FitchRatings

Corporates
Global

Corporate Hybrids Treatment and Notching Criteria

Cross-Sector Criteria

Scope

Fitch Ratings applies the criteria outlined in this report to assess the effects of hybrid instruments on the financial leverage of corporates, including non-bank financial institutions, and to determine how to notch these instruments relative to the issuer's Issuer Default Rating (IDR) globally. These rating criteria are used for both new and ongoing rating analysis.

The criteria outlined in this report are directed at hybrids purchased by unaffiliated investors that are expected to exercise all available remedies. These criteria do not apply to holding-company payment-in-kind notes (HoldCo PIK) or shareholder loans held by affiliated investors or issued outside the rated entity. For the above cases, see *HoldCo PIK and Shareholder Loans* on page 30 of the *Corporate Rating Criteria*, published May 2020.

Key Equity Credit and Rating Drivers

Preserving Ongoing Viability: Fitch allocates hybrids to the following categories: 100% equity; 50% equity and 50% debt; and 100% debt. The decision to use only three categories reflects Fitch's view that the allocation of hybrids into debt and equity components is a rough and qualitative approximation, and is not intended to give the impression of precision.

Fitch's focus on ongoing viability means it will typically allocate equity credit to instruments that are subordinated to senior debt and have an unconstrained ability for at least five years of consecutive coupon deferral. To benefit from equity credit, the terms of the instrument should not include mandatory payments, covenant defaults or events of default that could trigger a general corporate default or liquidity need. Structural features that constrain a company's ability to activate equity-like features of a hybrid make an instrument more debt-like.

Mandatory Conversion: Instruments with mandatory conversion into equity can fulfil many of these equity-like features by reducing interest and principal payment obligations, avoiding covenants and events of default, or absorbing loss.

Mandatory convertible securities may receive a maximum of 100% equity credit. Meanwhile, optional convertible securities would typically receive no equity credit, except to the extent justified by other features of the instrument. Fitch does not assign ratings to mandatory convertible instruments, or similar instruments that are exclusively redeemable into shares.

Issue Ratings Notched from IDR: Hybrids that qualify for equity credit are typically subordinated instruments with very low recovery prospects in liquidation or bankruptcy. Such instruments will therefore be treated as being highly loss-absorbing and rated at least two notches below the IDR for most corporate issuers. A hybrid's features will determine whether such notching will be reduced or, more likely, increased.

Higher-Recovery Corporate Sectors: Hybrids are typically rated a net one notch below the IDR for certain sectors that typically have higher recovery values, such as utilities and REITs in certain jurisdictions.

Wider Notching: Fitch regards permanent write-down of principal as particularly aggressive and will generally rate instruments with this feature at least three notches lower than an issuer's IDR. Wider notching will also be deployed if a trigger for going-concern loss absorption or equity conversion is easily activated or if the IDR benefits from support that does not extend to the hybrid.

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This report updates and replaces *Corporate Hybrids Treatment and Notching Criteria*, dated 11 November 2019.

Related Criteria

Corporate Rating Criteria (May 2020)

Corporates Notching and Recovery Ratings Criteria (October 2019)

Non-Bank Financial Institutions Rating Criteria (February 2020)

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Definition of Hybrids

Fitch's definition of "hybrids" refers to hybrid instruments and securities, including preference shares that are neither common stock nor ordinary senior or subordinated debt. Accordingly, "hybrid coupon" refers to all hybrid interest paid to hybrid investors, inclusive of dividends paid to preference shareholders. See *Appendix B: Glossary of Terms* for further definitions.

Fitch's method for allocating hybrids into debt and equity components applies to all non-financial corporate sectors and across the rating spectrum, for issuers with both investment-grade and speculative-grade IDRs. However, it cannot cover all scenarios and possible features of hybrids. The rating committee will therefore examine each hybrid case by case and evaluate the principles set out in the criteria to assign hybrids' equity credit and ratings.

Basic Principles

Hybrids Are More Flexible than Senior Debt and Less Flexible than Equity

In Fitch's view, a security's equity credit is derived from the financial flexibility provided by the following core features:

- liquidity flexibility/preservation, e.g. provisions for coupon payment omission or deferral, and no mandatory payments of principal within the rating horizon of five years;
- limited or no covenants;
- no events of default or acceleration that could trigger a general corporate default or cross-default that would spread to more senior corporate obligations;
- no maturity, investor put rights, or other features that would force repayment of principal within five years;
- loss absorption after a general corporate default either by means of deep subordination or principal write down.

However, Fitch considers hybrids less flexible than common equity, which has no maturity or right for the investor to put it back to the issuer. Hybrids can contain some or many of the key features of common equity, but exhibit some debt-like qualities. Among the potential debt-like qualities of hybrids are the following:

- management may feel obliged to continue making scheduled periodic hybrid payments during a period of distress, despite the existence of provisions that permit deferral;
- many hybrids have either a contractual or an implied maturity, in the case of nominally perpetual instruments issued with an implied expectation of redemption;
- many hybrids are structured to take advantage of tax regulations, and the issuer may suffer some economic consequences from changes in the tax regime.

Equity Credit and its Application to Credit Ratios

Equity credit is an analytical concept that expresses the extent to which Fitch views a security as containing debt- or equity-like qualities. The equity credit assigned to a hybrid can be 0%, 50% or 100%. The debt- or equity-like qualities will be evaluated assuming the issuer is experiencing financial distress, irrespective of the probability of such financial distress occurring.

