Evaluation of Equity Credit Attributes of Hybrid Securities and Rating Perspectives

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What are hybrid securities?

In general, hybrid securities refer to securities that have the characteristics of both equity and debt, including subordinated bonds, preferred securities and preferred stock. In this methodology, hybrid securities also include loans.

R&I refers to the extent to which it believes a hybrid security's characteristics are similar to those of common stock as "equity credit." Common stock has the following major characteristics: (1) there is no maturity date or repayment obligation, (2) there is no obligation to pay dividends and (3) a shareholder's claim is the most subordinated in the event of bankruptcy. Even though there is a difference of degree, hybrid securities possess one or several of the three characteristics of common stock. R&I assesses equity credit by judging these characteristics comprehensively and classifying hybrid securities into five classes.

■Examples of hybrid securities and R&I's classifications and equity credit guidelines

	Equity credit guideline	Example of hybrid securities
	0	Straight bonds
Class 1	10	Long-term subordinated bonds/preferred stock Interest/dividends are cumulative and deferrable
Class 2	30	Super long-term and perpetual subordinated bonds/preferred stock Interest/dividends are cumulative and deferrable
Class 3	50	Super long-term and perpetual subordinated bonds/preferred stock (with replacement provision)* Interest/dividends are cumulative and deferrable
Class 4	70	Super long-term and perpetual subordinated bonds/preferred stock (with replacement provision) Interest/dividends are non-cumulative and mandatory suspension applicable
Class 5	90	Preferred stock with mandatory conversion provision within three years Dividends are non-cumulative and mandatory suspension applicable
	100	Common stock

* A call incentive will arise in five years or later and less than ten years from issuance

(1) Term to maturity

Among the three parameters of a hybrid security, R&I places the greatest emphasis on term to maturity. This is because the large principal repayment amount makes refinancing the key concern in an evaluation of creditworthiness. If a hybrid security has no maturity date, there is no contractual obligation to redeem the security and the degree of financial freedom increases. Even if a maturity date is stipulated, some leeway can be secured, provided the term to maturity is extremely long.

Nevertheless, many hybrid security investors will expect the security to be redeemed at a certain time, and the incentives encouraging redemption work easily for issuers as well. This is because, for example, the coupon rate normally is high compared with straight bonds, and even an issue with a low initial coupon rate may have a mechanism to enable a call (prepayment) after a certain period has passed and step up the coupon rate. In this case, even if no maturity date has been provided, the substantive maturity date probably will be the date on

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which the call becomes possible and the coupon rate increases. R&I uses a step-up in the coupon rate of 100 basis points or lower as a guideline.

If a replacement provision is described in the securities indenture and R&I is able to confirm management's intention to observe the provision through meetings with the issuer or similar means, it is possible to mitigate the negative features regarding the term to maturity. A replacement provision is a pledge to raise funds before a call by means that possess equity credit equal to or greater than that of the security. In many cases a replacement provision is expressed in the form of a statement of management's intention and therefore is also referred to as replacement language. Even if the hybrid security is called immediately prior to the interest step-up, the issuer's debt-equity structure before and after the call will not be greatly altered because a comparable security with equal or greater equity credit will be recorded on the balance sheet.

If a call incentive, such as an interest step-up, arises in five years or later and less than ten years from issuance, R&I believes a security must have a replacement provision in order to be evaluated as having the equity credit of Class 3. In a replacement provision, the fulfillment of certain requirements determined beforehand, such as a capital level and a debt-equity structure, may be accepted as an alternative to a replacement. A security for which a call incentive will occur ten years or later from issuance may be evaluated as Class 3 even without a replacement provision, as long as a capital level, debt-equity structure and/or other indicators serving as certain requirements are clearly communicated to the market. For Class 2, R&I expects a capital level, debt-equity structure and/or other indicators serving as certain requirements to be clearly communicated to the market, if a call incentive arises in five years or later and less than ten years from issuance.

