Article Title: ARCHIVE | Criteria | Corporates | General: Australia and New Zealand Hybrid Securities--Equity or Camouflaged Debt? Data: The recent proliferation of hybrid securities in Australia and New Zealand is further evidence of the growing sophistication in the region's capital markets. For investors, hybrid securities provide an opportunity to diversify their investment portfolios and to achieve high returns. For issuers, these securities provide an opportunity to diversify their funding sources, to manage their cost of capital and funding structures (as they are a cheaper form of capital than common equity), and to improve shareholder returns. Three of the most popular hybrid securities issued in the Australian and New Zealand markets—reset convertible preference shares, income securities, and capital notes—typically reflect the challenge that companies face in choosing securities that have equity-like features to appropriately manage their capital structures, and that are attractive to fixed-income debt investors. Significantly, the market for nongovernment debt securities, including hybrids, is being driven by the growth of life and superannuation funds under management, and a broadening in the risk appetite of fixed-income investors that are slowly moving down the credit curve in pursuit of greater investment diversity and higher returns, and because the supply of highly rated government debt issuance is slowing. Also, retail investors, an important target market for the hybrids, are attracted by their high returns and the well-known name of the issuers. Secondary trading through stock exchange listings further enhances their attractiveness to investors. As companies face pressure from shareholders for growth, capital management initiatives, and higher returns, hybrid securities provide an appealing funding option to straight debt or equity. For financial institutions, hybrid securities have the added appeal of qualifying as capital from a regulatory perspective. Furthermore, the attraction of hybrid securities remains despite a recent Australian Taxation Office (ATO) draft ruling that declared the coupon payments of some securities were no longer tax deductible. Significantly, a large proportion of the hybrids issued have been used to fund share buybacks or pay special dividends, especially in recent months, as companies distribute surplus franking credits to shareholders ahead of a fall in the corporate tax rate on July 1, 2001. Also, companies that have issued hybrid securities have been either investment grade (or were at the time of issue) or are well known household names in Australia or New Zealand. The continuing popularity of hybrids could result in negative consequences where the core capital of issuers is affected to an unacceptable extent. For example, core capital in the Australian banking industry has deteriorated materially in recent years, caused by the increasing prevalence of buybacks of common equity, substitution of common equity with hybrid capital, and the deduction against core capital for unconsolidated subsidiaries. The deterioration in core capital is clearly indicated by the ratio of adjusted common equity to assets for the Australian major bank sector, which has decreased to 3.6% in fiscal 2000 from 5.5% in 1996. Negative rating changes in the Australian banking sector are a possibility considering that lower core capital weakens the financial strength of issuers and their capacity to contend with softer economic conditions. With the volume of hybrid securities expected to grow, set out below is an overview of the methodology used by Standard & Poor's in analyzing and assigning ratings to hybrid instruments. General Credit Rating Principles The evaluation of hybrid securities and the degree to which they affect an issuer's fundamental credit quality is based on the security's perceived economic impact, not its name or accounting classification. Standard & Poor's analyses the specific features of the securities to determine the extent of financial risk and flexibility that applies to the issuer, especially the hybrid's effect on a company's cash flow. Also important is the materiality, including size of the hybrid issue to the company's capital base, the purpose to which the funds will be put, and the company's overall financial policies and strategy. In assigning an issue rating to hybrid securities, Standard & Poor's takes into account the specific features that differentiate the securities from the entity's general creditworthiness (that is, its most senior credit rating), and notches them down accordingly. The senior rating (or issuer credit rating) for corporates is the corporate credit rating (CCR); for financial institutions, it is the counterparty credit rating; and for insurance companies, either the counterparty credit rating or insurer financial strength rating. The senior credit rating is a current opinion of an issuer's overall capacity to meet its financial obligations—that is, its fundamental creditworthiness. Ratings on specific hybrid issues, in addition to the issuer's general creditworthiness, take into account the nature and provisions of the obligation and the protection afforded by the obligation in the event of default. Consequently, junior debt is rated below the senior rating, and hybrid securities are often rated even lower because of their