Fitch's decision to allocate part or all of an issuer's hybrid to equity or debt is not driven by accounting rules or the classification of the instrument in the issuer's financial statements. Fitch adjusts an issuer's financial leverage ratios based on a hybrid's debt and equity characteristics, as discussed in this report. Instruments that are reported as debt or as equity on an issuer's balance sheet will be reallocated from that category and classified as entirely debt, entirely equity, or 50% debt and 50% equity for Fitch's ratio analysis. Fitch uses the resultant adjusted leverage ratios in its fundamental analysis of an issuer.

Fitch does not exclude coupons paid on hybrid securities from its interest or fixed-charge coverage ratios, irrespective of the equity credit assigned to the instrument, because the assumption is that the interest on such instruments will be paid.

No Limit on Equity Credit in Most Cases

There is no explicit limit on the amount of equity allocated from hybrids relative to the equity capital of an issuer. Fitch will cap equity credit in exceptional cases in which the committee considers that the proportion of hybrids in the capital structure is unsustainably high and/or reduces the benefits of the instrument's equity-like features. While we do not set a hard limit, a high share of hybrids may lead to a closer analysis of the capital structure, including leverage, an absolute amount of hybrid debt, its call dates and maturity concentration and the company's ability to utilise hybrids' features when needed.

Equity Credit and Credit Metrics

Compared with the same amount of senior debt or hybrids attracting 0% equity credit, issuance of hybrids with 50% or 100% equity credit leads to stronger leverage ratios and – in most cases – weaker coverage ratios. This is because equity credit affects only the amount of debt in leverage ratios, as Fitch incorporates 100% of the coupons into its cash flow forecast and coverage ratios. Empirical observations from the financial crisis indicate that coupons are paid on an ongoing basis.

Issuer IDR and Equity Credit

Fitch applies the above equity credit criteria irrespective of an issuer's IDR. However, as ratings deteriorate or improve, the change in treasury policy and role of hybrids in the funding mix may lead to a different assessment of the factors influencing equity credit. Fitch would consider the economic circumstances of an issuer on a case-by-case basis in its assignment of equity credit.

Criteria for Assigning Equity Credit

Deep Subordination

The security must be subordinated to all senior creditors. In addition, non-cumulative hybrids will only qualify for 100% equity recognition if they are senior only to common equity. The level of subordination must be consistent both before and upon bankruptcy. Holders of hybrids that attract equity credit are not assured of principal or coupon recovery either before or after a general corporate default.

Mandatory Convertibles and Seniority to Preference Shares

Exceptions to the requirement for deep subordination are mandatory convertibles that convert in the near future. This is because conversion to equity increases the issuer's financial flexibility and does not result in the obligation to repay principal. Mandatory convertibles that are senior obligations but convert within one year are eligible for up to 50% equity credit. In addition, Fitch considers seniority to preference shares sufficient for equity credit consideration for companies in jurisdictions where preference shares fulfil the function of common equity and these preference shares receive 100% equity credit under these criteria.

Hybrids Issued by Operating Subsidiaries

Equity credit assigned to an operating subsidiary's hybrid is not automatically applied to the parent's ratios. Fitch applies the principles of equity recognition to evaluate whether the equity-like features of a subsidiary's hybrid also benefit the parent. For example, equity credit will not be applied at parent level if the subsidiary's hybrid structurally subordinates senior debt at the parent company, or if the deferral of the subsidiary hybrid coupon results in the subsidiary's inability to pay dividends to the parent, therefore reducing going-concern loss absorption for the parent.

Inability to Trigger a Default

The presence of cross-defaults or cross-acceleration to other capital instruments can result in a hybrid being allocated entirely to debt. Hybrids qualifying for equity credit generally also do not have any events of default or only limited events of default. Acceptable events of default include:

- events of bankruptcy and liquidation;
- failure to redeem the securities after the invalidation of a guarantee or other forms of credit support;

- failure to pay amounts due after application of all permitted deferrals;
- accelerated conversion (in the case of mandatory convertibles).

An example of invalidation would be if a hybrid issued by an SPV gains its credit strength from its parent company's guarantee. The invalidation of this guarantee would remove the instrument's credit support and an event of default in such a case would not negate equity credit.

Preference shares commonly do not have events of default. Instead, non-payment will often result in investors' ability to block payment of common distributions or dividends and/or to appoint directors. Fitch considers these consequences sufficiently benign to be acceptable for equity recognition.

Absence of Material Covenants and Change of Control Clauses

Material affirmative or negative covenants can lead to 0% equity credit, if they have the potential to lead to acceleration or prepayment of the hybrid notes or place limitations on management in terms of day-to-day operations. Administrative covenants, such as information covenants, are viewed as neutral as long as they are not associated with meaningful rights for creditors to seek enforcement.

Mandatory repayment in case of change of control would negate equity credit. In contrast, change-of-control clauses that provide the issuer with a call option do not. In particular, call options that result in mandatory conversion to equity or a coupon step-up of up to 500bp, if the hybrid is not called, do not negate equity credit.

Effective Maturity of More than Five Years or Conversion to Equity

The securities must be perpetual or have an effective, remaining maturity that is not less than five years. An instrument with a remaining effective maturity of less than five years would receive no equity credit, unless it converts to equity during this timeframe (as in the case of mandatory convertibles). For example, instruments with an effective maturity of 10 years are only eligible for equity credit during the first five years from their issue date.

Call Date Effect

A call date will not be deemed an effective maturity date unless it is accompanied with a coupon step-up greater than 1%. In the event that the coupon step-ups are in increments (for example, 0.25% step-up per call date), the call date will be deemed an effective maturity date at the point when the cumulative step-up exceeds 1%. Fitch does not expect a minimum non-call period for an instrument to receive equity credit.

