Criteria | Financial Institutions | Banks:

Assumptions: Clarification Of The Equity Content Categories Used For Bank And Insurance Hybrid Instruments With Restricted Ability To Defer Payments

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*(**Editor's Note:** This article has been superseded by "Hybrid Capital: Methodology And Assumptions," published July 1, 2019, but may still be in use in certain markets.)*

1. This article presents S&P Global Ratings' assumptions for assessing the equity content of bank and insurance hybrid capital instruments that have materially restricted ability to stop paying coupons. We are publishing this article to help market participants better understand our approach to reviewing clauses in such instruments whereby coupons must be paid. This article is related to our criteria article "Principles Of Credit Ratings," which we published on Feb. 16, 2011.

SCOPE OF THE CRITERIA

2. S&P Global Ratings is updating its criteria for assessing the equity content of bank and insurance hybrid capital instruments to clarify several areas. The clarification focuses on:

- Situations where restrictions on the ability to stop paying coupons are sufficiently material that they disqualify the hybrid from our "Intermediate" equity content category.
- How we assess "look-back" or dividend pusher features.

SUMMARY OF CRITERIA UPDATE

3. This article partly amends "Hybrid Capital Handbook: 2008 Edition," published Sept. 15, 2008. Notable changes include:

- We do not assume that regulators will over-ride restrictive clauses that would prevent the issuer from stopping a hybrid coupon.
- We define how we assess "look-back" periods for issuers that have been assigned investment-grade issuer credit ratings (ICRs), but that have stand-alone credit profiles (SACPs) in speculative-grade (where the ICR benefits from government support).

ANALYTICAL CONTACTS

Dennis P Sugrue
London
(44) 20-7176-7056
dennis.sugrue
@spglobal.com

Natalia Yalovskaya
London
(44) 20-7176-3407
natalia.yalovskaya
@spglobal.com

CRITERIA CONTACTS

Michelle M Brennan
London
(44) 20-7176-7205
michelle.brennan
@spglobal.com

Takamasa Yamaoka
Tokyo
(81) 3-4550-8719
takamasa.yamaoka
@spglobal.com

Mark Button
London
(44) 20-7176-7045
mark.button
@spglobal.com

4. This paragraph has been deleted.

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ASSUMPTIONS

6. Banks and insurance companies issue hybrid instruments that contain certain debt-like features (such as stated coupons) as well as equity-like features (such as the right to defer coupon payments during times of financial stress). Previously, S&P Global Ratings believed that regulators would encourage coupon deferrals to preserve capital. Over the last year, however, the inability or reluctance of regulators to enforce coupon deferrals in certain stress situations has caused us to revisit our approach regarding equity content of some hybrids.

7. S&P Global Ratings assesses the equity content of hybrids on a scale ranging from "High" to "Minimal". The issuer's ability to defer coupons is a key criterion for determining equity content and we evaluate the documentary provisions governing the right of the hybrid issuer to defer or omit payment.

8. In light of recent experience within the bank hybrid capital market, and our interpretation of regulators' handling of bank hybrid capital instruments, we are refining our treatment of such hybrids that have material restrictions on their ability to defer payments, or otherwise absorb losses. We continue to exclude from "Intermediate" or "High" equity content all hybrids that materially restrict the issuer's ability to stop paying coupons in the event of a stress (or materially restrict the ability to absorb losses through other characteristics such as a principal write-down), including those with dividend pusher (or "look-back") features that would delay the stopping of the coupon for a material length of time (as defined below).

9. Until now, we made exceptions--and did assign equity credit--in cases where we believed that regulators would over-ride such restrictive clauses. We no longer believe that regulators can be expected to act this way. In our opinion, they have not done so for many banks in recent times of stress (be it due to policy considerations or potential legal concerns).

10. Accordingly, we treat as having no better than "Minimal" equity credit any bank or insurance hybrid that can only stop paying coupons if the issuer breaches minimum regulatory capital requirements. In other words, coupon payments are mandatory for as long as the issuer still meets these requirements. We may still assign "Intermediate" equity content to such a hybrid if it has an alternative mechanism for loss absorption--such as a principal write-down feature--that has sufficient flexibility to be used in a time of stress.

11. Similarly, for investment-grade issuers, the existence of a "look-back" feature that could impose a delay of over one year would disqualify a security for our "Intermediate" equity content category. A "look-back" or dividend pusher period of over six months pertains in the case of speculative-grade entities. For clarity, in the case of an issuer with a SACP that is speculative-grade, the six-month limit would apply (even if the ICR is investment-grade due to government support). This is because the equity content assigned to the hybrid is included in our assessment of the issuer's stand-alone capitalization, and because potential extraordinary government support for senior debt may not extend to hybrids.

12. These criteria are applicable to all rated banks and insurers.

How restricted ability to stop hybrid payment affects equity content

13. The section "Equity Content: Ongoing Payments" in our "Hybrid Capital Handbook" states that the fewer restrictions imposed on an issuer's ability to defer or forgo payments, the higher the equity

content potentially is. For example, some issues include a "look-back" provision under which the issuer can only defer or forgo payments after some minimum period of time has elapsed since the last distribution to common shareholders (common dividend or share repurchases) was paid. In other instances, there is a requirement--for example, under the corporate charter or the national corporate legal framework--that any dividend changes be approved at the annual shareholders' meeting. There may also be other preconditions that must be satisfied, such as the breach of certain financial tests. With any such restrictions, the issuer's ability to react to worsening circumstances by deferring or forgoing payments can be considerably hampered, and so such features undermine equity content.