more equity-like characteristics. Furthermore, the degree to which the rating on a specific issue is notched also depends on the entity's overall credit quality. As the default risk increases, the concern over protection and recovery takes on greater relevance, and therefore, greater rating significance. Accordingly, the ultimate recovery aspect of ratings is given more weight, as movement down the rating scale occurs. Although these general principles apply to financial institutions, insurance companies, and corporates, some differences exist in the approach. In part, these differences reflect the role that capital adequacy and regulatory issues play in the analyses of financial institutions and insurance companies imposed by the Australian Prudential Regulation Authority (APRA). Where financial institution analyses focus more intently on the loss-absorbing character of equity capital, corporate rating methodology emphasizes cash flow over balance-sheet analyses. Characteristics Of Hybrid Securities The hybrid securities issued in Australia and New Zealand have a variety of features and names; however, their equity-like characteristics are generally derived from all or some of the following features: Perpetual nature. Although most of the hybrids have no set maturity date, a number have reset or roll over dates. Some hybrids have optional redemption clauses, whereby on or after a specified call date the issuer has the option to redeem the security for cash. These features give rise to refinancing risk and doubt as to the permanency of the hybrid in the company's capital structure. Furthermore, even where the hybrid only converts into equity (or preference shares), the conversion of those securities into a variable number of shares limits the hybrids' equity-like characteristics because of the potential for significant and intolerable dilution in the company's equity base. Capital notes issued by New Zealand corporates have set maturities, increasing the refinancing risk. Deferrable coupon rights. Nonpayment of interest, coupon, or dividends generally is not an act of default. The unwillingness of issuers to pass on a coupon payment and the expectation of fixed-income investors of regular payments, however, may limit the practical benefits of this feature for investment-grade issuers. Where securities have nonpayment clauses, security holders can be protected by restrictions, preventing issuers from making dividend or other defined payments until coupon arrears have been met. Payments in arrears may be cumulative and attract an interest penalty, alternatively they can be either noncumulative or set to zero at the company's option. In some cases, nonpayment of interest may be a trigger for conversion into some form of equity. Coupon payment test. Interest payments on some of the securities are subject to a distributable profit or funds availability test, and in the case of financial institutions, a capital adequacy test. Subordination. The securities generally are subordinated to all creditors, but rank ahead of ordinary and preference shares in liquidation. Some hybrids, in the event of default on the notes, may convert into ordinary or preference shares. The equity benefit of this feature, however, is linked to the practical benefits that the issuer will derive from having such a security in its capital structure and the permanency of the hybrid in the company's capital structure. If the size of the hybrid is significant, the subordination of these securities enhances the likelihood that bank loan ratings for speculative-grade corporates could be notched higher than the senior credit rating. Evaluating And Rating Hybrids For Corporates Hybrid securities, by their very nature, cannot be treated simply as either equity or debt. Rather, Standard & Poor's assigns "equity credit" to these securities in recognition of the features that allow them to be differentiated from bank or public debt. Assigning equity credit to a security is not simply a yes/no proposition. The notion of "partial credit" is more appropriate. Additionally, financial ratio analysis emphasizes cash flow adequacy and financial flexibility, not just simply leverage. Indeed, leverage, while important, has long been surpassed by these other factors in corporate rating assessment. Each attribute of the hybrid is analyzed separately. The aspect of servicing ongoing coupon payments is considered in cash flow adequacy and fixed-charge cover; equity cushion is considered in leverage and asset protection; the need to refinance on maturity is considered in financial flexibility; and the potential for conversion is considered in financial policy. Indeed, a company's willingness to issue or retain equity over time (to maintain credit quality) is an important element of financial policy. Other important considerations are the materiality of the hybrid in the capital base, and the use of the funds—will the hybrid refinance debt or fund a capital return, or is it related to a specific acquisition or business growth? There is no uniform weighting of the analytical categories to arrive at a rating conclusion. Consequently, the relative importance of each equity-like attribute can vary, and depends on the economic benefit derived compared with that of ordinary equity. Deferrable coupon rights, for example, give the company ultimate discretion to forgo a payment