General Criteria:

Hybrid Capital: Methodology And Assumptions

February 10, 2025

These criteria are effective Feb. 10, 2025, except in jurisdictions that require local registration. In those jurisdictions, the criteria are effective only after the local registration process is completed.

ANALYTICAL CONTACT

Gregg Lemos-Stein, CFA
New York
+ 212438 1809
gregg.lemos-stein
@spglobal.com

Eric Tanguy
Paris
+ 33 14 420 6715
eric.tanguy
@spglobal.com

Volker Kudszus
Frankfurt
+ 49 693 399 9192
volker.kudszus
@spglobal.com

Salla von Steinaecker
Frankfurt
+ 49 693 399 9164
salla.vonsteinaecker
@spglobal.com

METHODOLOGY CONTACT

Michelle M Brennan
London
+ 44 20 7176 7205
michelle.brennan
@spglobal.com

Takamasa Yamaoka
Tokyo
+ 81 3 4550 8719
takamasa.yamaoka
@spglobal.com

See complete contact list at end of article.

OVERVIEW AND SCOPE

1. The criteria establish our framework for assessing equity content for and assigning a rating to a hybrid capital instrument, as well as clarifying how we consider the hybrid when assessing the capitalization or cash flow/leverage, and thus the creditworthiness of the issuer. Appendix A provides additional details on the criteria application, while certain terms are defined in the glossary (see Appendix B) and presented in title case on first reference. We use the terms hybrid capital instrument, hybrid instrument, and hybrid interchangeably in this article, and instrument refers to a hybrid capital instrument unless we specify otherwise. For information about the initial publication of this article as of Feb. 10, 2025, including key changes, the impact on ratings, and superseded criteria, see "Updated Hybrid Capital Criteria Published".
2. The criteria explain how we:
   - Define a hybrid that falls under these criteria;
   - Categorize a hybrid capital instrument by whether it has high, intermediate, or no equity content. The equity content determines how we consider it when assessing the capitalization or cash flow/leverage of the issuer; and
   - Rate a hybrid capital instrument.
3. Hybrid capital generally refers to an instrument that has characteristics of both debt and equity, and therefore excludes common equity. S&P Global Ratings considers an instrument to be a hybrid capital instrument if, and only if, without causing a legal default or liquidation of the issuer, it can absorb losses or conserve cash. Examples of such loss absorption or cash conservation include:
   - Deferral of the coupon;
   - Write-down of principal; or
   - Conversion into common equity or another hybrid capital instrument.
4. This applies to all hybrid instruments issued by corporate, financial institution, and insurance entities, non-U.S. public-sector funding agencies (PSFAs), and multilateral lending institutions

(MLIs) and multilateral insurance institutions. Project finance issuances are excluded from the scope of this criteria.

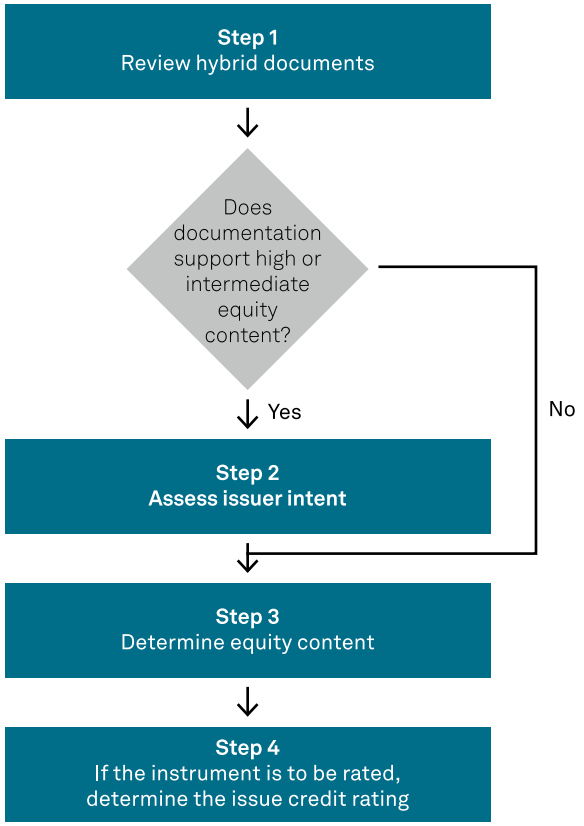
5. For corporate ratings, securities held by an issuer's owner are governed by "The Treatment Of Non-Common Equity Financing In Nonfinancial Corporate Entities".

METHODOLOGY

6. These criteria provide our methodology for identifying, categorizing, and rating hybrid capital instruments. Although we apply consistent principles across all sectors, the treatment of certain hybrid instruments may reflect sector-specific characteristics. The sectoral classifications of certain financial services subsectors and PSFAs are summarized in table 3.

Chart 1

Assessing hybrid instruments



Source: S&P Global Ratings.

Equity Content: General Framework

7. This section describes the driving factors that govern how we assess the equity-like features of hybrid instruments. Our assessment initially focuses on the terms and conditions of the security, rather than the nomenclature alone. It also incorporates our view of issuer intent. An instrument may be considered to have high, intermediate, or no equity content, depending on the degree to

which a hybrid instrument has equity-like features. Our view of its equity content can change over time. The key principles underpinning our view of a hybrid instrument's equity content are:

- Its ability to absorb losses or conserve cash, if and when needed; and
- Its availability to absorb losses or conserve cash, based on the hybrid instrument or its replacement remaining outstanding for a sufficiently long period.

8. To determine the equity content, we evaluate all the terms and conditions, and other relevant hybrid documentation, both separately and in a holistic manner. Where our assessment of the instrument does not lead to a clear and conclusive determination of the equity content, we will assign intermediate or no equity content if the hybrid could potentially have qualified for high equity content (with intermediate only assigned if the hybrid is consistent with the features for that category), and no equity content if the hybrid could potentially have qualified for intermediate equity content. Where we believe the instrument will not be available or that it cannot absorb losses or conserve cash in stress scenarios (see "Stress scenarios" in Appendix A for more details), we will assess the instrument as having no equity content, regardless of whether the terms and conditions might otherwise support higher equity content.

9. We assess issuer intent in determining whether the hybrid instrument would be available for loss absorption or cash conservation, if and when needed. The instrument will be classified as having no equity content if there is material uncertainty regarding whether the issuer will 1) keep it (or its replacement) outstanding for a sufficiently long period and 2) use it to absorb losses or conserve cash when needed.

