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# Methodology: Hybrid Capital Issue Features: Update On Dividend Stoppers, Look-Backs, And Pushers

February 10, 2010

*(Editor's Note: This article has been superseded by "Hybrid Capital: Methodology And Assumptions," published July 1, 2019, but may still be in use in certain markets.)*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. S&P Global Ratings is refining its methodology for analyzing the impact of "look-back" periods (sometimes called dividend pusher clauses) on hybrid capital instruments. We are publishing this article to help market participants better understand our approach to reviewing look-back periods and dividend pusher clauses by providing more detail on how we define and calculate the periods covered by such clauses. This article is related to our criteria article "Principles Of Credit Ratings," published Feb. 16, 2011.

## SCOPE OF THE CRITERIA

2. S&P Global Ratings is updating its criteria for reviewing look-back features or dividend pusher clauses contained within hybrid capital instruments (other than securities gaining equity content as being mandatorily convertible) to clarify several areas. This applies to bank, insurance, and corporate issuers rated globally. The clarification focuses on:
  - Clarification of the cut-off points when we consider that the length of the look-back period (during which coupon payment is mandatory) would disqualify a hybrid from our "Intermediate" equity content category.
  - Clarification of the cut-off point that we use for look-back periods in hybrids issued by investment-grade entities that have non-investment-grade stand-alone credit profiles (SACPs) (while they benefit from expectations of extraordinary government support factored in the issuer credit rating).
  - Clarification of how we calculate the length of a look-back or dividend pusher period.

## SUMMARY OF CRITERIA UPDATE

3. This article supersedes the section entitled "Issue Features: Dividend Stoppers, Look-Backs, And Pushers" in "Hybrid Capital Handbook: September 2008 Edition," published Sept. 15, 2008. Notable changes include:
  - Clarification that a look-back period of more than one year generally disqualifies a hybrid issued by an investment-grade entity from treatment in our analysis as "Intermediate" equity

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content. A look-back period of one year or less for a hybrid issued by an investment grade entity is generally eligible for treatment in our analysis as "Intermediate" equity content (assuming the other features of the hybrid are consistent with our criteria).

- Clarification that a look-back period of more than six months generally disqualifies a hybrid issued by a non-investment-grade entity from treatment in our analysis as "Intermediate" equity content. A look-back period of six months or less for a hybrid issued by a non-investment-grade entity is generally eligible for treatment in our analysis as "Intermediate" equity content (assuming the other features of the hybrid are consistent with our criteria).
- Clarification that we use the six-month cut-off when we analyze a hybrid issued by an investment-grade-entity that has a non-investment-grade SACP (but where the issuer credit rating factors in our expectation of government support).

4. This paragraph has been deleted.

5. This paragraph has been deleted.

## METHODOLOGY

6. Many types of hybrid capital instruments include so-called dividend stoppers, whereby if there is an optional or mandatory deferral of dividends/interest on the hybrid issue, the company is prohibited from making payments on, or repurchasing, any pari passu or more junior issues--including making dividend payments on common stock--until the arrearage, if any, has been cured and payments resume. We generally view such a stipulation as a neutral factor from a credit perspective. On the one hand, eliminating both the common dividend and the hybrid payment maximizes the overall cash conserved. On the other hand, in the case of optional deferrals the link between the two may increase the reluctance of the issuer to forgo paying on the hybrid. Indeed, in cases where shareholder expectations or tax considerations--for real estate investment trusts (REITs)--increase the reluctance to suspend common dividends, the inclusion of a dividend stopper clause could in our view significantly decrease the issuer's willingness to defer payments on the hybrid issue. In general, the presence or absence of a common dividend stopper is not essential to our recognition of equity content.
7. By contrast, some instruments incorporate so-called look-backs, which we generally view as negative from a credit perspective. In these instruments, the right to optionally defer payments on hybrids typically applies only after a period of no repurchases nor payments on junior securities, including common equity. The main point of deferrable payment securities generally is to accommodate a company experiencing credit stress that needs to save cash. Look-backs can constrain this flexibility, as a practical matter. Specifically, if the company had recently effected distributions on junior securities, they would have to pay the hybrid dividends until the look-back period passed. Look-backs that refer to parity securities involve in our view an even greater potential for having such recent payments on the reference security (as opposed to look-backs on common share distributions, which arguably could be expected to stop in advance of the need to defer on hybrids).
8. In the case of look-back provisions in which two or more parity instruments refer to each other, there is the potential for a scenario to arise where a company is not able to stop distributions--which we believe may significantly reduce the potential for hybrids to be treated in our analysis as equity. We also note that, depending on the alignment of payment dates, such situations can create the ability to stop distributions, but we believe they can potentially impact the decision to exercise a discretion to defer distributions, by forcing a company to decide whether

to simultaneously defer on multiple securities.

