

Article Title: ARCHIVE | Criteria | Corporates | General: Hybrid Instruments--Capital or Debt in Disguise? Data: Hybrid capital instruments have gained enormously in popularity over the past two years. This has mainly been driven by the increasing acceptance of hybrids by financial institutions' regulators, beginning with the U.S. Federal Reserve in October 1996, and more recently by the Basel Committee on Banking Supervision in its October 1998 pronouncement on instruments eligible for inclusion as Tier 1 capital. Attractive to financial institutions' management, hybrid capital instruments generally qualify as capital from a regulatory perspective, while attendant interest, coupon, or dividend payments (depending on how instruments are engineered) are tax deductible. Standard & Poor's emphasizes, however, that hybrid capital instruments represent lower quality capital compared with adjusted common equity, which is viewed as core capital in rating assessments of financial institutions. An escalating concern is that financial institutions could increasingly substitute common equity with hybrid capital instruments that will weaken the financial strength of institutions individually, as well as the industry as a whole. Because of their lower quality characteristics, capital credit is allowed for preference shares up to 25% of a financial institution's adjusted total equity, and for hybrid capital instruments up to 10% of a financial institution's adjusted total equity; noting that the 10% limit for hybrid capital instruments is a sublimit of the 25% limit for preference shares. Standard & Poor's definitions of adjusted common equity and adjusted total equity are as follows: Adjusted common equity includes a financial institution's common equity, share reserves and retained earnings, less its intangible assets, asset revaluation reserves, and equity in unconsolidated subsidiaries, plus minority interests. Adjusted total equity includes a financial institution's adjusted common equity, plus issuances of preference shares and hybrid capital instruments up to allowable limits. What Is Hybrid Capital? Hybrid capital instruments, including preference shares, are securities reflecting equity and debt characteristics. Recent hybrid issuances by financial institutions differ greatly, with instruments individually tailored to reflect a different combination of features depending on the objectives of the issuer, drawing on the traditional building blocks of debt and equity finance. Hybrid instruments can be perpetual or limited life, cumulative or noncumulative, redeemable or irredeemable, convertible or nonconvertible, and can involve step-ups. Terms and conditions regarding when and under what circumstances an issuer is obliged to pay, and how a security is defined to rank in liquidation, vary on an issue-by-issue basis. Central to rating assessments is an analysis of prudential regulations and their application in an issuer's market. The essential instrument underlying many hybrid issues is a deeply subordinated security, which usually has the capacity to pass on interest, and ranks lower than straight subordinated debt in a liquidation scenario. There are many variations on this common theme, ranging from simple preference share and capital note issues, to complex instruments that involve the combination of two junior subordinated debt securities through a stapling arrangement. There are greater similarities between common equity and garden-variety hybrid capital instruments (such as preference shares) than between common equity and hybrids that are more debt-like in nature (such as trust preferred securities). Accordingly, greater credit is allowed for preference shares in assessments of a financial institution's adjusted total equity. Regardless of the issuing structure, hybrid instruments resemble debt from the perspective that they pay a regular fixed or floating interest rate, coupon, or dividend. Similar to common equity, however, investor payments under hybrid capital instruments are usually contingent on a range of performance criteria, typically including a satisfactory level of distributable profits and capital. What Is Core Capital? Core capital is defined as a financial institution's adjusted common equity. Capable of absorbing losses on an ongoing basis, permanently available with no repayment requirements or fixed financing costs, and subordinated to the claims of all creditors, common equity is the building block for a financial institution's capital and the only type of capital that provides maximum possible protection for depositors and debt holders. The 25% and 10% limits for preference shares and other hybrid capital instruments as a percentage of adjusted total equity are a general guide to Standard & Poor's maximum tolerance for lower quality capital. The issuance of hybrid capital, instead of common equity by a financial institution in fulfillment of its new capital requirements, would weaken its capital structure. Hybrid capital in excess of the 25% and 10% limits are taken into consideration, however, in a broader range of capital ratios including a financial institution's risk-weighted capital ratios, as well as in qualitative assessments of an institution's capital strength and flexibility. Criteria for the classification of hybrid capital instruments within the 25% and 10% limits