Where the step-up involves a switch from fixed to floating rate, Fitch will review the effective change in spread to the floating index from the fixed rate's implied spread to the index rate at the inception of the financing and compare this with its threshold step-up level. Fitch will not assign or withdraw equity credit based on changes in market rates.

Fitch will not consider call options that relate to certain events, such as changes to tax or rating agency treatment of hybrid securities, as effective maturities, and they are not detrimental to equity credit. This acknowledges issuers' need to manage their capital structures and adapt to changing circumstances.

Mandatory Convertibles: Conversion to Equity

In the case of mandatory convertibles, the earlier the date of conversion, the more likely Fitch will consider the hybrid as equity-like. This is because the conversion increases the issuer's financial flexibility and does not result in an obligation to repay principal, as is the case on maturity of most other hybrid types. Mandatory convertibles are eligible for equity credit irrespective of their conversion date if they are subordinate to all senior debt. For mandatory convertibles that are senior obligations, conversion must take place within one year. However, senior-ranking mandatory convertibles will not be eligible for equity recognition if the issuer's IDR is 'B-' or below, and there is no automatic conversion to the resulting instrument upon the issuer's bankruptcy. This is due to Fitch's concerns about the near-term viability of issuers rated 'B-' and below.

To qualify for equity credit, conversion must be established at a predetermined date and not hinge on a trigger event. The conversion rate or ratio also must be fixed at issuance or have limited flexibility within a predetermined band. To achieve 100% equity credit, the instruments must convert to common equity or a hybrid that would receive 100% equity credit under this criteria report. Instruments that convert to a hybrid that would achieve 50% equity credit under these criteria are eligible to a maximum of 50% equity credit.

Optional Convertibles

Optional convertibles (whether the option is with the issuer, instrument holder, or both), will be treated as debt in all cases, unless the instrument has other features described in this criteria report and conducive to equity credit that would enable it to qualify for equity credit. For example, a debt-based hybrid that meets all the criteria to achieve 50% equity credit may have an optional conversion mechanism as an additional feature attached to it. This would neither positively nor negatively influence the equity credit of the overall instrument based on its other features.

This reflects Fitch's view that optional conversion cannot be relied upon during periods of distress and, in many cases, conversion would be viewed as unlikely. If a portion of the principal of optional convertibles is classified as equity on the issuer's balance sheet, Fitch will reduce equity and allocate the full value of the instrument as debt.

(Tangible) Equity Units

Fitch has decided not to allocate any equity credit to equity units as it does not expect these instruments to be a permanent part of the issuer's capital structure. Equity units are offerings that combine a fixed-income instrument with a forward purchase obligation to purchase equity or similar securities at a known exercise price. The fixed-income instrument serves as collateral for the investor's commitment to the stock purchase agreement. The fixed-income instrument of the equity unit may contain a deferral option in addition to subordination, which replicates a mandatory convertible instrument.

However, the fixed-income instrument is remarketed after settlement of the share purchase obligation, and typically at this point the issuer has a call option. Therefore, the fixed-income instrument of an equity unit has a much shorter tenure (typically five to eight years) than a hybrid. While technically it may have an effective maturity of five years or more, Fitch's belief is that the instrument will be redeemed (and not necessarily replaced) at its (relatively near) maturity at the latest. Therefore, Fitch does not allocate any equity credit to these instruments since in most cases this would not reflect the company's intended long-term capital structure.

Similarly, tangible equity units, where the equity portion is paid up-front and guarantees a certain number of shares at maturity, do not qualify for 100% equity credit. Fitch will typically treat the debt consideration for the short-term fixed-income instrument as 100% debt and the consideration paid for the equity forward as 100% equity.

Fitch will model the exercise of the forward stock purchase commitment on the exercise date in accordance with the terms of the transaction in forward financial projections. New equity is contributed upon exercise of the stock purchase agreement, which is reflected as common equity both in the issuer's financial statements and in Fitch's equity credit analysis.

Permanence

Permanence of the capital structure is necessary for equity recognition. Fitch applies judgment in determining whether the hybrids' features are conducive to maintaining them as a permanent part of the capital structure. Hybrids with questionable permanence may be denied equity recognition. It is important that hybrids remain a part of the capital structure in a time of financial stress with management retaining flexibility to utilise instruments' loss-absorption features if needed.

Replacement Language

Issuers may use replacement language to express their intent to redeem the instrument at its call date with either the proceeds of a similar instrument or equity. As the focus is on the permanence of a capital structure instead of the permanence of the individual instrument, there is no expectation for the replacement language pertaining to the instrument to be in the form of a legally binding covenant.

In cases where a hybrid was not accompanied with replacement language at issuance, an intention-based replacement provision that is issued subsequent to the issue date can suffice. The key premise to this is that Fitch views those stated intentions as robust. Where Fitch regards this as open to question, an instrument might receive no equity credit despite the existence of replacement provisions. For example, if the economic circumstances of the issuer make the exercise of a call option probable without being replaced by a similar instrument, committees may decide not to provide equity credit to such an instrument. Similarly, Fitch will apply judgment in evaluating whether replacement language is sufficiently strong for equity recognition, in particular in regards to carve-outs and exceptions that dilute replacement intent.

Where a hybrid security is issued within a group of companies and where the replacement language refers to a group entity other than the issuer (as an alternative replacement issuer, e.g. the parent), Fitch's decision on whether this is sufficient for the call date not to be considered the effective maturity will be based on the analysis of the terms of the replacement, with a specific focus on the effect of the replacement instrument on the financial flexibility of the original hybrid issuer. It is not possible to provide an exhaustive list of scenarios where this will come into play. As a general guideline, Fitch will in most cases not consider such replacement language as meeting the criteria for the assignment of equity credit.

