

Nordic Credit Rating's view on corporate hybrid securities

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Nordic Credit Rating (NCR) notes increasing interest in hybrid debt issued by rated corporates in the Nordic region. In addition to diversifying an issuer's capital structure, at least part of the rationale behind such instruments is to improve a company's credit metrics depending on how rating agencies view their equity content. NCR believes that there is a role for corporate hybrids in an issuer's capital structure to diversify the investor base and support senior creditors. However, there is little historical evidence that corporate hybrids can be loss absorbing prior to a restructuring and for this reason NCR is unlikely to view them as a standalone driver of higher issuer ratings.

WHAT IS A HYBRID SECURITY?

A hybrid security is a subordinated debt instrument which holds characteristics similar to both debt and equity and can be viewed as equity, debt or a combination of these depending on the instrument's characteristics. Corporate hybrids carry a commitment to make interest or coupon payments, but also possess the equity-like ability to defer instalments when necessary without triggering default. In this sense, they can provide an element of loss absorption before an issuer is restructured and protect more senior creditors in an event of default.

Hybrids are meant to be a semi-permanent component of a company's capital structure. They are long-dated instruments, typically with call dates, and are subordinated to more senior debt and senior to common equity (see Figure 1). Generally, they carry a higher coupon rate to compensate investors for the additional risk.

LESSONS FROM BANK-ISSUED HYBRIDS

The hybrid debt market grew sharply in the early years of the century as a means for banks to improve their capitalisation and fulfil their regulatory capital requirements. Prior to the 2008-2009 financial crisis, banks issued instruments similar to today's corporate hybrids – long-dated and deferrable but with cumulative coupons, step-up structures to incentivise repayment and non-payment options at the issuer's discretion. However, the crisis demonstrated that such instruments provided little or no loss absorption without regulatory intervention. As a result, the distinction between "upper" and "lower tier 2" instruments was eliminated, coupon step ups were removed and objective conversion triggers were introduced. Bank hybrid instruments are now clearly defined as gone-concern (loss absorbing in a restructuring) and going-concern (loss absorbing prior to default via write down of principal or conversion to equity).

NCR believes that some of the lessons learned from the experience and subsequent transformation of bank hybrids has been overlooked in the construction of today's corporate hybrid debt instruments. In addition, for many corporate issuers leverage and cash flow metrics are more important credit drivers than solvency ratios, whereas solvency and capital metrics are a material part of a bank's credit profile. As such, NCR is unlikely to see corporate hybrid issuance as a standalone driver for higher corporate issuer ratings.

GENERAL VIEWS ON HYBRID SECURITIES

NCR believes that corporate hybrids can form a meaningful component of a company's capital structure. For issuers, they provide equity-like flexibility at a lower cost of capital and increase investor diversification by attracting higher-risk investors by offering higher yields than senior bonds. Senior investors also benefit from more junior securities in the capital structure, increasing their own expected rate of recovery.

NCR assesses the merits of hybrid securities on an individual basis. Under our Corporate Rating Methodology published 14 Aug. 2018¹, the standard notching for hybrid instruments is two notches below the issuer rating on companies with ratings in the 'BBB' category or higher and three notches below the issuer rating on issuers with ratings of 'BB' or below.

Furthermore, hybrid securities can receive equity treatment of 0%, 50% or 100% in our calculations of the financial ratios used in our assessment of an issuer's financial risk. In particular, the equity treatment of hybrid securities affects net debt and interest costs after our adjustments. These two values are components of all key metrics for corporates and real estate companies, and for this reason the equity treatment of a given issuer's hybrid debt could affect the overall rating on the company.

In the interests of clarity and transparency, NCR plans to present a given issuer's key credit metrics both with and without equity treatment in cases where it has decided to accord equity treatment to a hybrid security. For example, interest coverage metrics including all anticipated hybrid coupon payments is considered a more appropriate reflection of actual financing costs.

ASSESSING THE EQUITY FEATURES OF HYBRID SECURITIES

As hybrids occupy a place in the capital structure between senior debt and equity, NCR assesses at what level they compare to equity. The main characteristics for common equity are subordination, permanency and deferability. Below we compare the three most common hybrid securities – hybrid bonds, preferred shares and D-shares – on these characteristics.

Figure 1. Corporate capital structure

Balance sheet seniority	Expected risk	Required return
Bank debt	Low	Low
Secured bonds	↓	↓
Unsecured bonds		
Hybrid securities:		
Hybrid bonds		
Preferred shares		
D-shares	↓	↓
Common equity		

Subordination

Hybrid securities rank below non-deferrable subordinated loans in the balance sheet hierarchy (see Figure 1). Accordingly, they are senior only to common equity and more junior hybrids. Typically, a D-share will have lower priority than hybrid bonds and preferred shares both in terms of payment of coupons and in a restructuring situation.