reflects the probability of timely repayment of principal and interest. Traditional preference share issues will usually fall within the 25% limit, while other types of hybrid instruments that have become popular over recent years, such as junior subordinated debt issues with limited interest deferral characteristics may be classified within the 10% limit. Ratings Approach to Hybrid Capital Instruments The capacity of a hybrid instrument to absorb losses by a financial institution operating on a going-concern basis is important in rating determinations. Under the terms of most hybrid instruments, interest, coupon, or dividend payments may be deferred under certain circumstances, including when an institution has not paid a dividend on ordinary shares. The key question of when and how an issuer is obliged to make payment usually comes down to an interpretation of what constitutes distributable profits out of which interest, coupon, or dividend payments may be made. Traditional subordinated debt, whether perpetual or limited life, is not taken into consideration in the assessments of a financial institution's adjusted total equity because it can only absorb losses in a liquidation scenario. Hybrid capital instruments must demonstrate a capacity to absorb losses prior to a financial institution's liquidation without triggering an event of default. While being capable of absorbing losses, hybrid instruments should also demonstrate a degree of permanence to qualify for inclusion in an institution's adjusted total equity. In theory, hybrid instruments that are perpetual in nature are viewed more favorably than limited life instruments. A key concern with limited life instruments is that they can mature at a time when a financial institution is experiencing financial stress, and when generation of fresh capital can be problematic. Limited life hybrid instruments that are long-term in nature, however, generally with a maturity of at least 15 years, can qualify for inclusion as capital, although these instruments are usually reclassified in debt as they approach maturity. Whether a hybrid instrument is cumulative or noncumulative is not a rating factor. Hybrid instruments redeemable at the option of the issuer are more capital-like, where the redemption period does not begin for many years after initial issuance. It is possible, however, for instruments where the redemption period begins after five years to qualify for inclusion as adjusted total equity (up to allowable limits) depending on other features of the instrument, the strength and quality of the issuer's capital base, and the issuer's general credit standing. In contrast, hybrid instruments redeemable at the option of the investor can never be included in adjusted total equity because of uncertainty regarding permanence. Terms requiring redeemable instruments to be replaced with capital of the same or higher quality following redemption are viewed favorably from the perspectives of gaining comfort regarding an issuer's long-term capital management program, as well as the sustainability of its existing credit standing. The design of the issuing structure also can be important in the allocation of capital credit. Since the pronouncement on instruments eligible for inclusion as Tier 1 capital by the Basel Committee on Banking Supervision, issuing structures for hybrid capital instruments have tended to become less complex. More complex hybrid capital instruments are generally engineered for specific regulatory and tax reasons. The possibility of a change affecting fundamental, prudential, or taxation regulations underpinning hybrid issuances is considered in the allocation of capital credit. When Is Management Obligated to Pay? A key consideration in terms of how many notches below a financial institution's counterparty credit rating is assigned to a hybrid capital instrument, or the most fundamental question of whether a hybrid instrument is ratable, usually depends on the distributable profits test. Many hybrid issuers are only obliged to pay interest, coupon, or dividends when there are sufficient profits available for distribution to investors. Therefore, a key question is "What constitutes distributable profits?" The answer to this question varies greatly on a country-by-country, issuer-by-issuer, and issue-by-issue basis. Central to the interpretation of distributable profits are regulatory guidelines affecting financial institution issuers. In countries where a narrow definition of distributable profits is utilized by bank regulators (for example, current year earnings) or in corporate law, a clear view must be formulated regarding the likelihood of regulators allowing payment even though a financial institution may not technically be obliged to make payment. Factors taken into consideration include previous instances of regulatory forbearance toward disbursements to investors where distributable profits were insufficient, as well the size of payments due under hybrid instruments compared with distributable profits. Where payments to hybrid investors are small in relation to distributable profits, there is a stronger inclination toward discretion by regulators. The potential crisis of confidence affecting a financial institution that did not pay provides a strong incentive for regulators to allow payment even if distributable profits are technically insufficient.