Fitch would not automatically assume lack of permanence if replacement language does not exist or is limited. Fitch's qualitative assessment of permanence considers legal obligations, economic incentives, replacement language or covenants and analytical discussions with management. Where Fitch assumes permanence without a publicly stated intention from management, we would communicate in our Rating Action Commentary the basis of our permanence assumption.

Refinancing, Redemption and Extension Options

Sometimes circumstances arise whereby issuers refinance hybrids earlier than originally anticipated. Fitch's focus is on the permanence of the issuer's capital structure and the specific instrument is typically only a vehicle to achieve such a capital structure. Therefore, early refinancing or redemption of a hybrid instrument will generally not affect the equity credit Fitch gives to a replacement instrument unless it believes the issuer's commitment to a specific capital structure has changed. Except in circumstances where an issuer's use of hybrids has generally become short-term, such a refinancing will not reduce or limit the equity credit on the replacement instrument.

The timing of issuing a replacement instrument is not always fully synchronised with the maturity or call date of the outstanding instrument, resulting in a transition period during which there might be newly issued hybrids and hybrids to be refinanced outstanding in parallel. Fitch appreciates that market conditions may be challenging for the refinancing of hybrids close to a call date, which justifies early refinancing. In this case, the equity credit of the instruments that are to be refinanced will be reduced to zero and the newly issued instruments will attract equity credit in accordance with this methodology. During the transition period, this will result in a deterioration in key credit ratios. However, where refinancing is imminent, this will be viewed as temporary and analysts will base their analysis on normalised (i.e., post-refinancing) ratios, provided there is limited risk that the increase in hybrids outstanding will be permanent.

Fitch does not automatically consider a refinancing of a hybrid with senior debt or a redemption of a hybrid an event that leads to equity credit withdrawal for the remaining instruments. Equally, Fitch would not view management's decision to redeem a hybrid to be detrimental to equity credit of remaining instruments, given a scenario where an issuer's capital strength has materially altered the maintenance of the current hybrid or its replacement with a similar security can make little or no economic sense. The impact of hybrids refinancing or redemption on the equity credit for the remaining instruments depends on the circumstances surrounding it and Fitch's analysis of the management's underlying motivation for such actions. We view a redemption of hybrids as somewhat similar to common equity repurchase, which is voluntary.

Some hybrids provide the issuer with an option to extend the maturity for a number of years beyond the stated maturity date. In such cases, Fitch treats the original maturity date as the effective maturity and only when exercise of the extension option has taken place will the extended maturity date become the "new" maturity date.

Unconstrained Deferability for at Least Five Years

An unconstrained option to defer or omit payments of coupons at the issuer's discretion for at least five years is a prerequisite for equity recognition.

Cumulative and Non-Cumulative Deferrals

Fitch believes that cumulative hybrids, where deferred coupons accumulate and will have to be paid later, are less equity-like than non-cumulative hybrids, which allow omission of coupons. Therefore, cumulative hybrids that enable deferability for at least five years receive no more than 50% equity credit, while non-cumulative hybrids that enable omission for at least five years are entitled to up to 100% equity credit. Cumulative coupon deferrals that can only be satisfied using common equity are viewed by Fitch to be non-cumulative and are entitled to up to 100% equity credit. Instruments where the issuer has an option to settle deferred coupons via shares are considered cumulative, as long as the instrument continues to remain outstanding. This does not apply to interest settlement of mandatory convertibles at their conversion (see *Settlement of Deferred Coupons on Conversion* below).

Optional and Mandatory Deferrals

Some hybrids contain mandatory deferral mechanisms, which prohibit the payment of the hybrid coupon if a certain threshold ratio is not achieved (e.g. interest coverage) or surpassed (e.g. leverage test). Instruments that only contain a mandatory deferral feature do not receive any equity credit under Fitch's methodology. The primary reason for this is that mandatory deferral triggers may be activated too late, in the emergence of financial distress. The presence of a mandatory deferral mechanism in addition to an optional deferral option is generally neutral for equity recognition. However, Fitch recognises that the presence of a mandatory deferral could deter management from deferring under an optional deferral when the conditions for mandatory deferral are not yet met. Analysts would consider this in their scenario analysis.

Settlement of Deferred Coupons on Conversion

Deferred coupons of mandatory convertibles that can be settled in cash or equity at conversion or on a predetermined date or event are entitled to up to 100% equity credit. In cases where the issuer is required to pay cash, the instrument will receive up to 50% equity credit. If the settlement of deferred interest on conversion is contingent on conditions that are very restrictive, Equity credit will be reduced to 0%

Deferral Constraints

Hybrids may include terms that limit the issuer's right to defer coupon payments. The existence of such constraints will result in an instrument being treated as 100% debt. Examples include limitations on the deferral period, provisions requiring the issuer to attempt to issue equity securities in the market and use the proceeds to pay the deferred or omitted coupons (alternative settlement mechanism). An aggregate coupon step-up of up to 1% is not considered a coupon deferral constraint.

Commonly, deferral constraints exist in the form of look-back provisions and parity securities language. These limit the issuer's ability to defer coupons following a reference event, which is most commonly payments to junior or parity securities. In contrast, hybrids with dividend stopper or blocker clauses qualify for equity credit. These clauses "block" payment of dividends or interest to junior and parity securities if hybrid coupons have been deferred (see *Appendix B: Glossary of Terms* on page 16 for definitions).