10. We consider factors including, but not limited to, public statements regarding replacement, as well as our view of the issuer's capital strategy, and the issuer's past behavior concerning hybrid issues. Other factors include attempts to circumvent any restrictions on optional calls through repurchases, or where there is reason to think the issuer will do so in the future.

11. If the terms and conditions in the hybrid issuance or related agreements would lead us to assess the hybrid as having no equity content, our assessment of issuer intent cannot lead to an assessment of intermediate or high equity content.

12. A particular term or condition of the instrument may cause us to assess it as having no equity content upon issuance, but subsequently become obsolete (for example, due to the passage of time). In such cases, we will reassess the equity content, to the extent that we determine the issuer exhibits an intent to allow the instrument to absorb losses or conserve cash in stress scenarios.

13. We will typically reassess all of an issuer's hybrids and assess any future issue of hybrids as having no equity content if the issuer redeems any part of a hybrid that we assessed as having intermediate or high equity content before its Effective Maturity date, and does not replace it with an equivalent or stronger equity content instrument (see "Hybrid redemptions/repurchases and replacement" in Appendix A for more details on redemptions, both with and without replacement, and on features that may affect the likelihood of redemption). However, we may keep intermediate or high equity content on the remaining outstanding hybrid issues and continue to assign equity content to future hybrid issuances where:

- Creditworthiness has improved (see "Assessing improvement of creditworthiness" in Appendix A for details), and lack of replacement will not cause us to lower the long-term credit rating on the issuer or revise the outlook on the long-term credit rating to negative (or from positive to stable at the same rating level);
- The hybrid was redeemed due to an External Event; or
- The Redemption is immaterial in the context of the capital structure.

14. Where an issuer repurchases an existing hybrid (or takes similar action, excluding the exercise of a call option), even within five years of issuance date, generally, we would not change our view of the equity content of existing hybrid instruments (or preclude intermediate or high equity content for future hybrid issuances) if it issues a replacement instrument and meets all of the following conditions:

    - The replacement issuance has the same or higher level of equity content as the original instrument, or is a new issuance of common equity.
    - The replacement issuance does not, in our view, materially weaken the creditworthiness of the issuer, including that it will not cause a lowering of the long-term credit rating or cause a downward revision to the outlook on the long-term credit rating.
    - Our view of issuer intent--in particular, our view of the issuer's long-term intent to retain hybrid capital as a layer of capital to absorb losses or conserve cash in a stress scenario--remains supportive.

15. We assess a hybrid as having no equity content if, based on the hybrid documentation, a worsening of the issuer's creditworthiness would cause:

    - The cost of servicing or the likelihood of redeeming the hybrid to increase; or
    - The effective maturity date to move to an earlier date, whether this is due to a sliding step-up or other feature.

16. When loss absorption or cash conservation would be achieved by deferring coupon payments, the issuer must be able to defer payments for at least five years. If it cannot, we assess the hybrid as having no equity content.

17. For prudentially regulated entities, if a hybrid can only absorb losses in a Nonviability scenario--for example, at a breach of the minimum regulatory capital standard required to maintain its license--then we assess it as having no equity content.

18. We consider the views of regulators, insofar as they may influence the structure, terms, and payment of the issuance. For prudentially regulated banks and insurers, we assign no equity content to the instrument (or the portion of the issuance) where it is not included in regulatory capital. In jurisdictions where the regulators have expressed no view on a specific hybrid capital instrument, we will base our assessment on our view of the likely regulatory policy with respect to the instrument. For instruments that are included in regulatory capital, including those that are grandfathered by the regulators, we assess the hybrid instrument in line with the remainder of these criteria.

19. If we consider that a hybrid issued by an operating subsidiary can absorb losses or conserve cash to the benefit of the broader group, and it meets the conditions for high or intermediate equity content, we will assign such content to the instrument for the purposes of our group consolidated analysis (see "Hybrid instruments issued by operating companies" in Appendix A for an example). Hybrids issued by operating subsidiaries that cannot benefit the wider group in this way are treated as having no equity content in our group consolidated analysis. If, however, they can absorb losses or conserve cash at the issuer level, they are eligible for equity content in our analysis of the operating subsidiary on a stand-alone basis.

20. We typically assign no equity content to a hybrid originally issued to one or two investors by nonprudentially regulated entities, unless the instrument is issued to a government, invested in by the investor as a form of support during stress, or if the single or dual investor in the hybrid holds a relatively low percentage of the aggregate amount of intermediate (equity content) hybrids outstanding (see "Hybrids issued by nonprudentially regulated entities with one or two investors"

in Appendix A for details). If a hybrid issued by a nonprudentially regulated entity is not issued to one or two investors originally, as stipulated above, but it subsequently comes to our attention that ownership of the hybrid series has evolved in the secondary market such that it is now owned by one or two investors, and we expect that ownership structure to be retained in future, we may decide to remove any equity content that was previously assigned.

21. We typically apply the sector-specific hybrid criteria applicable to the issuer, even where the parent entity operates in a different sector. For example, a hybrid issued by an insurer in a bank group is analyzed under the insurance hybrid criteria, rather than the bank hybrid criteria.

Equity Content Categories

22. This section should be read in conjunction with the above general framework and the sector-specific sections below on additional considerations for corporate issuers, financial institutions, insurance institutions, and MLIs and multilateral insurance institutions, which describe our additional sector-specific criteria. Table 3 further clarifies how we apply the sector-specific criteria to certain financial services subsectors and PSFAs.

23. We assess hybrid securities as having high, intermediate, or no equity content.

High Equity Content

24. We typically assign high equity content to mandatory convertible securities (MCS) that have the following characteristics (see "Mandatory convertible securities" in Appendix A for details):

- If the issuer credit rating (ICR) is 'BBB-' or higher (stand-alone credit profile [SACP] is 'bbb-' or higher for banks), the issue converts into ordinary equity in no more than three years; if the ICR is in the 'BB' rating category (SACP is 'bb' category for banks), the issue converts in no more than two years; if the ICR is in the 'B' rating category (SACP is 'b' category for banks), the issue converts in no more than one year (for bank non-operating holding companies [NOHCs], the reference in all rating categories is the group SACP, rather than the SACP);
- The instrument includes a conversion price floor equal to or higher than the issuer's share price at the time of issue (adjusted for any subsequent share issuances); and
- We consider the issuer committed to allowing conversion and do not expect it to undermine the conversion benefit through subsequent stock repurchases.