The intentions of bank management regarding the circumstances of when payment may or may not be required under hybrid capital instruments also are considered in rating determinations. The following general rating principles apply to hybrid capital instruments subject to a distributable profits test issued by financial institution issuers rated 'BBB-' and above. Greater notching, assessed on a case-by-case basis, may apply to hybrid instruments issued by noninvestment grade financial institutions, or by financial institutions whose counterparty credit ratings are boosted by government support. Preferred stock issues or other types of Tier 1 capital with a distributable profits test reflecting a narrow definition of distributable profits (for example, current year earnings), and terms stating that management may not pay on the instrument if the institution does not meet the requirements of that test are rated at least three notches below the counterparty credit ratings of the issuer. Preferred stock issues or other types of Tier 1 capital with a distributable profits test reflecting a narrow definition of distributable profits (for example, current year earnings), with terms stating that management cannot pay on the instrument if the institution does not meet the requirements of that test (i.e., mandatory nonpayment), and for which there is no scope for regulatory discretion regarding payment, may not be able to be rated at all, or will be rated low compared with the counterparty credit ratings of the issuer (i.e., more than three notches below the counterparty credit ratings). Junior subordinated debt issues or other types of Tier 2 capital with a distributable profits test reflecting a narrow definition of distributable profits, and with terms stating that management may not pay on the instrument if the institution does not meet the requirements of that test, are rated at least two notches below the counterparty credit ratings of the issuer. Junior subordinated debt issues or other types of Tier 2 capital with a narrow distributable profits test, with terms stating that management cannot pay if the institution does not meet the requirements of that test (i.e., mandatory nonpayment), and for which there is no scope for regulatory discretion regarding payment, may not be able to be rated at all, or will be lower compared with the counterparty credit ratings of the issuer (i.e., more than three notches below the counterparty credit ratings). Hybrid instruments reflecting a liberal definition of distributable profits includes those allowing interest, coupon, or dividend payments to be made from current and prior year earnings, presuming that prior year earnings are comfortably more than payments required on the hybrid instrument, and which unequivocally allow discretion by regulators regarding making payment. Generally, hybrid instruments (including preferred stock and junior subordinated debt issues) subject to a liberal definition of distributable profits are rated two notches below the counterparty credit ratings of the issuer, unless there are other reasons to apply greater notching. The reason that preference shares and other hybrid instruments are rated so highly is that it is fully anticipated that investors will be paid on a timely basis, even when an institution experiences a period of financial stress. Globally, there are very few instances of financial institutions that have not made timely repayment on hybrid capital instruments. Timely repayment is fully expected on hybrid instruments that are subject to a narrow distributable profits test, albeit that these issues are moderately more risky than issues subject to a liberal distributable profits test. Less notching on some types of Tier 2 issues, compared with Tier 1 issues with similar terms, reflects the commercial reality that it is more likely that a financial institution will effect timely repayment on these instruments. The importance of the distributable profits test demonstrates the principle that a Standard & Poor's rating primarily represents the probability of repayment and only secondarily considers ranking in liquidation. Also demonstrating the importance of the test is the potential differential between ratings of hybrid capital instruments depending on the geographic domicile of the issuer. This is because bank regulations, as well as the philosophical approach of bank regulators, vary by country, and each banking industry reflects a unique set of risk factors. For example, a narrow definition of distributable profits is adopted by Australian regulators, compared to a more liberal definition of distributable profits adopted in the U.K. Furthermore, corporates sometimes face less constraints from a regulatory perspective compared with banks in terms of making distributions from retained earnings or surplus funds, which can result in less notching on hybrid capital issues. The above points indicate that there is the potential for ratings arbitrage by hybrid capital issuers that have operations domiciled in different geographic locations, or that are diversified or conglomerate in nature. This reinforces the case for hybrid instruments to be carefully evaluated on a case-by-case basis, and for ratings to be assigned according to general guidelines that take into account all potential risks affecting timely repayment, rather than according to a rigid formula-driven approach. Analysis of the