In addition, hybrids with future look-back provisions qualify for equity credit, as long as unconstrained deferability can be ascertained over the next five years. For example, a hybrid with a look-back provision that comes into effect 15 years from issuance qualifies for equity credit during the first 10 years.

Absence of Punitive Consequences of Deferral, Call or Conversion

Equity credit will be denied when a deferral or non-payment of principal or coupons, when due, triggers an event that Fitch would view as sufficiently onerous to create an incentive for the issuer to redeem the security. This includes the following:

- common shareholders lose all voting control;
- mandatory conversion to common shares that would excessively dilute the existing shareholders.

This also applies if a corporation operates in a confidence-sensitive business, whereby the deferral or omission of coupons or failure to redeem or call an instrument could undermine viability. In these cases, Fitch views any call date as an effective maturity date and/or applies either 50% equity credit or no equity credit, depending on the situation and as determined by a committee. Fitch does not expect this to be common in corporates.

Similarly, equity credit will be reduced to 50% or zero if Fitch has concerns that the exchange terms of a mandatory convertible might create significant incentives to take actions that would weaken an issuer's credit quality in order to avoid excessive dilution (e.g. securities repurchases or asset sales). An issuer should have authorisation or capacity to issue the required number of shares to complete any conversion.

Equity Credit Withdrawal

Fitch will remove equity credit when the criteria for assigning equity credit laid out on pages 3 to 8 are no longer met. For example, we will withdraw equity credit during the last five years before maturity of a non-convertible hybrid, because the instrument no longer has an effective maturity of more than five years. Equally, we may withdraw equity credit during the lifetime of the instrument if permanence can no longer be assumed. Fitch will reflect the removal of equity credit in its corporate financial forecasting if the hybrid ceases to meet equity credit criteria during the forecast horizon.

Notching Hybrids from the IDR

Hybrid ratings are notched down from the IDR. The notches represent incremental risk relative to the IDR and are a function of increased loss severity due to subordination and heightened risk of non-performance relative to other (e.g. senior) obligations. Hybrids that qualify for equity credit are (deeply) subordinated and typically rated at least two notches below the IDR.

Hybrids that are either subordinated or have deferrable coupons are rated at least one notch below the issuer's IDR, although they are denied equity credit if they do not combine both features. An example is a security that has a coupon deferral option but otherwise ranks pari passu with other senior obligations.

Fitch does not assign ratings to mandatory convertible instruments, or similar instruments which are exclusively redeemable into shares.

The Rating Life Cycle of a Hybrid

The following outlines how Fitch evaluates the notching of hybrids with going-concern loss absorption at the various potential stages of their life cycles.

Stage 1: At Initiation and Thereafter in Going Concern; Coupon Payments Occurring as Expected

Usual Notching

Hybrids with going-concern loss absorption are typically deeply subordinated instruments with very low recovery prospects in liquidation or bankruptcy. Such an instrument will therefore be treated as highly loss-absorbing and rated at least two notches below the IDR.

The notching scheme shown in the table below is indicative of the treatment of all obligations in the corporate hierarchy, including the typical forms of hybrids with going-concern loss absorption that are most likely to be notched either two or three notches below the IDR. It is possible that hybrids are devised with special features that require a modification of this notching approach, such that the notching will be reduced or, more likely, expanded. Above-average recovery prospects for hybrids are highly unlikely due to their deeply subordinated nature.

Equally, Fitch will not rate the hybrid if loss-absorption triggers are constructed where Fitch does not have the necessary visibility or ability to adequately assess the risk of loss absorption being initiated. For example, Fitch will not rate a hybrid that had a loss-absorption trigger related to a commodity price or equity valuation.

Typical Notching Relative to IDR – Performing Instruments

Recovery prospects	Notching to IDR
Outstanding	2
Superior	1
Good	1
Average	0
Below average	–1
Poor	–2 or below

IDR – Issuer Default Rating
Source: Fitch Ratings

Wider Notching Reflecting Low Recovery Prospects

There are four forms of loss absorption that Fitch regards meriting further notching, set out in the sections below.

Easily Activated Going-Concern Loss Absorption

Fitch will lower the instrument rating by at least one additional notch for instruments with features that materially increase the likelihood of going-concern loss absorption. The most typically encountered of such features is a mandatory loss-absorption trigger that is easily activated. An example would be an annual profits test or a mandatory deferral mechanism that only requires a modest deterioration in operating performance as compared to Fitch's rating case. In consequence, this means that notching is likely to widen if the operating performance of the issuer deteriorates substantially.

Permanent Write-Down of Principal

Fitch will generally rate instruments with permanent principal write-down at least three notches lower than an issuer's IDR. Within this category, Fitch includes instruments where any principal write-down including one could be reversed.

Supported IDR

Wider notching might also be applied in cases where an issuer's IDR benefits from some form of support (e.g. from its parent) but where it is questionable whether such support would actually extend to the hybrid of the issuer. Conversely, narrower notching will be applied if a hybrid benefits from additional support in the form of a third-party guarantee. However, this will not affect the equity credit assigned to the hybrid if it is an issuer's only instrument benefiting from such guarantees. This is because the guarantee may not improve the issuer's financial flexibility, especially if the hybrid benefiting from such a guarantee comprises a sufficiently small portion of the issuer's capital structure.

Likely Conversion into Equity

Similar to our approach to apply wider notching for hybrids that have permanent write-down features, Fitch will rate a mandatory convertible with a conversion trigger that is viewed as being easily activated at least three notches lower than the IDR.