25. Typically, we also assign high equity content to mismatched MCS (that is, transactions under which the debt remains outstanding after the associated equity issuance) so long as the associated equity issuance meets the above conditions, and we are confident that the issuer will use the proceeds of the equity issuance to repay debt (see "Mismatched mandatory convertibles" in Appendix A for details).

26. We typically assign high equity content to hybrids held solely by or on behalf of a government if we anticipate that the hybrid will absorb losses or conserve cash in a stress scenario (which, in the case of prudentially regulated banks and insurers, is equivalent to a going-concern basis) and it meets all of the following conditions:

- The government has invested in the instrument to rescue or provide extraordinary support to an issuer, or as part of a long-term support arrangement for 1) a bank, or 2) a specific project of an issuer that is of significant importance to the government.
- In the case of a bank hybrid, the government appears likely to continue to support the bank,

even if it does not strengthen quickly. Examples of ongoing support include conversion of a bank hybrid capital instrument into common equity and the waiver of coupons or fees.

- During a period of stress at the issuer, we do not expect the hybrid to be redeemed unless it is replaced by similar hybrid capital instruments owned by the government, or by common equity. Similarly, we do not expect the instrument to be sold to a nongovernment investor during the period of stress. If the issuer is a bank and the hybrid has an effective maturity date, the government has stated that only the bank's retained earnings would be used for redemption, and we expect that after such a redemption the bank's SACP will be at 'bbb-' or higher.
- The instrument is subordinated in liquidation (or an equivalent proceeding) to senior debt obligations of the issuer.
- Cash coupons are fully discretionary; deferred payments are not subject to a dividend or interest rate that is materially higher than the initial dividend or coupon; and payment flexibility can be exercised independently of all other hybrid capital instruments in the public market.
- The hybrid is not subject to "Criteria - Corporates - General: The Treatment Of Non-Common Equity Financing In Nonfinancial Corporate Entities," which covers corporate hybrids for which the government is also a strategic owner of the issuer.

Intermediate Equity Content

27. In order to achieve intermediate equity content, the instrument must:

- Be available and able to absorb losses or conserve cash in stress scenarios, before the point of nonviability or bankruptcy (or similar proceedings), whichever is earlier.
- Have a residual time until the effective maturity exceeding 20 years if the issuer ICR is at 'BBB-' or higher; 15 years if the ICR is in the 'BB' category; and 10 years if the ICR is in the 'B' category or lower (except for banks' Tier 2 going-concern Contingent Capital and for prudentially regulated insurers, for which a shorter time is acceptable, as explained in "Equity Content: Additional Considerations For Financial Institutions" and "Equity Content: Additional Considerations For Insurance Institutions" below). In this analysis, we generally use the ICR for entities other than banks, but we may use the SACP instead in circumstances where this better reflects the likelihood that the instrument will absorb losses or conserve cash (see table 1 for the residual time until the effective maturity for bank hybrids).
- Be subordinated in liquidation or equivalent proceedings to all senior debt obligations of the issuer.
- Not be callable within five years of the issue date (unless the call option is based on an external event). Also see "Make-whole clauses" in Appendix A.
- Be able to absorb losses or conserve cash, such as via nonpayment of dividends or coupons, or principal write-down, for at least five years without triggering a default or wind-up of the issuer.
- Be free from terms or features that discourage or materially delay deferral--such as a higher rate on accrued deferred amounts, or a Look-Back or similar Pusher restrictions of more than one year (see "Look-back periods" in Appendix A for more details), or most Alternative Payment Mechanisms (or similar) that do not incorporate adequate anti-dilution features--and shareholder approval is not required to activate a deferral (see "Restriction on the issuer's ability to defer payments" and "Features that mitigate concerns about APM usage" in Appendix A for more details and examples). Coupons can be either cumulative or noncumulative.

- If the instrument converts to equity on a preset date, the conversion price floor is typically equal to or higher than the issuer's share price at the time of issue (adjusted for any subsequent share issuances). Also see "Treatment of contingent capital instruments that have mandatory conversion features issued by Australia-regulated financial institutions and insurers" in Appendix A for specific details on conversion features for such issuers.

No Equity Content

28. We assign no equity content to hybrid instruments that do not meet the requirements for high or intermediate equity content, including when issuer intent is lacking, and therefore treat these instruments as akin to debt in our analyses, where applicable (see "No Equity Content" in Appendix A for more details).

29. If the effective maturity of a hybrid would be accelerated in the event of a rating deterioration, we classify it as having no equity content.

Equity Content: Sector-Specific Criteria

Additional considerations for corporate issuers

30. We apply the following additional criteria when assessing the equity content of hybrids issued by a corporate entity.

31. The nominal value of hybrid instruments eligible to achieve intermediate or high equity content (excluding MCS) may constitute up to 15% of a corporate issuer's capitalization, as defined in "Corporate Methodology: Ratios And Adjustments." All hybrid instruments in the capital structure are accounted for in order of decreasing equity content, when assigning equity content. Where more than 15% of capitalization consists of hybrid capital instruments, and we anticipate that this will continue, we generally classify all hybrid amounts in excess of 15% of capitalization as having no equity content. However, an issuer's capitalization could decline because operating performance has deteriorated, as demonstrated, for example, by asset write-downs or operating losses. In such a case, we would not generally adjust the amount of hybrids receiving intermediate or high equity content, even if the amount of hybrids exceeds 15% of capitalization.

32. Where a corporate issuer redeems a hybrid without replacement to reduce aggregate hybrids outstanding to allow for the ratio of hybrid debt to capitalization to decrease from above 15%, and such redemption would have no or minimal negative impact on creditworthiness, we typically do not reclassify the equity content of its remaining hybrids.

33. The treatment of hybrids for the purposes of our leverage and debt service ratio calculations depends on the equity content classification and is explained in the Hybrid Capital Instruments section of "Corporate Methodology: Ratios And Adjustments".

Additional considerations for financial institutions

34. We apply the following additional criteria when assessing the equity content of hybrids issued by a financial institution (see table 3 for the treatment of certain financial services subsectors and PSFAs). Total adjusted capital (TAC) and adjusted common equity (ACE) are defined in the bank capital criteria "Risk-Adjusted Capital Framework Methodology".

