RFC Process Summary:

Hybrid Capital: Methodology And Assumptions

July 1, 2019

We would like to thank investors, issuers, intermediaries, and all parties who provided feedback to our "Request For Comment: Hybrid Capital: Methodology And Assumptions," published on Nov. 26, 2018. Following careful consideration of market feedback, we finalized and published our criteria titled "Hybrid Capital: Methodology And Assumptions," on July 1, 2019.

This RFC Process Summary provides an overview of the substantive analytical changes we made between the request for comment (RFC) and the final criteria in response to external written comments or other substantive feedback received, and the rationale behind those changes. It also provides an overview of other analytical changes made following further consideration by us during the RFC period, and the rationale behind these. In addition, it provides an overview of external written comments that we chose not to adopt in our final criteria and our rationale for not adopting them.

As part of the RFC feedback process, we also received various comments requesting guidance on the application of certain aspects of the proposed criteria. We have addressed these requests in the article titled "Guidance: Hybrid Capital: Methodology And Assumptions," published on July 1, 2019. An overview of the changes to the guidance document is also provided below.

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Summary Of Changes To Criteria In Response To External Written Comments Or Other Substantive Feedback

Change

We have changed to 10 years the minimum residual maturity standard for insurance hybrids to receive equity content. This applies to all insurance hybrids regardless of their issue date.

Related comment

We received significant market feedback stating that our proposed approach to residual maturity for insurance hybrids, which was the same as that for hybrids issued by corporates that are not subject to prudential regulation, did not take sufficient account of the prudential regulatory oversight that influences insurers' decisions regarding redeeming and replacing hybrids. Insurers have to take account of their regulatory solvency measures (both current and projected) and other regulatory views when deciding how to manage their hybrid capital base. Given that the regulatory framework also acts as a constraint on insurers' plans to manage their capital, and reinforces the

potential for a hybrid to absorb losses or conserve cash, we determined that the residual maturity standards for insurers do not need to be the same as for nonprudentially regulated corporate issuers. Examples of the potential regulatory actions include how regulators can prevent a hybrid redemption; direct a company to stop paying coupons; for certain instruments, enforce a principal write-down, conversion into common equity, or extension of the principal maturity date; and oversee capital-raising plans.

In setting a minimum standard of 10 years for all insurance hybrids, we considered how this compares with our approach for bank and corporate entities, as well as the residual maturity standards required by insurance regulatory authorities. We note that the regulatory standards can still differ considerably by jurisdiction. We therefore decided not to apply intermediate or high equity content automatically to all insurance hybrids that are included in regulatory capital measures. Instead, we decided to apply a global standard for residual maturity that determines whether the hybrid is eligible for high or intermediate equity content or whether it should be classified as having no equity content. This also reflects how we typically have a longer time horizon when assessing insurance capital than do insurance regulators when assessing regulatory solvency.

Change

We added more detail to our approach to determining equity content to a hybrid originally issued to one or two investors by nonprudentially regulated entities. We clarified that such an instrument is eligible for intermediate equity content if the one or two investors in the hybrid hold a relatively low percentage of the aggregate amount of intermediate equity content hybrids outstanding, and if the instrument has the same terms and conditions as existing intermediate equity content hybrids. We also provided additional detail in the related Guidance on the circumstances where such a hybrid is eligible for equity content.

Related comment

We received considerable market feedback stating that the influence of the one or two investors in such a hybrid is weaker depending on the overall hybrid capital structure of the issuer and the size of the layer of hybrid capital. The added text considers the influence of these investors in the context of the overall hybrid investor base in situations where the hybrid held by one or two investors is a relatively low percentage of the overall hybrid layer.

Change

We have clarified that we treat exchange and tender offers on hybrids in the same way.

Related comment

Several market participants asked whether we would treat exchange and tender offers differently under the proposals. We clarified the language to show that we treat these offers in the same way when assessing the implications of a company redeeming a hybrid.

Change

We have made several clarifications throughout the text based on market feedback.

Related comment

These clarifications do not change the criteria, but do provide additional context to make the criteria clearer. For example, we have clarified that we consider the nominal value of hybrids when we calculate the proportion of a corporate issuer's capitalization that consists of hybrids. We have also clarified that certain bank Tier 2 hybrids are potentially eligible for intermediate equity content, whether they are deferrable or nondeferrable in nature. In addition, we have confirmed that the list of potential ways in which a hybrid can absorb losses or conserve cash are examples and not an exhaustive list, and that coupon nonpayment is a form of cash conservation. We added a definition of mismatched mandatory convertible securities (MCS). We also added a definition of prudentially regulated entities to the Glossary.

Summary Of Changes To Criteria Following Further Consideration By S&P Global Ratings During The RFC Period

Change

We have added detail to the "Material incentive to redeem" entry in the Glossary to address situations when we may accept a higher step-up when market spreads rise dramatically as potentially being consistent with an intermediate equity content hybrid. We may accept a step-up equivalent to no more than 50% of the original credit spread, subject to a cap of 200 basis points, where such a step-up is explicitly accepted by insurance regulators.