Low Speculative-Grade Issuers

Fitch undertakes a bespoke analysis of the recovery prospects of an issuer's various classes of debt and assigns them Recovery Ratings when an issuer has a Long-Term Foreign-Currency IDR of 'B+' or lower. This bespoke approach is more specific and, therefore, overrides the generic notching set out in the table *Typical Notching Relative to IDR – Performing Instruments* above. For more details on Fitch's Recovery Ratings, see the sector-specific Recovery Rating criteria listed under *Related Criteria* on page 1.

Unusually Strong or Weak Baseline Recoveries

The notching approach outlined in the table *Typical Notching Relative to IDR – Performing Instruments* can be modified for types of issuers or industries where Fitch expects unusually strong or weak recoveries in the event of default. These relatively rare cases generally coincide with senior unsecured debt that is rated above or below the IDR, rather than at the same level, as is most common across Fitch. In such cases, Fitch will typically reflect the unusually strong or weak recoveries through either additional or reduced notching for the hybrids from the IDR. Examples of organisations that are assumed to have unusually strong recoveries include utility companies (where unsecured and secured debt can be rated above the IDR) and REITs in certain jurisdictions. See Corporates Notching and Recovery Ratings Criteria, published October 2019.

Stage 2: As Fundamentals Decline and the Probability of Some Form of Loss Absorption Increases

If Fitch considers the probability of the activation of loss-absorption features to have materially increased, a rating committee will first consider the likely rating of the hybrid if the loss-absorption features are activated as outlined in Stage 3. The committee will then lower the instrument rating below the band indicated in the previous page to a rating that is intermediate to or approaches the expected rating in the event of the activation of loss absorption.

Stage 3: When Loss-Absorption Features Are Activated

The activation of loss absorption is viewed by Fitch as a liquidity preservation tool in a financial distress. Hybrid ratings will be evaluated case by case but are likely to be very low, given their typically very deep subordination. The rating determined will generally be based, in part, on the net present value of the likely impairment of cash flows, if any, over the life of the instrument, as well as the credit outlook of the issuer.

Fitch generally regards going-concern loss absorption and/or interest deferral of a rated instrument to be non-performance from a rating perspective. However, we do not consider a short-lived cumulative deferral non-performance.

Short-Lived Cumulative Deferral

An activation of a cumulative deferral by itself is not automatically deemed to be non-performance. However, Fitch considers the instrument non-performing if the following occur:

- the deferral period is expected to exceed six months or one due payment in the case of an annual pay instrument;
- other forms of loss absorption are likely to be activated; or
- ultimate default is a real possibility.

Analysis of Loss-Absorption Features

Fitch takes into consideration the form and expected duration of loss absorption. Factors considered include the following:

- the issuer's fundamental financial condition as reflected in the IDR;
- cumulative deferral or non-cumulative payment suspension, probability of resuming payments and any mitigating factors, such as alternative coupon satisfaction mechanisms (ACSMs), also known in some markets as alternative settlement mechanisms (ASMs);
- forced loss absorption through conversion to an equity instrument or write-down of principal, if applicable, and whether, after write-down, the instrument is subject to writing value upward revision;
- other forms of loss absorption, if relevant (see below).

Other Forms of Loss Absorption

Ratings of Non-Performing Hybrid Obligations

Obligation rating category	Non-performing obligation
CCC	Loss absorption has been triggered but the rated obligation is expected to return to performing status, with only very low economic losses being sustained that are consistent with a Recovery Rating of 'RR1'.
CCC-	Loss absorption has been triggered but the rated obligation is expected to return to performing status, with only moderate economic losses being sustained that are consistent with a Recovery Rating of 'RR2'.
CC	Loss absorption has been triggered and the rated obligation is only expected to return to performing status with economic losses being sustained that are consistent with a Recovery Rating of 'RR3'.
C	Loss absorption has been triggered and the rated obligation is only expected to return to performing status with severe economic losses being sustained (consistent with a Recovery Rating of 'RR4', 'RR5', or 'RR6') or is not expected to return to performing status.

Source: Fitch Ratings

Where bespoke recovery analysis is used in evaluating hybrids (i.e. for issuers with IDRs of 'B+' or below), this table does not apply. Fitch's applicable Recovery Ratings and notching criteria are applied.

The loss absorption may be in the form of a short-lived cumulative deferral or the deferral is effectively mitigated for the investor by an ACSM or other mechanism. In these instances, Fitch analysts will typically lower the rating during the payment suspension to a rating no higher than the 'BB' category. Under these circumstances, the rating is likely to be accompanied by a Rating Watch, the direction of which will depend on the particular circumstances.

When the loss absorption takes the form of a cumulative deferral that is expected to be other than short-lived, is on a non-cumulative basis or involves principal write-down, the hybrid is deemed to be impaired and the rating table applicable to non-performing instruments is applied (see the table above). Fitch will lower the instrument's rating to 'C' and simultaneously withdraw the rating in the case of activation of a contingent conversion into common equity.

Ratings will be revised up or down during a deferral or non-payment period to reflect changes in fundamental prospects and outlook for loss absorption or resumption of performance.

Stage 4: When Normal Payments Are Resumed and the Instrument Resumes Debt-Like Performance

Reassessment Under Stage 1 Methodology

A hybrid's rating will return to being assessed on the basis of the Stage 1 methodology outlined above as a hybrid returns to normal performance and the risk of reactivation of loss absorption features recede. This return to Stage 1 notching may be gradual if the risk of reactivation is deemed material. There is no prejudice to the instrument for the prior interruption of payments.