Table 1

Treatment Of Hybrid Equity Content In Banks

Equity content category*	Maximum amount in TAC§	Qualifying instruments
High	Included in TAC at par amount, with no limit for qualifying government-owned hybrids for banks and up to 50% of ACE for MCS; for MLIs, included in TAC at par amount up to an amount equivalent to 50% of ACE	See "Equity Content Categories--High Equity Content"
Intermediate	Included in TAC at par amount, to an amount equivalent to up to 33% of ACE	Hybrids that meet all of the following conditions:
		1) Able to defer coupons, write down principal, or convert into common equity, without triggering a default or wind-up of the issuer;
		2) Have no material restriction on the ability to defer or otherwise absorb losses while the issuer is a going concern;
		3) Are perpetual or have a residual time until the effective maturity of at least 20 years if the issuer SACP assessment is 'bbb-' or higher, at least 15 years if the SACP category is 'bb', at least 10 years if the SACP category is 'b' (the reference point is the ICR, in the case of a NOHC), or a shorter residual life if they are Tier 2 going-concern contingent capital instruments as described in paragraph 36; and
		4) Do not contain a Step-Up clause, or an alternative incentive to redeem, associated with a call date during the residual life periods described above. If a step-up clause applies during the residual life period, the instrument may still qualify for this equity content category if it also contains a contingent capital feature that can be activated on a going-concern basis and is consistent with the features outlined in paragraph 36.
No	Not included in TAC	Instruments not meeting the requirements for high or intermediate equity content.

*In addition to meeting the features outlined in the table, the instruments must be included in regulatory capital to qualify for the high or intermediate categories. §We use the par amount unless an eligible instrument is subject to regulatory amortization. If so, we include the amortized amount in TAC until the aggregate amount of eligible instruments exceeds the TAC limits shown in this table. TAC--Total adjusted capital. ACE--Adjusted common equity. MCS--Mandatory convertible securities.

35. **Intermediate equity content.** If a bank hybrid capital instrument is a going-concern contingent capital instrument, we consider the regulatory classification of the instrument. If the instrument forms a part of Tier 1 regulatory capital, or if the regulation for the issuer does not differentiate between Tier 1 and Tier 2 capital, then the going-concern contingent capital qualifies as intermediate equity content if, in addition to meeting the cross-sector characteristics, it also meets the features shown in table 1.

36. If a going-concern contingent capital instrument is classified as Tier 2 regulatory capital (whether deferrable or nondeferrable), it qualifies as intermediate equity content if it meets all the following features:

- Residual time to the effective maturity date of at least 15 years if the SACP is 'bbb–' or higher; or at least 10 years if the bank's SACP is 'bb+' or lower. We use the ICR as a reference point if

the issuer is an NOHC;

- Even in cases where regulatory approval is required for any redemption, the Hybrid Documentation stipulates that it may only be replaced by issuing new common equity instruments or by an equivalent or stronger instrument (with high or intermediate equity content) and that such a replacement would take place before the redemption of the instrument; and
- A conversion feature that transforms it into common equity or a feature allowing a permanent write-down of at least 25% of the principal. The triggers for these features would kick in mandatorily and on a going-concern basis. A temporary write-down would still be consistent with this condition if the permanent portion of any write-down is at least 25% of principal.

Additional considerations for insurance institutions

37. For all insurance sectors, we apply our insurance capital model criteria, "Insurer Risk-Based Capital Adequacy--Methodology And Assumptions," with respect to hybrid capital limits.

38. To be eligible for intermediate equity content, hybrids issued by prudentially regulated insurance companies must have a residual time until the effective maturity exceeding 10 years.

Additional Considerations For MLIs And Multilateral Insurance Institutions

39. If a hybrid is eligible for high or intermediate equity content, then we:

- Include it in the issuer's TAC in accordance with the limits in the "Maximum Amount In TAC" column of table 1 (which we also use for banks) if the issuer is an MLI, or
- Use the limits in "Insurer Risk-Based Capital Adequacy--Methodology And Assumptions" if the issuer is a multilateral insurance company.

40. If the MLI or multilateral insurance institution is subject to regulatory capital requirements, then a hybrid is only eligible for high or intermediate equity content if it is included in regulatory capital.

41. For us to assign equity content to a hybrid, we would expect to receive comfort that the issue of the hybrid has been approved and authorized in accordance with the governance structures established by the entity's member governments, in addition to assessing the features outlined elsewhere in the criteria. An MLI or multilateral insurance institution hybrid receives no equity content if it is convertible into common equity, unless it is clear that the investor is able to own common equity in the entity, and that the conversion would take place automatically if the conversion trigger occurs. (For example, the conversion, and the associated creation of new common equity, would not require any authorization or approval once the trigger event occurs.) To be eligible for equity content, the amount of common equity created on the conversion must be equal to the principal amount of the hybrid. (For example, a $100 million principal hybrid would convert into $100 million of common equity on the MLI's balance sheet.) If the convertible hybrid can be traded to another investor, then we don't assign any equity content because it is not clear that all future investors would be able to own common equity in the entity.

High equity content

42. A hybrid that an MLI or multilateral insurance institution issues is eligible for high equity content if

it meets the features outlined in the cross-sector hybrid capital criteria for high equity content--including the bank-specific references in paragraph 24 (for an MCS) or paragraph 26 (for other instruments)--and is invested in only by member governments. Unless it is an eligible mandatory convertible security (MCS), it also has all the MLI/multilateral insurance institution sector-specific features outlined for an intermediate equity content hybrid as proposed below. For instruments other than an MCS, it also clearly absorbs losses before a hybrid issued to nongovernment investors. (But if not, it could be eligible for intermediate equity content if it meets all the features for that category.) For instruments other than an MCS, the mandatory coupon deferral trigger would be set to occur at an earlier level than for an intermediate equity content hybrid.

Intermediate equity content

43. To be eligible for intermediate equity content, a hybrid that an MLI or multilateral insurance institution issues must be consistent with cross-sector criteria for that category (including the bank-specific references in paragraph 27) and all of the following apply:

- Has no stated maturity;
- Does not contain a step-up clause, or an alternative incentive to redeem, associated with a call date;
- In addition to a mandatory coupon deferral if a specific going-concern capital-based financial trigger is breached, has no material restriction on the ability to defer or otherwise absorb losses while the issuer is a going concern;
- In addition to a coupon deferral feature, has a mandatory permanent write-down of 100% of principal or conversion into new common equity that occurs before the drawdown of any callable capital and before default on any senior obligations (if the entity does not have any callable capital, then the write-down or conversion occurs before default on senior obligations); and
- The hybrid documentation stipulates that it may only be replaced by issuing new common equity instruments (such as by a general capital increase) or by an equivalent or stronger instrument (with high or intermediate equity content) and that such a replacement would take place before the redemption of the instrument.

