

NCR comments: Sustainability-linked hybrid bonds

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Nordic Credit Rating (NCR) notes increasing interest in sustainability-linked bond (SLB) securities with hybrid structures. SLB hybrids can increase an issuer's appeal to impact investors and incentivise issuers to improve their performance in terms of energy usage, waste management or other sustainability-related issues. While coupon step-up features in regular hybrids are a key factor in our assessment of equity treatment, in the case of SLB hybrids they can be viewed differently if they are not deemed to be incentives to call the instrument.

WHAT IS AN SLB HYBRID?

An SLB hybrid is a subordinate debt instrument with sustainability-linked targets which combines the characteristics of both debt and equity and can be viewed as equity, debt or a combination of both. SLB hybrids oblige an issuer to make coupon payments but also enable an equity-like ability to defer instalments when necessary without triggering default. In this sense, they can in theory provide an element of loss absorption before an issuer is restructured and thereby protect more senior creditors in an event of default, although there is little historical evidence for this. For this reason, we are unlikely to view them as a standalone driver of higher issuer ratings. However, SLB hybrids can diversify an issuer's investor base and support senior creditors (see [Nordic Credit Rating's View on Corporate Hybrid Securities](#), published 3 Oct. 2019).

SLB hybrids are meant to be a semi-permanent component of an issuer's capital structure. They are long-dated instruments, typically with call dates, and are subordinate to more senior debt but senior to common equity. Generally, they carry a higher coupon rate to compensate investors for the additional risk. Unlike traditional hybrid instruments, SLB hybrids contain sustainability goals. Often, such goals are linked to the terms and conditions of the instrument. Typically, some or all such goals act as sustainability covenants which must be fulfilled by pre-set dates to enable a pre-agreed reduction in interest or avoid pre-agreed penalty interest payments.

ASSESSING THE EQUITY FEATURES OF SLB HYBRIDS

NCR assesses the merits of SLB hybrids on an individual basis. Under our [Corporate Rating Methodology](#), the standard notching approach for hybrid instruments is two notches below the issuer rating on issuers with ratings in the 'BBB' category or higher and three notches below the issuer rating on issuers with ratings of 'BB' or below. This standard notching approach also applies to SLB hybrids.

In our calculations of financial ratios, SLB hybrids can receive equity treatment of 0%, 50% or 100%. In particular, the equity treatment of SLB hybrids affects net debt and interest costs after our adjustments. These two values are components of all key metrics for corporate and real estate issuers, and for this reason the equity treatment of a given issuer's SLB hybrid debt can affect the overall issuer rating.

NCR does not assess the relevance or efficacy of SLB hybrid sustainability targets. Our sustainability analysis is limited to an assessment of whether the targets are reasonably achievable within the stipulated time frame on the basis of our knowledge of the issuer's sector of operation.

Call and step-up features

When SLB hybrids carry step-up penalties for non-fulfilment of sustainability targets, we can allow equity treatment up to the first call date providing the following requirements are met:

1. the original maturity of the instrument is at least 25 years;
2. the first call date is no sooner than five years from issuance;
3. step ups not linked to sustainability targets fall at least five years after the first call date;
4. the issuer presents a plan to achieve the targets set out in the terms of the instrument;

5. step ups are clearly linked to sustainability targets and, in our view, do not incentivise early redemption, acting only as a penalty for failure to meet targets;
6. step-up rates are reasonable in relation to the original coupon rate;
7. the sustainability targets are not unreasonable, that is they are highly unlikely to result in step-up penalties;
8. the issuer reports publicly on the targets according to pre-set terms and conditions; and
9. the targets are observable and monitored by a relevant entity.

In instances where fulfilment of sustainability targets reduces rather than increases coupon rates, we can allow equity treatment prior to the first call date, providing the following requirements are met:

1. the original maturity of the instrument is at least 25 years;
2. the first call date is no sooner than five years from issuance; and
3. step ups linked to non-sustainability are at least five years after the first call date.

Subordination

We can allow equity treatment of SLB hybrids if they are subordinate to senior debt and other non-deferrable debt. Subordination provides a buffer for senior debtholders, which we consider in our recovery analysis, when applicable, and could affect the issue rating(s) on more senior debt.

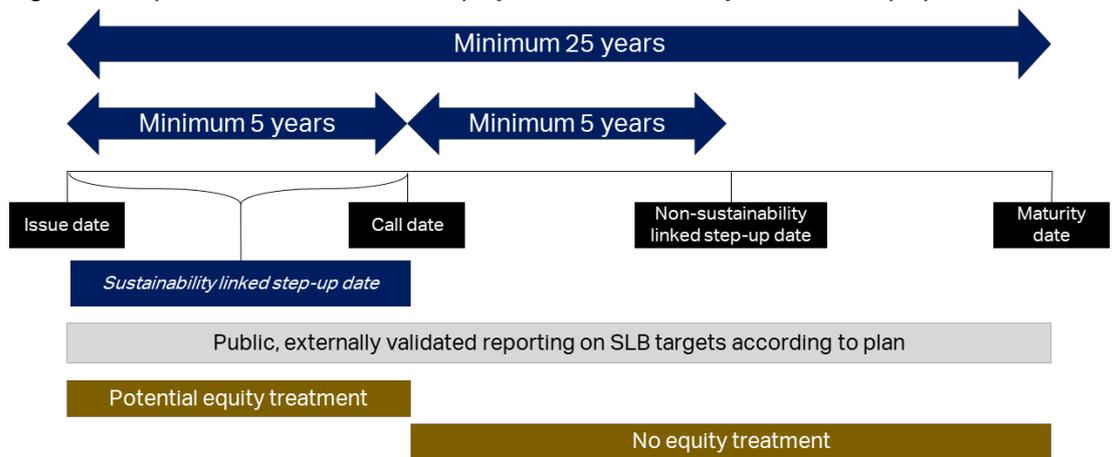
Replacement commitment

We typically anticipate that issuers will replace SLB hybrids with similar or more junior instruments on the call date, which, where applicable, would be reflected in the ratings on the issuer's more senior issues. We acknowledge that in some instances an issuer's financial circumstances might change, reducing the incentive to keep relatively expensive SLB hybrids in the capital structure after the call date or that the sustainability-linked features could cease to be relevant. We would consider any such changes on a case-by-case basis.

Deferability of coupon payments

To receive equity treatment, the issuer of an SLB hybrid must be able to defer coupon payments, with no time limit. Deferred coupons can be either cumulative or non-cumulative. However, if the issuer were to defer coupon payments for a protracted period, we would assess the increasing liability and consider whether the issuer had liquidity issues or if it was selectively deferring coupon payments. Such an assessment could affect the overall credit rating on an issuer.

Figure 1. Simplified overview of NCR's equity treatment of SLB hybrids with step ups



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