9. The details of a look-back provision help us to form a view regarding the extent of the potential issue. For example, does even the repurchase of a trivial amount of stock in conjunction with an employee option plan violate the look-back? Is the look-back period a quarter? Six months? One year? How do the frequency and juxtaposition of common and preferred dividend payment dates affect the possible delay in deferring payments on the hybrids?
10. The existence of a look-back that could impose a delay of more than one year would generally disqualify a hybrid issued by an investment grade entity from treatment in our analysis as "Intermediate" equity content. A look-back period of one year or less for a hybrid issued by an investment grade entity is generally eligible for treatment in our analysis as "Intermediate" equity content (assuming the other features of the hybrid are consistent with our criteria).
11. A look-back period of more than six months generally disqualifies a hybrid issued by a non-investment-grade entity from treatment in our analysis as "Intermediate" equity content. A look-back period of six months or less for a hybrid issued by a non-investment-grade entity is generally eligible for treatment in our analysis as "Intermediate" equity content (assuming the other features of the hybrid are consistent with our criteria). (Additionally, we note that even where a look-back period is shorter and does not in itself disqualify the security for treatment as equity content under our criteria, we may consider that the potential for delay is still an issue--and, in combination with other features of the security, this could weigh on our assessment of its equity content categorization.)
12. When considering in our analysis hybrids issued by investment-grade issuers that benefit from government support but have non-investment-grade SACPs, we typically use the cut-off point of six months that we use for non-investment-grade issuers. This is because we generally take account in our analysis of the equity benefits of the hybrid when we assess the issuer's SACP.
13. With respect to mandatory-deferral instruments, look-backs or dividend pusher clauses may make the deferral of dividend payments on hybrids optional in practice. For example, a company may choose to avoid the deferral by paying a minimal common dividend. Such issues would, therefore, likely not qualify for our "High" equity content category.
14. We understand that our assessments of relative cut-off points for a look-back period is a matter of interpretation and that, for example, any one day difference in the length of the period would likely not be expected to make a material difference in the equity nature of hybrids. As such, the thresholds explained in this report are general guidelines. We set out these guidelines in order to make our criteria transparent and make our equity assessment of hybrids more predictable for market participants. If the look-back period extends slightly beyond a threshold outlined in this criteria, we may still assess (in exceptional cases) such a look-back for our "Intermediate" equity categorization if the hybrid's other features are otherwise considered by us to be sufficiently supportive of such characterization.
15. For the purposes of our analysis when we calculate the length of any look-back period, we focus on the length of the time that the issuer is restricted from coupon nonpayment. Our calculation does not start from the first day of accrual of interest since the previous payment date, but typically starts from the date of the last distribution to junior securities (which could be a dividend payment or a stock repurchase) or distribution to other securities mentioned in the look-back clause. We typically do not start counting from the date that a distribution was announced (for example, an ordinary dividend is typically announced in advance of the actual distribution or payment date).
16. For example, consider the following scenario. An issuer with a non-investment-grade issuer credit rating has issued a hybrid which includes a three-month look-back based on common dividend payments. The hybrid pays in arrears on January 1 and July 1 of each year, the common dividend is

typically paid on Jan. 2, April 2, July 2, and Oct. 2. In a given year, on April 2 it pays a common dividend, declared when the company was still confident on its earnings outlook. However, on April 3, the company's business prospects suddenly worsens to the point that the company turns to saving any cash it can, including on the hybrid.

17. Under the hybrid instrument's documentation, it will first be allowed to defer on January 1 of the following year (assuming the company has not otherwise paid the July 2 or Oct. 2 common dividend payments). The issuer will need to pay the July 1 hybrid coupon because it has made the April 2 common dividend payment. Therefore, the first nonpayment date on the hybrid will occur almost nine months from the previous junior-security payment (which in this case was a common dividend payment). Since, however, it will not have been remunerating the hybrid since the July 2 coupon date, or three months since last paying on a junior security, we interpret this as a three-month, not a nine-month, look-back.

## **REVISIONS AND UPDATES**

This article was originally published on Feb. 10, 2010. These criteria became effective on Feb. 10, 2010.

Changes introduced after original publication:

- Following our periodic review completed on June 29, 2015, we updated the contact information.
- Following our periodic review completed on June 29, 2016, we updated the contact information and deleted paragraphs 4 and 5, which were related to the initial publication of our criteria and no longer relevant.
- Following our periodic review completed on June 25, 2018, we updated the contact information and criteria references.
- On March 18, 2019, we republished this criteria article to make nonmaterial changes to the contact information.

## **RELATED CRITERIA AND RESEARCH**

### **Related Criteria**

- Bank Hybrid Capital And Nondeferrable Subordinated Debt Methodology And Assumptions, Jan. 29, 2015
- Principles Of Credit Ratings, Feb. 16, 2011
- Assumptions: Clarification Of The Equity Content Categories Used For Bank And Insurance Hybrid Instruments With Restricted Ability To Defer Payments, Feb. 9, 2010
- Hybrid Capital Handbook: 2008 Edition, Sept. 15, 2008

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