44. The level of the capital-based financial trigger that corresponds to a going-concern basis could differ by entity depending on the nature of its assets. If the entity is subject to regulatory capital requirements, then the capital-based financial trigger will be based on a regulatory capital ratio. If not, then the trigger will be based on an MLI equity-to-assets ratio, using the entity's reported members' equity and assets. We define MLI equity as paid-in equity from shareholders and accumulated profit reserves.

Assigning An Issue Credit Rating To A Hybrid Instrument

General Principles

45. For instruments that are ratable, we assign an issue credit rating by notching down from the starting point for that issuer. Notching for hybrid instruments generally combines: 1) one or two notches for subordination and 2) one or more notches to reflect the risk of loss absorption or cash conservation. This applies to all hybrids, even those that have no equity content.

46. We do not rate a hybrid instrument if it has a loss-absorption or cash conservation trigger that is not related to the issuer's creditworthiness. Examples of such triggers include those linked to an issuer's market capitalization or share price. Others include those based on regulators' concerns about financial stability in the broader market, or linked to events or situations that cannot be observed using public information, for example, where a regulator has full discretion to activate the trigger while an issuer is still a going concern. However, if the regulator's discretion extends only to deciding whether an issuer is about to breach a defined and observable regulatory ratio, or only to deciding whether an issuer is nonviable, then the instrument is a nonviability contingent capital (NVCC) instrument and is ratable.

47. A debt instrument that transforms into a hybrid instrument upon a trigger event will be rated based on its hybrid features if we anticipate that the trigger will be activated at or before loss absorption or cash conservation on an equivalent hybrid instrument.

48. If a hybrid instrument has a guarantee from a higher-rated entity, then we apply our criteria "Guarantee Criteria."

49. Table 3 provides further clarification regarding the application of criteria to certain financial services subsectors and PSFAs.

Starting point for notching in corporate and insurance entities

50. For corporate and insurance entities (including insurance NOHCs) we generally assign an issue credit rating to a hybrid capital instrument by notching down from the ICR on the issuer. That said, we exclude any elements of support that we do not expect to apply to the hybrid from our starting point. For example, if the ICR includes uplift for potential extraordinary group, government, or additional loss-absorbing capacity (ALAC) support that we do not expect to apply to the hybrid, we typically exclude those elements of potential support from the starting point for notching (see "Starting Point For Notching For Insurance Subsidiaries Of Banking Groups" in Appendix A for an example). For example, we may notch down from the SACP in certain cases instead.

Notching for subordination

51. For corporate entities, our criteria "Reflecting Subordination Risk In Corporate Issue Ratings" describes how we notch down to reflect the subordination of hybrid capital instruments.

52. For hybrids issued by banks and insurance entities (including NOHCs), MLIs, and multilateral insurance institutions, where the applicable starting point for notching is 'bbb-' or 'BBB-' or higher, we deduct one notch for subordination. Otherwise, we deduct two notches for subordination.

53. We do not deduct additional notches for different degrees of subordination in any sector.

Notching for risk of loss absorption or cash conservation

54. We reflect the risk of loss absorption or cash conservation, either of which create payment risk, by deducting one or more notches. See "Deferral Triggers And Impact On Notching For Corporates And Prudentially Regulated Insurance Entities" in Appendix A for more details, for example on our treatment of multiple deferral triggers.

55. Instruments issued by prudentially regulated entities that have a mandatory contingent capital clause based on a nonviability trigger are rated one notch lower than an equivalent hybrid instrument that does not have such a feature, unless the clause is only activated after the issuer's share capital has been depleted to zero.

56. If we consider that the payment risk (that is, the likelihood of loss absorption or cash conservation) for a specific instrument is not reflected in either the starting point or the minimum notching, we apply wider notching at issuance. We may also revise the notching as part of our surveillance if the payment risk increases or decreases over the life of the instrument. We do not impose a limit on the number of notches that we may deduct for payment risk.

57. If the instrument includes features that enable the issuer to modify it in such a way that the risk of loss absorption or cash conservation would increase, we incorporate those features into the rating from the issue date. Where an external event must occur before an issuer may modify the instrument, we do not typically incorporate the potential change in the terms of the instrument into the rating.

58. Payment-in-kind (PIK) instruments (including toggle notes) are typically not subject to notching for the risk of loss absorption or cash conservation, as the imputed promise will not generally be breached before the instrument's maturity date. However, if a PIK instrument's terms and conditions create an imputed promise that the investor will receive payments in cash during the instrument's life (and these payments can be deferred), we typically treat the feature as equivalent to cumulative coupon deferability and notch as if the instrument contained such a deferability feature.

59. We cap at 'CCC' our rating on a hybrid instrument that has a contingent capital trigger leading to common equity conversion or principal write-down, or both, that is based on a specified rating change. Note that we do not consider a contingent capital trigger to be based on a rating change if it is based on an entity entering into bankruptcy or similar proceedings.

60. We apply "Criteria For Assigning 'CCC+', 'CCC', 'CCC-', And 'CC' Ratings," where the risk of loss absorption or cash conservation exceeds a 'B-' scenario. We first determine the likelihood of the instrument defaulting, and then adjust for subordination where relevant, subject to a floor at 'C' for subordinated instruments and at 'CC' for unsubordinated instruments. See "S&P Global Ratings Definitions" for situations where the rating on a hybrid capital or similar instrument goes to 'D'.

Rating The Hybrid Instrument: Additional Considerations For Banks

61. The criteria in this section apply to all ratable bank hybrid instruments, regardless of their equity content classification or whether they are considered part of regulatory capital. This section also applies to certain nonbank financial institution (NBFI) subsectors and PSFAs, as shown in table 3, and also gives the approach for rating bank conventional nondeferrable subordinated debt instruments that are not classified as hybrids. See "Rating The Hybrid Instrument: Additional Considerations For Banks" in Appendix A for more details, including on the use of the different steps outlined in this section.

62. To assign a rating to a bank hybrid capital instrument, we deduct notches from our starting point.

63. The sum of the total number of notches deducted in each step is deducted from the starting point to arrive at the issue credit rating on the hybrid (see table 2).