14. Bank regulators typically have strong powers to intervene in banks' capital management policies, but, given recent experience, we cannot assume that bank regulators will always intervene to over-ride a restrictive clause. In particular, we have seen many cases where regulators have respected restrictive clauses that require mandatory hybrid coupon payment on the basis that the issuing bank still meets regulatory capital requirements, even though the underlying position of the bank may be one of acute stress.

15. We recognize that many countries have different regulatory capital requirements. Some apply a standard minimum to all banks in the sector (such as a 4% regulatory Tier 1 ratio), but other countries assign higher requirements to individual banks based on their particular risk profiles. We also note that different regulators apply different levels of conservatism when setting the guidelines for calculation of these ratios. It is therefore possible that a regulatory capital-based deferral trigger could kick in "earlier" (or at a more conservative level) for certain banks. Even taking these factors into account, we still consider such mandatory payment clauses to be inconsistent with intermediate equity credit.

Examples of material restrictions on the ability to stop hybrid payments

16. Certain bank and insurance hybrids contain features that restrict the ability to stop paying coupons (or otherwise absorb losses) in the event of a financial stress. These features disqualify these hybrids from our "Intermediate" equity content category, regardless of their regulatory classification, and leave them in our "Minimal" equity content category. (This is consistent with our criteria for nonregulated corporates.) Examples of such features include:

- Clauses that require coupons to be paid if the issuer meets minimum regulatory capital requirements.
- Clauses that require coupons to be paid if the issuer has sufficient distributable reserves according to the most recent financial statements.
- Clauses that introduce "look-back" periods or "dividend pushers" that would prevent an investment-grade issuer from stopping coupon payments for a period of more than one year or prevent a speculative-grade issuer from stopping coupon payments for a period of more than six months if the issuer had paid a coupon on, or repurchased, a junior or pari passu instrument.
- Clauses that link two or more pari passu hybrid capital instruments in such a way as to create a circular reference for look-back provisions such that there is the potential for never being able to stop distributions.
- Mandatory payment clauses other than the above that we also consider to materially affect the ability of the issuer to stop paying coupons (or otherwise absorb losses) even though the issuer would be in a position of stress.

17. We recognize that these features do not prevent the issuer from stopping coupon payments at some point, but we consider that they slow down the issuer's response to a financial stress and could make this response "too little too late". Regulatory capital measures are frequently lagging indicators of financial strength, and an issuer can be right at the point of collapse by the time it has depleted distributable reserves. These features materially reduce the ability of hybrids to act as buffers in the event of stress.

18. As stated above, we also take account of mechanisms whereby a hybrid can absorb losses other than through stopping coupons--such as principal write-down. We could include in "Intermediate" equity content a hybrid with sufficient flexibility to write down principal in the event of stress, even if it had a materially restrictive coupon payment clause.

Our equity content criteria do not require fully discretionary coupons

19. Our criteria do not require coupons to be entirely optional or discretionary in order to consider the instrument in our "Intermediate" equity content category. We accept that mandatory payment features can be consistent with this classification if they only make payment mandatory in situations where the issuer is clearly in good financial health. We are, however, concerned when the terms of the instrument require coupons to be paid even in situations where the issuer could be in financial stress.

"Minimal" equity content (extract from Hybrid Capital Handbook, 2008 edition)

20. The "Minimal" equity content category includes some instruments with significant equity attribute(s), but which, as a whole, fall short of our standards for "Intermediate". This category includes, for the most part, either subordinated issues with deferrable payments, but where there are fewer than 20 years remaining until the maturity, or long-lived subordinated issues with deferrable payments, but where the ability to defer is limited to fewer than five years or otherwise restricted. One example of the latter is certain Tier 2 or Tier 3 subordinated issues of issuers on which the interest payments are not subject to optional deferral, but where the payments can be restricted by a relatively loose earnings test.

REVISIONS AND UPDATES

This article was originally published on Feb. 9, 2010. These criteria were first effective on Feb. 9, 2010.

Changes introduced after original publication:

- Following our periodic review completed on April 11, 2017, we updated the contact information and the "Related Criteria And Research" section. We also deleted text in the appendix that was related to the original publication of the criteria and no longer relevant.
- Following our periodic review completed on April 10, 2018, we updated the contact information and the "Related Criteria And Research" section.

RELATED CRITERIA AND RESEARCH

Related Criteria

- Methodology And Assumptions: Assigning Equity Content To Hybrid Capital Instruments Issued By Corporate Entities And Other Issuers Not Subject To Prudential Regulation, Jan. 16, 2018
- Bank Hybrid Capital And Nondeferrable Subordinated Debt Methodology And Assumptions, Jan. 29, 2015
- Insurer Hybrid Capital Instruments With Nonviability Contingent Capital (NVCC) Features, July 24, 2014
- Assumptions: Application Of Hybrid Capital Criteria Methodologies To Japanese Insurers, Aug. 6, 2013
- Criteria Clarification On Hybrid Capital Step-Ups, Call Options, And Replacement Provisions, Oct. 22, 2012
- Methodology: Hybrid Capital Issue Features: Update On Dividend Stoppers, Look-Backs, And Pushers, Feb. 10, 2010
- Principles Of Credit Ratings, Feb. 16, 2011
- Intermediate Equity Content For Certain Mandatory Convertible Preferred Stock Hybrids, Nov. 26, 2008
- Hybrid Capital Handbook: September 2008 Edition, Sept. 15, 2008

These criteria represent the specific application of fundamental principles that define credit risk and ratings opinions. Their use is determined by issuer- or issue-specific attributes as well as Standard & Poor's Ratings Services' assessment of the credit and, if applicable, structural risks for a given issuer or issue rating. Methodology and assumptions may change from time to time as a result of market and economic conditions, issuer- or issue-specific factors, or new empirical evidence that would affect our credit judgment.

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