Permanency

A hybrid security is expected to be either perpetual or long-dated, typically to fulfil rating agency criteria. Both preferred shares and D-shares are by definition perpetual and therefore fulfil the requirement of permanency. Corporate hybrid bonds can have either a long time to maturity or be perpetual, with call dates typically after five years². To incentivise issuers to call these instruments, bondholders may require an interest rate step-up after a certain period, which effectively reduces the

¹ <https://nordiccreditrating.com/governance/methodologies>

²For financial institution hybrids a typical five-year hybrid call date allows 10-year debt instruments to receive full capital recognition until the call date given that "regulatory amortisation" generally begins when maturity is within five years.

expected maturity of the instrument. To convince rating agencies of the permanence of a callable instrument, issuers commit to replacing hybrid bonds with similar instruments in the event the instrument is called.

Deferability of coupon and dividend payments

While dividends on common shares are inherently flexible, defined dividends on both preferred shares and D-shares are expected to be paid in most instances. When deferred, the dividend related to both preferred shares and D-shares will typically be repaid, together with interest. Accordingly, the dividend commitment on preferred shares and D-shares is similar to the liabilities of an interest payment on a bond. Similarly, the interest payment on hybrid bonds can be deferred. In some cases, deferral of hybrid instruments will include dividend stoppers, prohibiting dividend payments from more junior instruments in the capital structure until paid in full including interest and ensuring the relative seniority of coupon and dividend payments.

Notably, most corporate hybrids do not include key features associated with bank hybrids (additional Tier 1 instruments), namely non-cumulative coupon deferral and objective triggers for conversion to equity or writing down principal prior to liquidation.

NCR'S REQUIREMENTS FOR EQUITY TREATMENT OF HYBRID SECURITIES

NCR can assign 0%, 50% or 100% equity treatment to hybrid securities, based on the equity-like characteristics of a given hybrid instrument. In line with the previous section, the following characteristics would be expected for a hybrid security to receive some level of equity treatment.

Subordination

We can allow equity treatment for hybrid securities if they are subordinate to senior debt and non-deferrable subordinated debt instruments in a company's capital structure. The subordination of the instruments provides a buffer for more senior debt, which we consider in our recovery analysis, when applicable, and could affect the issue rating(s) on more senior debt.

Call and step up features

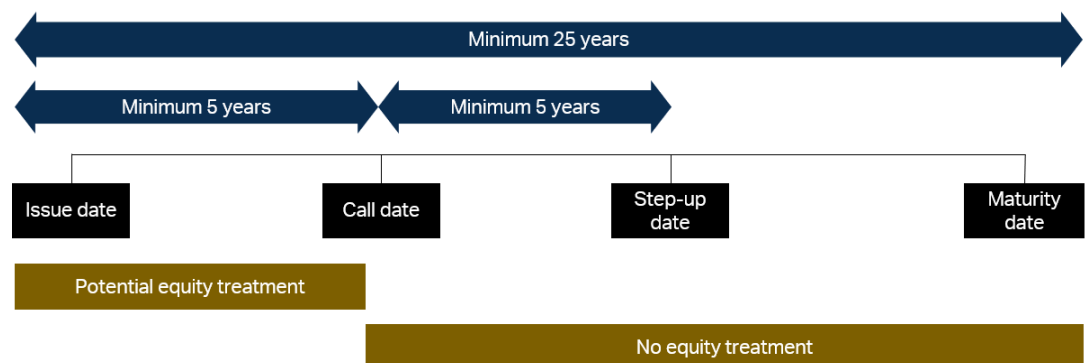
We allow equity treatment up to the first call date as long as the first step up is at least five years after the first call date and the original maturity of the instrument is at least 25 years.

We anticipate that issuers will most likely call hybrid instruments on their first call date. However, we would expect any step up in coupon rates to occur at least five years after the first call date. This reduces the incentive to call an instrument on the first call date if the company is under financial stress or otherwise unable to issue replacement instruments on the first call date. Issuers are typically able to call at any interest payment date after the first call date, in which case the instrument is no longer eligible for equity treatment.

Individual instruments will always be evaluated on the nature of the actual permanency features, which could allow instruments with multiple call dates otherwise fulfilling the five-year minimum to the first step up or final maturity date to receive equity treatment beyond the first call.

In Figure 2, we present a simplified summary of our explanation of permanency qualifying for equity content.

Figure 2. Simplified overview of hybrid bond equity treatment



Replacement commitment

In addition, we anticipate that an issuer will replace a hybrid instrument with a similar or more junior instrument 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 a company's financial situation could change, reducing the incentive to hold expensive hybrid instruments in the capital structure after the call date, in fact potentially improving the overall financial situation of the issuer. NCR would reflect any such changing situation on a case-by-case basis or in response to a company announcement to this effect.

Deferability of coupon and dividend payments

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

Figure 3. Equity content by hybrid security

	Hybrid loans	Preferred shares	D-shares
Equity treatment	0-50%	0-100%	100%

The individual assessment of equity treatment of hybrid securities is discussed and decided in the rating committee based on the features of the issue and in the context of the issuer's capital structure. Should we consider the amount of hybrid securities as a share of total equity and liabilities to be very high, we could adjust the level of equity treatment to reflect this.

RELEVANT RESEARCH

- (i) [Nordic Credit Rating's view on corporate preferred shares](#), 25 Aug. 2020
- (ii) [Nordic Credit Rating's view on sustainability-linked hybrid bonds](#), 3 Feb. 2022
- (iii) [Corporate Rating Methodology](#), 8 May 2023

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