when it faces a shortage of funds; however, for many hybrids the penalties incurred and the limited flexibility to sustain the arrears make this feature more restrictive than paying low or no dividends on ordinary equity. Furthermore, investment-grade issuers are expected to meet all financial obligations in a timely manner, and just as importantly, fixed-income investors expect ongoing coupon payments to be met. Accordingly, the coupon is treated as a fixed charge, and only a limited amount of equity credit is ascribed to this feature. Although the perpetual nature of most hybrids and the conversion of some only into equity give them the appearance of being more equity-like, the key considerations for receiving credit today for the promise of future equity are predictability of the outcome and timing. These hybrids have medium-term roll over or reset dates, and convert into a variable number of shares based on the prevailing market price of the company's ordinary shares. These features diminish the security's equity characteristics and only provide limited flexibility, given the potential for significant and intolerable dilution in the company's equity base, or the prospect of the company raising the hybrid's coupon rate to prevent conversion. Indeed, where the hybrid converts into a variable number of shares, little equity credit is given, as there is the likelihood that the issuer might not exercise this prerogative except in dire circumstances. After all, any firm can issue equity at the prevailing market price if it desires. The reality is that companies are rarely satisfied with the market price of their shares, and are reluctant to add such an expensive form of capital. Even where the conversion to equity is mandatory, a company that is disinclined to issue equity at the prevailing market price would merely repurchase those shares. Optional redemption clauses and the ability to redeem the securities for cash further limits the amount of equity credit ascribed to these securities. All of these features instill doubt as to the permanence of the securities in a company's capital base, and the potential for refinancing the securities with debt. The most favorable rating consideration is given to issues that are mandatorily convertible at a fixed time and at a fixed price. Regardless of the movement of the share price, there is little reason for the company to reconsider the conversion decision. Standard & Poor's does not simply haircut the hybrid security or assign fractional "equity credit" when calculating financial ratios. There is no neat way to adjust financial ratios to reflect nuances of complex structures. Sometimes, alternative sets of ratios are calculated treating the hybrid as either debt or equity, reflecting that the "truth" lies in a gray area between the two perspectives. Hybrid securities issued by Australian and New Zealand corporates generally have two features that make them subordinated instruments: the ability to forgo coupon payments, and subordination. An instrument with both of these features typically is rated below subordinated debt. For corporates, the security is rated two notches below investment-grade CCRs, and three notches below noninvestment-grade CCRs. This also would apply even if a company did not have subordinated debt. In the case where there is a high reliance on the hybrid (for example, 20% of the capital base), the issue could be notched further down, reflecting the heightened risk to paying the coupon. Securities with only one of these features—either subordination or deferral coupons—generally are rated one notch below investment-grade CCRs or two notches below noninvestment-grade CCRs. Rating Hybrids For Financial Institutions Hybrid securities have a number of attractions for financial institutions, particularly in capital management, as they generally are recognized as capital for regulatory purposes. Hybrid securities also facilitate a broadening of the institution's investor-funding base. Importantly, the attraction of hybrids remains despite the recent ATO draft ruling that coupons on some hybrids are not tax deductible. Although the draft ruling will, no doubt, reduce the relative attractiveness of these hybrids, the underlying foundation for hybrid securities does not appear to be undermined, as they remain a cheaper source of funds compared with common equity. Investor appetite for varying forms of debt with equity-like features is accommodated by issuers offering increasingly innovative hybrid securities. From an issuer's perspective, the cost of capital is lowered if the issue is treated as debt for taxation purposes (tax deductibility of dividend payments), and is considered equity capital for regulatory purposes. As hybrid equity is of a lower quality than common equity, Standard & Poor's has set relative limits on the equity credit afforded by the exchange of hybrid for common equity. Of primary concern for the investor, is the issuer's obligation to make interest, dividend, or coupon payments (depending on the structure), which are usually contingent on a range of performance factors, including satisfactory distributable profits and capital. The mixture of debt and equity characteristics within a given hybrid is noteworthy—particularly the terms that oblige the issuer to make a payment. An equity-like characteristic common within hybrid products