When a hybrid security has no replacement provision or the fulfillment of certain requirements is regarded as an alternative to a replacement, the issuer may redeem the security without issuing a security with equal or greater equity credit. If this is considered to be highly likely, future capital accumulation, for example, and the security's equity credit should not be double counted in the evaluation of creditworthiness. For a hybrid security part of which is judged to be similar to equity, R&I believes that the issuer needs to clearly communicate to senior creditors and other parties upon the issuance of the security what situation will be construed as an event that may result in the loss of the perpetuity of the security.

Note that R&I considers securities with a term of 30 years or more as super long-term and regards such securities as having no equity credit when their term to maturity becomes less than ten years (with the exception of securities with a mandatory conversion provision).

(2) Deferral of interest/dividend payments

If interest/dividend payments can be deferred when the issuer's financial condition is severe, this is advantageous from the standpoint of financial flexibility.

Deferral is classified into "optional deferral," which takes place at the issuer's discretion, and "mandatory deferral," which is triggered by a violation of specified conditions. Deferred interest/dividends may or may not accumulate (referred to as cumulative and non-cumulative, respectively). Under optional deferral, the issuer may continue paying interest/dividends even when its financial position is considerably severe, with the existence of investors who expect receipt of continuous interest/dividends taken into consideration.

Mandatory deferral allows the mandatory suspension of interest/dividend payments in the event of deterioration in the issuer's financial position, regardless of the issuer's intention. For each issuer, the financial

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indicators and levels shall be set as triggers that show the issuer's condition – whether it is in a situation where it has to suspend or reduce common stock dividends from surplus.

A payment resource limitation provision is generally used in combination with a cumulative deferral provision. This is a provision that limits the source of payment to the funds raised through means such as stock that will actually strengthen capital. Such provisions are referred to by names such as APM (Alternative Payment Mechanism) or ACSM (Alternative Coupon Satisfaction Mechanism). Although not identical to a non-cumulative indenture, the interest/dividends, even if cumulative, can be paid without eroding the present balance sheet if the source of funds for payment is restricted. Because further dilution of the stock can be expected if the issuer raises funds when its operating performance is poor, however, there is a possibility this provision will lead to a share buyback in the future. Thus for the issuer a non-cumulative indenture would offer more flexibility.

While the relationship between the mandatory deferral provision and the payment resource limitation provision is viewed as discussed above, R&I believes the payment resource limitation provision used with optional deferral could in fact reduce flexibility. This is because it is more likely that the issuer will not exercise the right to deferral even if an optional deferral provision is provided, given that the issuer does not prefer raising funds for accumulated interest payments through the issuance of another security that possesses equal or greater equity credit. When the issuer is obliged to pay the optionally deferred interest/dividends within a certain period of time using a limited source of payment, such obligation is considered to be a constraint on optional deferral. Among other constraints is the existence of conditions for optional deferral or the limitation of the period during which payments can be deferred.

(3) Priority of claims following bankruptcy

A subordination provision has the effect of relatively improving recovery of senior creditors' claims upon bankruptcy. Subordination fundamentally influences the extent of loss when a borrower is bankrupt, and unlike the cases in (1) and (2) above does not directly contribute to financial flexibility in situations where a going concern is presumed. However, the issuance of hybrid securities that are clearly stated to be in a subordinated position, even more than funds procured using general unsecured debt, can serve to remove the uneasiness of senior creditors' concern about the extent of recovery becoming thinner. Consequently subordinated hybrid securities might make it easier to raise funds.