Capital Test In addition to the proliferation of hybrid capital issues with distributable profits criteria, there has been an escalation in hybrid instruments utilizing a regulatory capital test, or some other form of solvency or capital test. Where a hybrid instrument utilizes a capital test, payment of interest, coupon or dividends is not required where capital falls below a stated minimum level (such as where Tier 1 capital falls below 4% under Bank for International Settlements (BIS) capital guidelines). Standard & Poor's has developed guidelines for hybrid instruments subject to a strict capital test. Hybrids will generally be rated three or more notches from an institution's counterparty ratings where: The buffer between the issuer's regulatory capital and the capital test trigger(s) is not deemed sufficient; or The proportion of hybrid capital in the issuer's Tier 1 capital is material; or The issuer's counterparty credit rating is in the 'BBB' category or lower; or The issuer's counterparty credit rating benefits in any way from government support. Hybrid instruments that do not fall into one or more of the four categories, and hybrids that do not reflect a strict capital test, are likely to be rated two notches below the issuer's counterparty credit rating. Distributable profits criteria must be considered in addition to capital criteria for hybrid instruments subject to both distributable profits and capital tests. Some hybrid instruments could be assigned three notches based on distributable profits criteria, for example, even though only two notches were required based on an application of capital criteria. A General Guide to Notching Conventions for Capital Instruments Issued by Private-Sector Financial Institutions Rated 'BBB-' and Above MINIMUM NOTCHES FROM COUNTERPARTY CREDIT RATING DEBT TYPE Nil Senior unsecured debt. One Subordinated debt - Standard subordinated debt, including perpetual and term debt that ranks pari passu among itself, and is subordinated to senior obligations. The issuer must have no ability to pass on interest payments. Two Junior subordinated debt and other Tier 2 capital instruments that are subject to a distributable profits test (narrow or liberal), with terms stating that management may not pay on the instrument if the institution does not meet the requirements of the test--at least two notches. Preference shares and other Tier 1 capital instruments that are subject to a liberal distributable profits test, with terms stating that management may not pay on the instrument if the institution does not meet the requirements of the test--at least two notches. Hybrid instruments (junior subordinated debt and preference shares) that do not reflect a strict capital test, or that are issued by financial institutions not impacted by ratings criteria for the capital test, specifying that three notches must be assigned--at least two notches. Three Preferred stock issues or other types of Tier 1 capital, with a distributable profits test reflecting a narrow distributable profits test, and with terms stating that management may not pay if the institution does not meet the requirements of that test--at least three notches. Hybrid instruments that reflect a strict capital test and satisfy ratings criteria specifying that three notches should be assigned. More than three Hybrid instruments subject to a narrow distributable profits test, with terms stating that management cannot pay on the instrument if the institution does not meet the requirements of the test (i.e., mandatory nonpayment), and where there is no scope for regulatory discretion regarding payment--more than three notches or may not be ratable (as assessed on a case-by-case basis). Not rated Ordinary shares. Capital instruments or synthetic equity which demonstrate the characteristics of ordinary shares. Note: More notches could be assigned to hybrid instruments than indicated in the table where justified depending on terms and conditions embedded in issue documentation, or because of other risks impacting the instrument or issuer. For hybrid instruments subject to capital tests, distributable profits ratings criteria must be considered (and vice versa). This could cause instruments to be notched by a greater amount.