Related comment

This addition reinstates a detail in the previous hybrid capital criteria that had not been included in the RFC. There is no change versus the previous approach to assessing step-ups for insurance hybrids. The added text therefore does not lead to any changes in ratings or equity content.

Change

We made several editorial changes to clarify our methodology. We also updated certain criteria article references throughout to reflect criteria articles that we published after the RFC.

Related comment

These editorial changes were to make the text read more clearly, and to update cross-references to related criteria.

Change

We have clarified the situations when a government-held hybrid is potentially eligible for high equity content by clarifying that we consider whether a project of the issuer is of significant importance to the government. This is part of considering whether there is a long-term support arrangement for a nonbank issuer from the government.

Related comment

This change clarifies that the assessment of whether a project is of significant importance to the government is not independent of the consideration of whether there is a long-term support arrangement. This clarifies the assessment of shorter-term arrangements between the issuer and government, and shows that the nature of a specific project is not a separate condition or category. We believe that this clarification better expresses the intent that the hybrids should be able and available to absorb losses as part of that long-term support. We do not expect any rating or equity content changes due to this clarification.

Change

We changed the references to unsupported group credit profile (unsupported GCP) throughout the criteria to group stand-alone credit profile (group SACP). This change does not have any analytical impact.

Related comment

We also published "Group Rating Methodology," on July 1, 2019, which updates our criteria for assessing members of groups. The change to group SACP reflects the new term used in that criteria article to describe what we previously referred to as the unsupported GCP. The change to this label does not alter the analytical concept and there are no rating implications for any hybrids that we rate using the group SACP as a benchmark.

Summary Of External Written Comments Not Adopted In The Final Criteria

Proposal

We received feedback suggesting that we should consider continuing our current equity content treatment of hybrids ("grandfathering") that are otherwise no longer eligible for intermediate equity content if they are still included in regulatory capital by the company's prudential regulator.

Related comment

We do not apply different criteria based solely on the issue date of a hybrid. We apply the same criteria to all hybrids irrespective of their issue date. We also decided not to automatically give intermediate or high equity content to all hybrids issued by prudentially regulated companies that are included in regulatory capital measures. This is because prudential regulatory standards differ by jurisdiction and we apply our own standards to assess the degree to which we consider that these hybrids are equity-like in nature and therefore whether they are classified as having high, intermediate, or no equity content.

Proposal

We received several comments requesting that we raise the 15% of a corporate issuer's

capitalization guideline to a higher level; or consider different thresholds for different corporate sectors; or consider alternative higher thresholds based on why an issuer might have gone above 15%; or take account of the impact of goodwill.

Related comment

We decided to maintain our approach because we consider it reflects appropriately the degree to which corporate issuers can typically rely on hybrids as part of their capitalization. This reflects how hybrids have performed, as well as their potential limitations. As indicated in the guidance, issuers can exceed the 15% guideline in various circumstances. We therefore consider that the criteria provide appropriate balance and flexibility.

Proposal

We received several comments proposing that we should not widen notching for mandatory deferral features.

Related comment

We decided to maintain the capacity to widen notching for such features, but have added more detail to the guidance document that discusses how we assess whether or not to do so.

Proposal

We received several requests for feedback on how we would assess specific hypothetical situations and structures under our criteria.

Related comment

We have addressed some of these items in the Guidance, but others represent situations where we would carry out a case-by-case assessment, taking account of who the issuer is, in accordance with the criteria.

Proposal

We received several requests to widen the capacity for an issuer to redeem a hybrid without replacement in the first five years from the issue date. We also received requests for an issuer to be able to replace a hybrid after instead of before the redemption of the original hybrid if the issuer commits to issuing the replacement within a set period.

Related comment

We have maintained our approach of only allowing redemptions without replacement in the first five years in particular circumstances. We consider that these allow appropriate flexibility. We also continue to expect that a replacement hybrid be issued before the original hybrid is redeemed, given that market disruptions or worsening credit conditions could prevent an issuer from issuing the replacement hybrid within a set time period even if they strongly intend to do so.

Proposal

We received a request to consider having the same residual maturity standards for corporate hybrids regardless of rating category, and that MCS should also have the same maximum time to conversion regardless of rating category.

Related comment

We have maintained our differing residual maturity standards for corporate hybrids by rating category, which become shorter as the credit profile deteriorates. This is so that an issuer can keep a hybrid outstanding for a longer period if its creditworthiness deteriorates, thus providing greater protection to senior creditors. With regard to MCS, we have maintained the different maximum times to conversion, which get longer as the rating category improves. This is to make it more likely that conversion will take place for issuers with very low ratings that are less likely to survive for longer periods.

Proposal

We received feedback proposing that we should consider assigning high equity content to a wider range of hybrids, given regulatory developments in sectors such as banks, as well as the respondent's view that preference shares are of a higher quality than other types of hybrids.

Related comment

We have maintained our approach as we consider that the confidence sensitivity of banks is high and that this is consistent with the current balance of reliance on hybrids in capital measures. We also decided to keep preference shares as eligible for intermediate instead of high equity content because we consider that issuers typically still intend to maintain coupons or dividends on these except in stress scenarios.