R&I believes that when classifying hybrid securities, whether the substantive financial flexibility is ensured based on an agreement or other means is more significant than whether an issue is classed as debt or equity from an accounting standpoint. In some cases R&I has judged an issue's parameters to strongly resemble common stock even though the issue is accounted for as debt, and in other cases has judged oppositely. For hybrid securities classified as debt, however, greater care must be exercised than with securities that are classified as equity. When nonpayment of the principal and interest of a hybrid security violates the cross-default provision of another obligation, the principal and interest payments become a substantive obligation. Furthermore, when numerous preconditions, representations and warranties or restrictive financial covenants are provided and a violation becomes a termination event, depending on the contents this might result in

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greatly accelerating the redemption period. For hybrid securities classified as debt in particular, sufficient care must be exercised to see whether the effects that are similar to equity have diminished.

(4) Comprehensive evaluation

Up to this point we have concentrated on three main points in the judgment of equity credit. Actual securities are a combination of various provisions, however. Broadly classified there are two types of provisions: factors that are indispensable for achieving the equity credit class, and factors that are not indispensable but should be taken into account. The former are items that make it difficult to achieve the class if the factors are not satisfied. The latter are factors that must be judged comprehensively by considering whether other strong factors are present that can compensate relatively weak factors.

R&I evaluates the equity credit of an issuer's hybrid security based on the equity credit that R&I has evaluated by focusing on the security's characteristics in this manner. Depending on the issuer, R&I believes different equity credit can result, even if the hybrid securities are identical, as a result of confirming such matters as the reasons why the issuer selected hybrid securities as a means of funding, how the issuer will pay the interest/dividends if its financial position becomes severe and the issuer's thinking regarding a call and its dividend policy.

Interests of the issuer, senior creditors and hybrid securities investors

The point on which a hybrid security differs from a normal security is that it is issued in consideration of not only the issuer and investors in the security, as is normally the case, but also senior creditors such as investors in unsecured bonds who are related indirectly through the equity credit. The issuer needs to give thought to the interests of the senior creditors as well as those of the investors in the security.

In this case, the interests of the senior creditors do not necessarily correspond to the interests of the investors in the security, which warrants attention. The reason is that from the standpoint of equity credit, it is necessary to ensure the financial flexibility of the issuer, but the greater the flexibility the more the investors in the security will be forced to bear the burden, including deferral of interest/dividends.

Effect of hybrid securities issuance on issuer creditworthiness

In its financial risk analysis, R&I conducts quantitative analysis based on financial statements and also adjusts numbers on financial statements as needed, by factoring in the equity credit of the issuer's hybrid securities. In this case, if it has judged the equity credit of the hybrid securities issued by a certain issuer to be 50, R&I will treat half the issue amount as debt and treat the remainder as equity capital.

In evaluating equity capital, R&I takes into account not only quantitative indicators such as its amount and a debt-equity structure, but also qualitative factors including the stability of equity capital by looking at its components and characteristics, for example. When a hybrid security has no replacement provision, or the fulfillment of capital accumulation or other requirements is regarded as an alternative to a replacement, it becomes increasingly likely that the issuer will redeem the security without issuing a security with equal or greater equity credit, as capital accumulates or its financial profile improves. The assessment of financial risk incorporates this fact. In its creditworthiness evaluation, R&I assumes scenarios of the future business risk and financial risk, while considering the present business and financial conditions.

In many cases a substantive debt-equity structure is an important factor for financial risk evaluation.