Table 2

Rating Bank And Bank Nonoperating Holding Company (NOHC) Hybrid Capital Instruments

Instrument features	Number of notches
Step 1: Standard notching	
Step 1a: Whenever an instrument is subordinated to senior unsecured debt in resolution or liquidation, regardless of its labeling, deduct notches to reflect contractual subordination. Notching does not vary for different subcategories of contractual subordination.	One notch where the starting point is 'bbb-' or above; otherwise two notches.
Step 1b: If the instrument has a discretionary or mandatory deferral clause that would lead to coupon deferral and the regulator classifies it as regulatory capital, deduct notches. This applies even if coupon deferral can only occur when a bank breaches its minimum regulatory capital requirements (see further details below).	For a regulatory Tier 1 instrument in a jurisdiction that has adopted or is planning to adopt the general provisions of Basel III or equivalent measures, deduct two notches. Otherwise, deduct one notch.
Step 1c: Identify whether the instrument has a mandatory contingent capital clause leading to common-equity conversion or a principal write-down, or both; or whether the relevant regulatory or legal framework creates the equivalent of such a clause.	Deduct one notch, in line with paragraphs 55, 70, and 71.
Step 2: Additional notching	
Step 2a: If the instrument has a mandatory going-concern trigger (either statutory or contractual) linked to a regulatory capital ratio in the form of a specific number, deduct notches as specified to factor in the difference between our expectations of a bank's regulatory ratios and the regulatory ratio level that triggers the loss absorption or cash conservation. Step 2a and Step 1c both apply for such an instrument.	If so, deduct additional notches or apply rating caps, as follows, when we expect the regulatory capital ratio to stay within a given range of the trigger or at a minimum level:
	--If 301 bps-700 bps: deduct one notch;
	--If 201 bps-300 bps: deduct two notches;
	--If 101 bps-200 bps: deduct four notches; or
	--If up to 100 bps: deduct four notches and set the issue credit rating no higher than 'CCC'.
Step 2b: Identify whether the instrument has loss absorption or cash conservation risks that neither our assessment of the starting point nor the standard notching in Steps 1a to 1c and Step 2a fully captures.	If so, deduct one, two, or three additional notches, depending on the likelihood of nonpayment on the instrument.
Step 2c: Identify whether the instrument has a contingent capital clause based on a rating change trigger that leads to common-equity conversion or a principal write-down, or both.	Refer to paragraph 59.

bps--Basis points.

Starting point for standard notching for banks and bank NOHCs

64. We assign a rating to an operating bank's hybrid capital instrument by notching down from the bank's SACP, except in the following situations, when the starting point is the ICR:

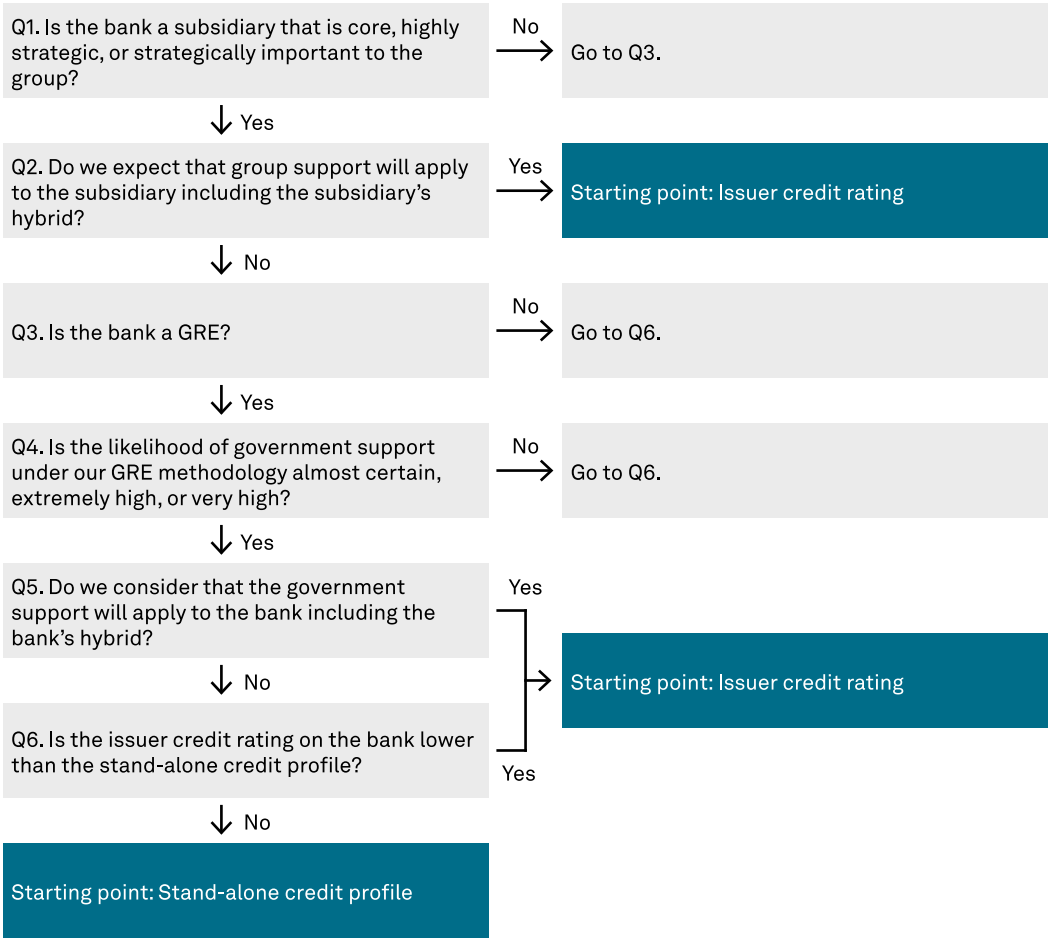
- If the bank is a subsidiary that is core, highly strategic, or strategically important, and we

expect that group support will apply to the subsidiary, including the subsidiary's hybrid;

- If the bank is a government-related entity, the likelihood of government support under our criteria "Rating Government-Related Entities: Methodology And Assumptions," is almost certain, extremely high, or very high; and we consider that the government support will apply to the bank, including the bank's hybrid; or
- If the ICR on a bank is lower than the SACP.

Chart 2

Starting point for notching an operating bank's hybrid capital instrument



GRE--Government-related entity. Source: S&P Global Ratings.

65. Where the hybrid instrument is issued by an NOHC, the starting point is typically:

- The lower of the ICR and the group SACP (subgroup SACP, if the issuer is the NOHC of a subgroup); or
- The lower of the ICR and the GCP (subgroup GCP, if the issuer is the NOHC of a subgroup).