Effect of ACSM on Hybrid Ratings and Notching

ACSMs Only Affect Notching in Stages 2 and 3

Some hybrids with mandatory deferral mechanisms contain ACSM provisions that allow or require the issuer to use the proceeds of a new issue of common stock or a junior hybrid to pay coupons that would otherwise have been avoided or deferred. Fitch gives it no recognition as a factor influencing the notching or rating of a hybrid in Stage 1 (at initiation of ratings or when fundamentals remain acceptable), as the investor cannot rely on the issuer's market access in distress. However, as the issuer moves into Stages 2 and 3, when a possible deferral of coupons is foreseen or comes close to occurrence, Fitch's rating committee will take into consideration its view of the issuer's likelihood of making use of the ACSM and the probability that a capital-market issue will be achieved to avoid deferral. In certain cases, the instrument may not be subject to rating transition from Stage 2 into Stage 3.

Criteria Data Sources

The key rating assumptions for the criteria are based on analytical conclusions drawn from Fitch's analysis of financial and non-financial information on hybrid issues and markets, their historical performance and impact on issuer credit quality. Transaction documents and financial statements are used when EC is assigned or when the notching of a security is determined.

Rating Sensitivities

Hybrid instrument ratings are notched from the IDR of the issuer and are therefore subject to upgrades or downgrades of the underlying entity's rating. The number of notches depends on the features of the hybrid, which are set at the time of issuance in legally binding transaction documents and are generally not amended during the lifetime of the instrument. Below is a non-exhaustive list of primary sensitivities that can influence hybrids' ratings.

- Issuer Credit Risk: Changes in an issuer's industry, business or financial risk, leading to upgrades or downgrades of the issuer's IDR.
- Recovery: Changes in the baseline recovery of companies with unusually strong or weak recoveries, such as utilities and REITs in certain jurisdictions, or changes in the recovery of hybrids issued by companies rated 'B+' or below, according to Fitch's Recovery Rating criteria listed under *Related Criteria* on page 1.
- Guarantees: Where third-party guarantees are put in place after issuance to benefit the hybrid, this could result in an upgrade of the hybrid's rating, even if the underlying IDR does not change.
- Loss Absorption: Higher probability of loss absorption or actual loss absorption activation through a long-lived cumulative deferral, a non-cumulative deferral or principal write-down increases will result in downgrades of the hybrid in line with Stages 2 to 4 on pages 10 to 11.

Criteria Disclosures

In its rating action commentaries and rating reports, Fitch expects to disclose the rationale for the allocation of equity credit assigned to the hybrid instrument, including assessing the following factors:

- the subordination level of the instrument within the issuer's debt;
- the instrument's unconstrained ability to defer coupon payments for at least five years, meeting its intent of providing financial flexibility to the issuer;
- absence of material covenants or change of control clauses; if change of control exists, whether equity credit is preserved through mandatory conversion to equity or coupon step-up of up to 500bp;
- effective maturity that is no less than five years or, if so, can convert to equity in that timeframe;
- type, i.e. mandatory or optional, and terms of conversion for convertible instruments, including time to conversion;
- other features that can affect the equity credit treatment of the instrument, including fixed-to-floating structures and call provisions with associated step-ups;
- rationale for applying a notching to the instrument that differs from standard notching where hybrids are rated at least two notches below the IDR for most corporate issuers;
- any variations from the criteria.

Variations from Criteria

Fitch's criteria are designed to be used in conjunction with experienced analytical judgment exercised through a committee process. The combination of transparent criteria, analytical judgment applied on a transaction-by-transaction or issuer-by-issuer basis, and full disclosure via rating commentary strengthens Fitch's rating process while assisting market participants in understanding the analysis behind Fitch's ratings.

A rating committee will adjust the application of these criteria to reflect the risks of a specific transaction or entity. Such adjustments are called variations. All variations will be disclosed in the respective rating action commentaries, including their impact on the rating where appropriate.

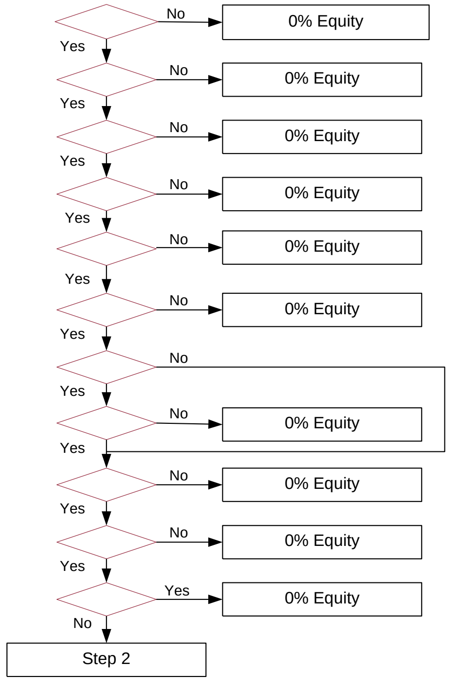
A variation can be approved by a ratings committee where the risk, feature, or other factor relevant to the assignment of a rating and the methodology applied to it are both included within the scope of the criteria, but where the analysis described in the criteria requires modification to address factors specific to the particular transaction or entity.

Appendix A

The following decision trees are guidelines to help readers evaluate the equity credit that Fitch will assign to hybrid instruments using the criteria outlined in this report. They do not replace a thorough understanding of the criteria. The decision trees reflect how much equity credit will be assigned at a single point in time and do not provide guidance on future changes in equity treatment.