is that an "event of default" would not be triggered where a dividend payment is not made. Standard & Poor's also considers the extent to which the hybrid issue dilutes the core capital base. More commonly with hybrid issues, a dividend payment and return of capital (in liquidation) is preferred to common equity, but subordinated in right of payment of principal and interest to all depositors and creditors. Generally, for investment-grade issuers, hybrid securities that are preferred issues (or other types of Tier 1 capital) containing a narrow definition of distributable profits (for example, must be paid out of current year earnings), and that have terms stating management may not make a payment if this requirement is not met, usually are rated at least three notches below the counterparty credit rating of the issuer. Because a narrow definition of distributable profits is utilized by APRA, Tier 1 hybrid issues by banks are typically rated three notches below the counterparty credit rating. For junior subordinated issues (or other types of Tier 2 capital with hybrid characteristics) that have a narrow distributable profits test and terms stating management may not make a payment if this requirement is not met, the issues are more likely to be rated two notches below the counterparty credit rating. Most hybrids issued by Australian financial institutions are noncumulative and have a preferred dividend payment. Other factors such as the term of the issue, redemption options, and converting status are taken into account. Earlier this year, St.George Bank Ltd. (A/Stable/A-1) and Commonwealth Bank of Australia (AA-/Positive/A-1+) issued hybrid securities as part of their capital management initiative. Both issues were rated three notches below the counterparty credit rating, reflecting the junior status of each hybrid within their respective capital bases. Dividend payments for each issue were subject to a narrow distributable profits test, and were noncumulative. As hybrid instruments are of weaker quality compared with common equity, Standard & Poor's recognizes partial equity credit for hybrid issues up to 25% of a financial institution's adjusted total equity for Tier 1 preference share hybrids, and up to 10% of a financial institution's adjusted common equity for Tier 2 junior subordinated hybrids; noting that the 10% limit for junior subordinated hybrids is a sublimit of the 25% limit for preference share hybrids. Adjusted total equity is defined as adjusted common equity (common equity, share reserves and retained earnings less intangible assets, asset revaluation reserves, and equity in unconsolidated subsidiaries, plus minority interests) plus issuances of hybrid capital instruments up to allowable limits. The 25% and 10% limits are a general guideline as to the maximum level of lower-quality capital that is acceptable. Rating Hybrids For Insurance Companies Two major insurance groups, AMP Ltd. group and Colonial Ltd. group (now part of the Commonwealth Bank of Australia group) have undertaken issues of hybrid securities in the form of income securities. In both cases, the securities were issued by nonoperating holding or finance companies, rather than by operating entities (either insurance or bank), although Colonial subsequently cancelled its income securities issue to issue ordinary shares, following its acquisition by Commonwealth Bank of Australia. More recently, the QBE Insurance Group Ltd. issued subordinated notes out of its U.K. holding company, with the notes guaranteed on a subordinated basis by two rated operating entities, QBE Insurance (Australia) Ltd. and QBE Insurance Ltd. (both rated A+/Stable/—). Hybrid securities issued by insurance companies can qualify for treatment as equity for calculation of capital structure ratios if they have maturities and features that are consistent with the advantages of long-term capital. Standard & Poor's views instruments with maturities of 20 years or longer as being part of an insurer's long-term capital, and therefore, treats them as equity. Obligations with maturities of 10 years-20 years may be viewed as long-term capital, but will be evaluated in the context of how aggressive an insurer's overall capital structure is relative to the outstanding rating. To be recognized as equity, the securities must also be subordinated in payment of interest and principal to debt and policy obligations. Finally, the insurer should not be forced into bankruptcy or receivership if interest, dividends, or principal repayment of the obligations is not paid. For quality of capital considerations, Standard & Poor's sets an upper limit on the amount of hybrid securities on issue that can be treated as equity. Issuance above this level puts sufficient pressure on the company, where incremental capital is treated as more debt-like than equity-like. Currently, Standard & Poor's views insurance holding companies with hybrid equity in excess of 15% of total capital as having sufficient quality of capital concerns, and that the increment of hybrids above 15% of capital is viewed as more debt-like than equity-like. The hybrid tolerance for operating companies with a mutual structure or no holding company varies by rating category according to the operating company's counterparty credit rating as follows: 15% at 'AAA', 20% at 'AA', 25% at 'A', and 30% at 'BBB' and below.