulty in calculating the penalty associated with use of long-term benchmarks, given the constantly fluctuating variables involved, we cannot presume the penalty is less than 100 basis points. Therefore, replacement provisions are insufficient to remedy this feature, without the aforementioned modifications and accompanying statistical analysis. Moreover, we increasingly are skeptical about features that seemingly try to obscure their purpose of provoking the issuer to call the issue. We do not intend to revoke any equity credit afforded to securities of this type that already have been placed. While we cannot rule out the likelihood that future rate changes could make us more leery about the permanence of those securities, we would give issuers the opportunity to explicitly address their replacement strategies and intentions.