Step 1: Criteria for Equity Recognition

Subordination?	Subordinated to all senior debt or mandatory convertible?
Covenants or EODs?	No cross-acceleration, cross-defaults or EODs, other than a) bankruptcy and liquidation, b) failure to redeem after invalidation c) failure to pay coupon after all permitted deferrals?
	No material covenants?
	No COC clause? If existent, can it be remedied through mandatory conversion to equity or a coupon step up <=500bps?
Permanence?	Can permanence be established through a) discussion with management b) replacement language or covenant or c) economic incentives or conversion to equity?
Effective maturity >=5y?	Maturity of >=5y or conversion?
	Call dates within next 5y?
	Aggregate step-ups =< 100bps within 5y?
Unconstrained ability to defer/omit coupon for >=5y?	Ability to defer or omit for >=5y or until conversion of hybrid?
	No look-back provision?
	Does interest deferral or non-payment of principal trigger events that are incentives to redeem?

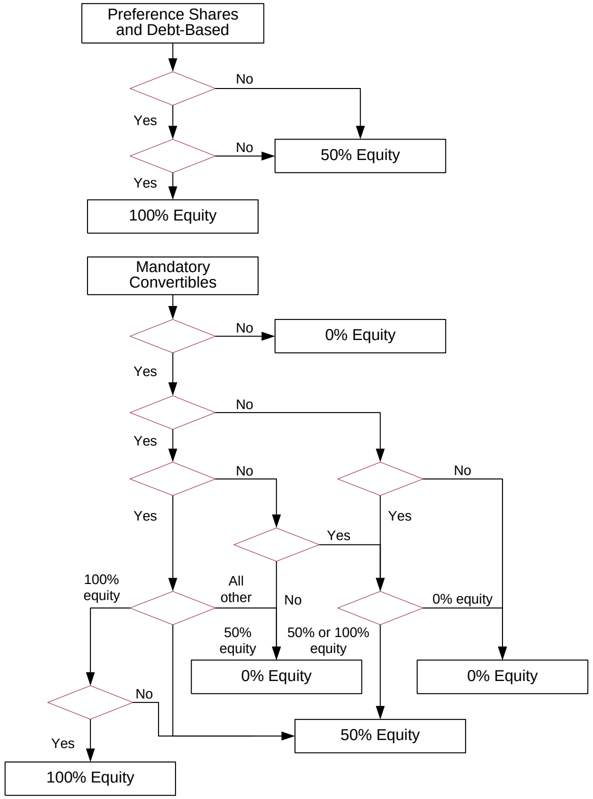


Decision points
EOD – Event of default
COC – Change of control

Source: Fitch Ratings

Step 2: Determine Equity Credit

Deferral non-cumulative?	Coupon deferral non-cum or if cum can only be settled through equity?
Seniority?	Senior only to equity?
Conversion rate and date fixed?	Conversion date no later than fixed date and conversion rate fixed at issuance?
	Time until conversion <=3y?
Subordinated?	Subordinated to all senior debt?
	Time until conversion <=1y and issuer rated B or above?
Equity credit on conversion?	How much equity credit will the instrument receive on conversion?
Deferral non-cumulative?	Coupon deferral non-cum or if cum can be settled in cash or equity at the issuer's discretion?



Decision points
EOD – Event of default
COC – Change of control

Source: Fitch Ratings

Appendix B: Glossary of Terms

Look-Back Provision

The most common form of deferral constraint is the look-back provision. This feature is more common in jurisdictions where dividend stoppers are not consistent with the national laws and practices of corporate governance. Under a look-back provision, the issuer cannot take advantage of its option to defer its payment obligation to the investors of the hybrid if a specific reference event has occurred within a certain time prior to the hybrid payment date.

The most common reference events are the declaration or payment of a dividend to holders of common equity, share repurchases, or any other form of distribution to common shareholders. In some cases, the reference event may include coupon payments on any instruments that are at a parity with or junior to the hybrid in question, rather than just ordinary share capital. A provision of this sort can effectively eliminate the issuer's ability to defer. Such provisions often require prospective planning on management's part to enact a deferral, which is inconsistent with having flexibility to defer or omit the payment on the hybrid.

Dividend Stopper or Dividend Blocker

This refers to a clause in the security agreement that if an issuer omits or defers a distribution to holders of a hybrid, the issuer is also barred from paying distributions or dividends on common shares or more junior classes of hybrid securities until coupon payments on the blocking hybrid are resumed. A provision whereby the issuer may pay a dividend and where such a payment then requires all deferred interest outstanding at the time of the dividend payment to be settled is not considered a dividend stopper.

Effective Maturity

Represents Fitch's opinion as to the most likely length of time the instrument or equivalent replacement will remain within the issuer's capital structure. Effective maturity is driven by a number of factors, including the final scheduled maturity, if any; call options and related incentives to call; and replacement language, including replacement capital covenants (see below).

Replacement Language (or Replacement Intention)

An intentional commitment or legally binding covenant that informs investors of an issuer's intent and commitment not to redeem the hybrid at the hybrid's optional call date unless the instrument is redeemed using the proceeds of an equally or more equity-like instrument. Clear disclosure to investors in the offering materials is adequate, and Fitch does not expect the replacement disclosure to be in the form of a legally binding replacement covenant.

Step-Up

A provision for increasing the hybrid's coupon at specified times, or upon certain events.

Alternative Coupon Satisfaction Mechanisms (ACSMs) or Alternative Settlement Mechanisms (ASMs)

Hybrid investors can benefit from alternative mechanisms that mitigate coupon deferrals or omissions. Such mechanisms may allow or require the issuer to use the proceeds of a new issue of common stock or a junior hybrid to pay coupons that would otherwise have been avoided or deferred.