66. The starting point for the NOHC hybrid is, however, the GCP (subgroup GCP, if the issuer is the NOHC of a subgroup), if:

- The ICR of the operating entity (in the relevant group or subgroup) is the starting point for an equivalent hybrid issued by the operating entity; and
- We expect that external support in the GCP will apply to the NOHC hybrid.

Standard Notching

67. For all bank hybrid capital instruments, our notching methodology starts with standard notching, which is the sum of:

- Step 1a: Notching for contractual subordination;
- Step 1b: For the risk of a partial or untimely payment; and
- Step 1c: Where applicable, for a mandatory contingent capital clause leading to conversion into common equity, a principal write-down, or both.

68. **Further details on step 1b:** We deduct one notch in the following cases:

- A Tier 1 instrument that is not subject to Basel III;
- A Tier 2 instrument that has a deferrable coupon;
- A legacy Tier 1 instrument that is not subject to the general provisions of Basel III (or equivalent rules) or where the issuer is not in a jurisdiction that plans to adopt Basel III or any equivalent measures;
- A deferrable instrument issued by a company that is not subject to Tier 1 or Tier 2 regulatory capital classifications; or
- A hybrid instrument that has restrictions preventing coupon nonpayment.

69. We deduct two notches in the following cases:

- A regulatory Tier 1 instrument issued by a bank that is subject to, or in a jurisdiction that plans to adopt, the general provisions of Basel III or equivalent rules;
- A legacy Tier 1 instrument that is now subject to Basel III or equivalent rules;
- A Tier 2 or other hybrid instrument for which coupon deferral risk is linked to a Tier 1 instrument; or
- A hybrid instrument for which Basel III provisions apply or will be adopted, even if it has a restricted ability to defer coupon payments.

70. **Further details on step 1c:** We deduct one notch for going-concern or NVCC clauses unless:

- We anticipate that the regulatory environment is such that the bank is likely to receive pre-emptive extraordinary government support if it is in distress, at a relatively early stage of its deterioration; and
- The regulator's statements suggest that such pre-emptive government support would not constitute a nonviability event and would therefore not lead to a principal write-down or equity conversion of the hybrid.

71. We would not typically deduct a notch for Tier 3 or similar instruments that are only subject to write-down or conversion in a resolution.

Additional Notching

72. Additional notching is applied to address the following risks:

- Step 2a: The instrument has a statutory or contractual mandatory going-concern trigger that is linked to a specific regulatory capital ratio, expressed as a number.
- Step 2b: Loss absorption or cash conservation risks that are not captured elsewhere in our assessment.
- Step 2c: Contingent capital clauses based on a rating change.

73. **Further details on step 2a:** We deduct further notches in line with the capital ratio ranges shown under step 2a in table 2 if the trigger results in deferral of coupons, or is a contingent capital trigger that leads to a principal write-down or conversion into common equity.

74. In these cases, the deduction reflects the difference between our expectations of a bank's regulatory ratios and the regulatory ratio level that triggers the loss absorption or cash conservation, based on the lowest regulatory capital ratio we expect for the subsequent 12-24 months, or a higher capital ratio if we strongly expect that capital will strengthen imminently in response to actions the bank has announced.

75. We consider a trigger that relates to compliance with a minimum regulatory capital requirement to maintain a banking license to be a nonviability trigger, in which case step 2a does not apply.

76. **Further details on step 2b:** We deduct up to three notches for loss-absorption risks that the standard notching and step 2a do not capture, depending on the likelihood of loss absorption on the instrument.

77. We cap our rating on a hybrid issued by a bank subsidiary of an operating bank at the level we would rate an otherwise identical hybrid issued by the parent bank (even if no such hybrid has been issued). We would not cap the rating at the level of the rating on an otherwise identical hybrid issued by an NOHC in the banking group. We also do not cap the rating on the subsidiary's hybrid if the ICR on the subsidiary is higher than that on the parent bank.

Nondeferrable subordinated bank debt (NDSD)

78. We classify NDSD (see "Bank nondeferrable subordinated debt (NDSD) hybrids" in Appendix A for more details) as hybrids, and rate it using the steps outlined in table 2 (including the relevant starting points) if the instrument:

- Has a contractual or statutory mandatory contingent capital feature that enables it to absorb losses before a legal default of the issuer; or
- Constitutes part of a bank's regulatory capital and has a higher default risk than the bank's senior debt due to a discretionary contractual or statutory contingent capital feature or resolution regime arrangements.

79. Conventional bank NDSD is not classified as a hybrid. See "Financial Institutions Rating Methodology" for the criteria for assigning ratings to these instruments.

Rating The Hybrid Instrument: Additional Considerations For MLIs And Multilateral Insurance Institutions

80. We apply the "Rating The Hybrid Instrument: Additional Considerations For Banks" section, including the starting point and notching approach in table 2 and associated text. MLI hybrids are therefore rated with reference to the SACP of the entity, except in the cases outlined in that section. Hybrid instruments do not, in our view, transfer or extend the preferred creditor status of the MLI to the hybrid investors, even if/when converted into common equity.

81. For step 1b, we deduct one notch if the entity is not subject to Tier 1 regulatory capital measures.

82. For step 1c, we generally deduct a notch for the principal write-down feature.

83. We apply step 2a using an MLI equity-to-assets ratio if the entity is not subject to a regulatory capital ratio.

SECTOR CLASSIFICATION OF CERTAIN FINANCIAL SERVICES SUBSECTOR ISSUERS AND PSFAS

Table 3

Subsectors As Defined In The Glossary

	Which section of the hybrid criteria to apply?		
	For equity content categorization	**For incorporating equity content category into issuer credit analysis**	**For rating the issue**
Financial services companies			
Financial services finance companies (FSFC) that are prudentially regulated	Cross-sector	Corporate	Bank
Other FSFCs	Cross-sector	Corporate	Corporate
Asset managers	Cross-sector	Corporate	Corporate
Certain financial market infrastructure companies (FMI)*	Cross-sector	Corporate	Bank
Other FMIs	Cross-sector	Corporate	Corporate
Nonbank financial institutions (NBFI)			
NBFI finance companies	Bank	Bank	Bank
NBFI securities firms	Bank	Bank	Bank
U.S. business development companies	Bank	Bank	Bank
Larger securities firms	Bank	Bank	Bank
Nonprudentially regulated holding companies of an insurance group	Cross-sector	Insurance	Insurance
Alternative investment funds (AIF)			
Alternative investment funds	Cross-sector	Corporate	Corporate

Table 3

Subsectors As Defined In The Glossary (cont.)