Proposal

We received a request to provide additional clarification on Real Estate Investment Trust (REIT) structures that combine mandatory and discretionary dividends.

Related comment

We consider that the current criteria and guidance are sufficiently clear and that they enable the assessment of different types of REIT dividend structures as either qualifying or not for intermediate or high equity content.

Proposal

We received feedback stating that a hybrid should still be eligible to receive intermediate or high equity content if the servicing cost increases because of market developments.

Related comment

We have maintained our proposed approach that, if the cost of servicing or the likelihood of redeeming the hybrid instrument increases in response to a worsening of the issuer's creditworthiness, we assess the hybrid as having no equity content. This does not refer to situations where, for example, a floating-rate coupon increases because of general market developments. However, it captures situations such as those where the servicing cost increases in response to the issuer's credit deterioration (for example, if the issuer is downgraded to a particular rating, or experiences a certain level of financial stress). The servicing cost could, for example, increase to a pre-set level, or the initial coupon spread above a market-interest rate could change to a higher level.

Proposal

We received feedback proposing that all hybrids should be eligible to receive intermediate or high equity content and that excluding some hybrids causes potential confusion in the market.

Related comment

We consider that all hybrids combine equity- and debt-like features to differing extents and therefore we maintain our three classification categories of high, intermediate, and no equity content. In our view, some hybrids have sufficiently weak equity-like features that they are classified as no equity content and therefore do not improve our quantitative assessment of the issuer's creditworthiness, even though we still consider them to be hybrids.

Proposal

We received a comment stating that we should change our notching approach for situations when the sovereign rating caps the ICR on the hybrid issuer, and consider narrowing the subordination notching for speculative-grade banks that may nevertheless be perceived as being relatively stable.

Related comment

We have maintained our notching approach for hybrids when the sovereign rating caps the ICR on the hybrid issuer because the ICR determines the senior bond rating and we consider hybrids as incrementally riskier than the issuer's senior bonds. We have not adjusted the subordination notching for banks that are relatively stable because the subordination notching indicates the impact of entry into bankruptcy or similar proceedings and does not indicate the likelihood of default.

Proposal

We received a comment that we should consider narrowing the notching approach for bank hybrids.

Related comment

Based on our current view of the performance of bank hybrids, we have not changed our approach.

Proposal

We received feedback proposing that we should confirm that hybrid follow-on issuances (such as tap issuances and top-ups), where an additional amount is added to a hybrid at a later date, may be executed at lower credit spreads than the original hybrid instrument, and still be eligible for intermediate or high equity content.

Related comment

We have not changed the criteria and we note that taps are subject to the same criteria as other hybrids. This includes the step-up limits applicable for that sector.

Proposal

We also received several comments related to our other criteria articles, such as "Corporate Methodology: Ratios And Adjustments," published on April 1, 2019, and "Refined Methodology And Assumptions For Analyzing Insurer Capital Adequacy Using The Risk-Based Insurance Capital Model," published on June 7, 2010.

Related comment

We acknowledge these comments as comments on in-force criteria. In line with our policies, we consider these comments as part of our annual reviews of those other criteria articles.

Overview Of Significant Changes To The Guidance Document Following The RFC Period

Change

Although we have not changed the principles in the criteria, we have provided additional details in the guidance document on when we widen the notching for a hybrid with a mandatory deferral feature, with a particular focus on insurance hybrids.

Related comment

We received considerable feedback requesting additional detail on our approach to assigning ratings to hybrids with mandatory deferral features, particularly insurance hybrids. The detail added to the guidance document builds on additional information we received during the RFC process on potential regulatory approaches to such hybrids. This includes information on when triggers set based on regulatory solvency ratios may be activated, as well as on how insurance companies are responding to the evolving regulatory frameworks. The additional detail includes

examples of the factors that inform our assessment of the relationship between the issuer credit rating (ICR) and hybrid rating for an insurance company, and how both ratings would respond to stress or volatility. We also provide details of our typical approach in certain jurisdictions based on their regulatory frameworks. This includes typical notching approaches based on the level of the regulatory solvency ratio that would trigger a mandatory deferral.

Change

We provided additional guidance regarding when we may assign equity content to a hybrid that was originally sold to one or two investors.

Related comment

We received considerable market feedback requesting further guidance around the application of the criteria, in particular around those circumstances in which we would assign equity content to hybrid issuances to one or two investors. We may assign equity content to a hybrid that was originally sold to one or two investors if that hybrid has the same terms and conditions as existing intermediate equity content hybrids, and subject to the condition that the single or dual investor in the new hybrid will hold 25% or less of the aggregate notional amount of intermediate (equity content) hybrids outstanding, and provided that all other criteria to achieve intermediate equity content are met.

Related Criteria And Research

Related Criteria

- Hybrid Capital: Methodology And Assumptions, July 1, 2019

Related Research

- Guidance: Hybrid Capital: Methodology And Assumptions, July 1, 2019

This report does not constitute a rating action.

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