Article Title: ARCHIVE | Criteria | Corporates | General: The Ratings Impact Of "Best Endeavors" Undertakings In Hybrid Capital Issues With Mandatory-Deferral Mechanisms Data: (EDITOR'S NOTE: —This article is no longer current. It has been superseded by "Hybrid Capital Handbook," published Sept. 15, 2008.) Further to the full criteria article published May 8, 2006, on RatingsDirect ("Assigning Ratings To Hybrid Capital Issues"), Standard & Poor's Ratings Services today reconfirmed its belief that some mandatory-deferral mechanisms appear to retain little real substance when offsetting mechanisms in the same issue significantly reduce their potential to force mandatory deferral of interest payments upon an issuer that does not wish to defer. This being the case, if Standard & Poor's believes that the likelihood of an issuer deferring on its hybrids containing mandatory-deferral language is no greater than the likelihood of it deferring on its other, conventional hybrids containing non-mandatory-deferral language then, all else being equal, the same rating will be assigned to all the hybrid issues of that issuer. Some future hybrid issues with mandatory-deferral language are expected to include undertakings of management to use its best endeavors to raise cash to settle coupons due, which would otherwise be deferred. Mechanisms Used For Deferring Payment Of Interest In the particular context of the hybrid equity issues of large European insurers and reinsurers, where mandatory-deferral features are increasingly common, Standard & Poor's has observed increasingly standardized wording of the deferral terms, which are invariably supplemented by optional-deferral triggers. In essence, the standardized language usually comprises two related mechanisms. The first mechanism establishes a multiple set of reasonably remote "events" or triggers, all of which must be activated in order to set in motion the mandatory-deferral mechanism. The second mechanism usually details various ways whereby the issuer can choose to raise new cash capital with which to continue making full and possibly uninterrupted coupon payments, preventing the forced deferral of payments from occurring. Mandatory-Deferral Mechanisms And Alternative Coupon-Settlement Mechanisms Typically, the first set of standardized language defines a mandatory-deferral event as having occurred when all of a defined series of incidents have taken place, usually along the following approximate lines: Cumulative consolidated net income for the two half-year periods ending six months prior to the coupon date must be less than zero; Adjusted consolidated shareholders' funds must decline by 10% or more over the four half-year periods ending six months prior to the coupon date; and Six months after the prior two triggers have been activated, total adjusted capital (including mandatory convertibles and/or hybrid securities) must have declined by more than 10% over the preceding five half-year periods. The second set of standardized language routinely relates to an alternative coupon-settlement mechanism (ACSM), whereby the issuer can raise new cash with which to maintain ongoing coupon payments despite the fact that a mandatory-deferral event has occurred. The ACSM usually indicates that newly raised cash can be used to continue uninterrupted payment of coupons, or to resume payment of already deferred coupons, as long as the new cash used is the product of one or more of the following: The sale of new shares, the sale of treasury stock held for more than six months, or the sale of three-year mandatory convertible notes; or The sale of hybrid securities containing credit terms approximately equivalent to or better than the existing mandatory-deferral issue. Standard & Poor's Treatment To Date To date, Standard & Poor's has accepted that ACSMs such as those indicated above have substantially mitigated the risk to investors of forced deferral under most foreseeable scenarios. Standard & Poor's has not, however, accepted that such ACSMs actually neutralize the potential effects of a mandatory-deferral mechanism under the potentially extreme stress scenarios that can be envisaged for some insurers and reinsurers with high exposure to possible underwriting and/or asset value losses. Consequently, although each issuer and each hybrid note structure is considered on a case-by-case basis when a rating is assigned, the standard European ACSMs indicated above have not been seen as sufficient in themselves to allow us to completely set aside the perceived incremental risk of deferral attaching to issues containing mandatory-deferral language. This being the case, virtually all mandatory-deferral hybrid notes issued by European insurers and reinsurers have been rated at least three notches below the counterparty credit rating on the issuer, as opposed to the two-notch gapping typically applied to investment-grade issuers of hybrid notes that contain only optional-deferral mechanisms. What Has Changed? Going forward, Standard & Poor's judgements may also in part be influenced by the existence of an undertaking whereby the issuer accepts to use its best endeavors to raise cash under the ACSM within 30 calendar days of any actual forced deferral of a coupon having occurred due to the effects of a mandatory-deferral mechanism. This new feature may or may not in itself prove sufficient to avoid gapping of three or more notches being applied to the rating on a mandatory-deferral hybrid. Nevertheless, when combined with remote mandatory-deferral terms that are unlikely to be activated under most stress scenarios, and a flexible ACSM that can realistically offer a high probability of new cash being raised to permit the servicing of otherwise mandatorily deferrable coupon obligations, this may well prove sufficient to allow Standard & Poor's to apply two-notch gapping to a hybrid issue. In summary, existing criteria remain unchanged and we will still expect to notch down mandatory-deferral hybrid issues by three notches or more if we believe that there is a realistic possibility of an issuer being forced to defer on a given issue against its will while that same issuer's other, optional-deferral hybrids continue to be serviced on time and in full. If, however, case-by-case analysis of the mandatory-deferral triggers, of the offsetting ACSMs, and of the issuer's "management intent" jointly or severally lead us to conclude with some certainty that the issuer will not in practice defer or be forced to defer on a given issue unless it is also deferring on all its other hybrid issues, then, logically, Standard & Poor's will rate the given issue at exactly the same level as the issuer's other hybrids, despite the mandatory-deferral language in that issue's terms. It is for this same reason that Standard & Poor's is prepared to set aside as a separate rating factor the ability of regulators to force a regulated financial services issuer to defer. Our expectation is that regulators would force across-the-board deferral of that issuer's debt, rather than deferral of specific, individual issues.