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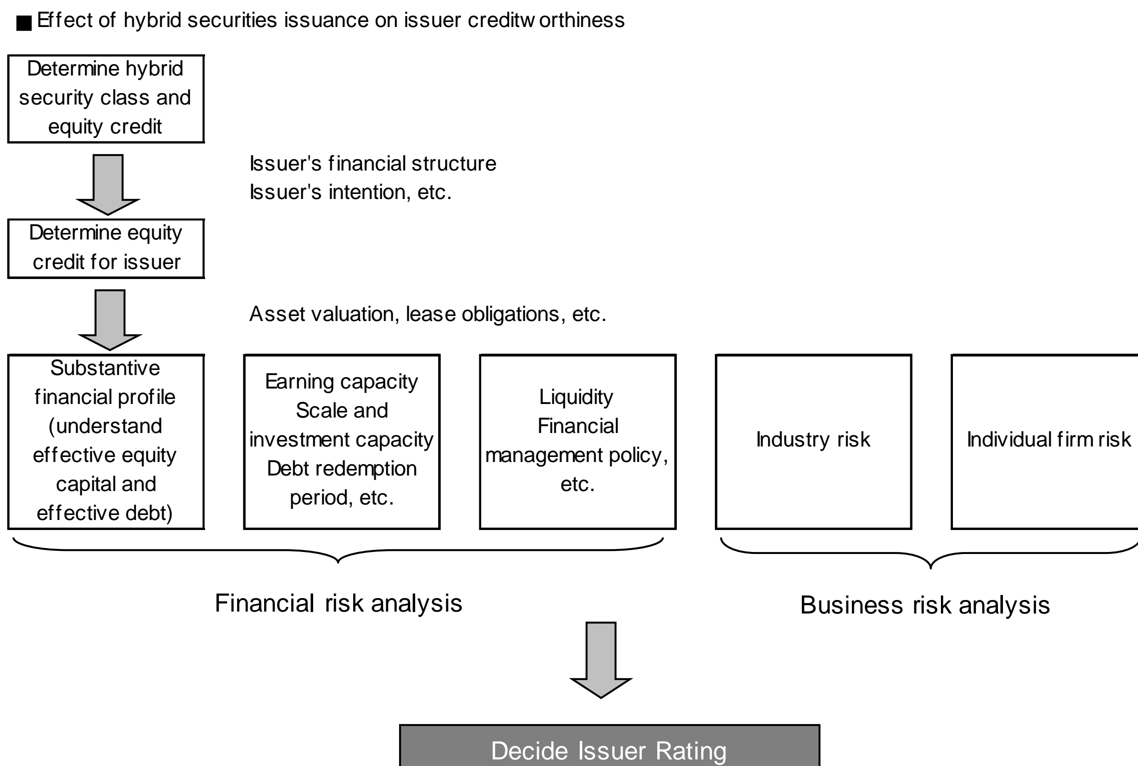
Even so, R&I looks at business risk to consider whether a particular debt-equity structure is sufficient for a rating. When a company issues a hybrid security to raise capital for a new business or for a merger and acquisition, R&I will factor the new business risk into the company's current business risk, and evaluate its creditworthiness by analyzing the risk together with financial risk. In assessing the prospect of return on the investment, among others, the business risk analysis is highly important.

Note that R&I will not evaluate the equity credit of all hybrid securities. Particularly when a specific company or other organization holds stock that is considered to be a hybrid security, its business strategy is highlighted in many cases. After considering the issuer's future capital and business strategies, R&I will determine an Issuer Rating by factoring in the possibility of a future change in equity. R&I will not incorporate the effect of hybrid securities judged by R&I to possess the equity credit of zero into creditworthiness evaluation in quantitative terms but may do so in qualitative terms.

Hybrid securities ratings

In principle, R&I's ratings of hybrid securities issued by corporations with Issuer Ratings in the BBB or above category are as follows: For subordinated bonds and preferred securities, etc. with an optional interest/dividend deferral provision, the hybrid securities ratings are two notches below the Issuer Rating, and those with mandatory deferral provisions are rated two or three notches lower than the Issuer Rating. R&I judges whether to assign a rating two notches or three notches lower based mainly on the level of the Issuer Rating and the probability of interest/dividends deferral in addition to the priority of claims. Even for a security for which suspension of interest/dividend payments is not a default under the security indenture, R&I will downgrade the rating to CCC+ or lower when the interest/dividend payments have been suspended. In some cases R&I might widen the notching difference of the security from the Issuer Rating if it judges the probability of the interest/dividend payments being suspended has increased.

■ Effect of hybrid securities issuance on issuer creditworthiness



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