	Which section of the hybrid criteria to apply?		
	For equity content categorization	**For incorporating equity content category into issuer credit analysis**	**For rating the issue**
Non-U.S. public-sector funding agencies (PSFAs)			
Non-U.S. public-sector funding agencies	Bank	Bank	Typically Bank

For other issuers that have a banking license, but where we do not use our bank criteria to assign the ICR and SACP, we generally use our bank criteria to rate the hybrid issue and the sector-specific criteria consistent with that used for the ICR/SACP to assess equity content. *Certain FMIs refers to those FMIs that are subject to Basel capital guidelines and have banking operations, however limited, and their holding companies that are prudentially regulated.

APPENDIXES

APPENDIX A: ADDITIONAL DETAILS ON THE CRITERIA APPLICATION

84. This appendix provides additional information related to the main body of this criteria article. It is intended to be read in conjunction with those criteria in the main body.

Equity Content--General Framework

Stress scenarios

85. We consider hybrid instruments as having equity content, despite their debt-like features, because they can absorb losses or conserve cash in stress scenarios, to the benefit of more senior creditors.

86. Examples of stress scenarios could include the following situations:

- The issuer has experienced a significant decline in creditworthiness, for example, into the 'B' rating category.
- An issuer initially rated in the 'B' category is now having difficulty accessing alternative sources of capital as a result of company-specific or market-related issues.
- For a bank that had an SACP of 'bbb-' or higher at the time of issuance, we generally expect its going-concern hybrid capital instruments to absorb losses early enough for the bank to maintain an SACP of at least 'b+'.

Hybrid redemptions/repurchases and replacement

87. Generally, we consider that redemptions negate the potential availability of hybrid issuance to absorb losses or conserve cash. Accordingly, the factors we consider when assessing redemption of a hybrid include the reason why the issuer chose to redeem the instrument. In particular, we assess what the redemption tells us about the issuer's intent to maintain the ability and availability of the hybrids to absorb losses and conserve cash, the use of hybrids within the

issuer's capital structure, and the potential impact on the issuer's creditworthiness.

88. When assessing hybrid redemptions, we do not consider that hybrid replacement is necessary when the redemption amount is immaterial in the context of the issuer's credit profile. Further, we typically consider redemptions of up to 10% over any 12-month period of aggregate hybrids outstanding, and up to 25% over any 10-year period, to be immaterial; therefore, they would not require replacement. We may allow for a higher percentage where we consider there has been a transformational divestment in the company and such redemption would have no or minimal negative impact on creditworthiness.

89. That said, our assessment also considers the credit effect of any redemption on an individual issuer's overall credit profile, and we assess the issuer's intent in redeeming the hybrids. If we anticipate the redemption will have a materially negative effect on an issuer's credit profile, a redemption without replacement may undermine our view of the equity content of the issuer's existing and future hybrids, even if the repurchase amount is within these guidelines.

90. In practice, for corporate and other nonprudentially regulated issuers (excluding nonprudentially regulated insurance holding companies), we consider a mix of 50% common equity and 50% debt to be an acceptable alternative to refinancing with 100% hybrid capital, for hybrids receiving intermediate equity content.

91. For example, consider a corporate issuer that has a $1 billion intermediate equity content hybrid which can be called now, plus several other hybrids that we classify as having intermediate equity content. The issuer calls the $1 billion intermediate equity content hybrid, and funds the call and replaces the instrument with $500 million of common equity and $500 million of nonhybrid debt. This financing would not lead us to question issuer intent and the intermediate equity content classification on the other hybrids (all other things being equal) because the issuer has replaced the hybrid with $500 million of common equity.

92. **Timing of issuance of a replacement hybrid:** A replacement hybrid can be issued up to or on the date the original hybrid is redeemed. We must be confident that it is being issued to replace the original hybrid, and that it otherwise qualifies for intermediate or high equity content. A new issuance of common equity can also be used to replace a hybrid.

93. **Terms and conditions:** A replacement hybrid need not have the same terms and conditions as the original instrument to qualify for intermediate or high equity content. For example, a hybrid with a noncall period of 10 years could be replaced by a hybrid with a noncall period of five years, assuming the replacement hybrid otherwise meets the criteria for intermediate equity content. If the original hybrid had intermediate equity content, the replacement hybrid must have intermediate or high equity content, or be a new issuance of common equity.

94. **Assessing equity content when an exchange or tender offer does not receive 100% take-up:** In the following examples, we are indifferent as to whether the redemption takes place as an exchange or a tender offer.

95. Consider, for example, a situation where an issuer issues a $1 billion replacement hybrid two years before the five-year, first call option date on an existing $1 billion intermediate equity content hybrid, and then immediately tenders for the original instrument, but attracts only 50% take-up under the tender offer. If we are confident that the replacement instrument is intended to replace the original instrument, and it meets our criteria for intermediate equity content, we would ascribe intermediate equity content to the full amount of the new hybrid.

96. The residual amount of the original hybrid would be regarded as having no equity content if we expect the issuer to redeem the remaining amount at the call date or repurchase it before the call date. Such a scenario would not adversely affect our view of the equity content of the group's

other existing or future hybrid issuances, all other things being equal.

97. Consider, for example, a situation where an issuer undertakes an exchange offer with an existing $1 billion intermediate hybrid two years before a five-year first call date, but attracts only 80% take-up under the exchange offer:

- If the new instrument qualifies for intermediate equity content and we consider that the issuer remains committed to maintaining the total $1 billion of hybrid capital as a permanent part of its capital structure, we would generally continue to maintain intermediate equity content on both the remaining portion of the existing instrument and the new instrument.
- If, on the other hand, we expect the total outstanding amount of hybrid capital to reduce, we could reassess issuer intent toward its hybrid capital instruments, depending on the magnitude and potential impact on the issuer's creditworthiness.

98. **Assessing equity content if instruments remaining outstanding following an exchange or tender offer are redeemed without replacement:** If, for example, 20% of a hybrid remains outstanding following an offer and is redeemed without replacement, this would not necessarily disqualify the issuer from intermediate or high equity content on all current and future hybrids. The level of equity content for the replacement hybrid would depend on our assessment of the feasibility of replacing the residual hybrid amount and the impact on the issuer's credit profile of not replacing it. If we consider that due to the size of the residual amount, it is not practical to issue equity or to raise a new hybrid as a replacement, we may continue to assign intermediate or high equity content to the issuer's existing and future instruments. However, this would assume that the reduction in hybrid capital is immaterial to the issuer's credit profile, and that the issuer's intentions toward its remaining hybrid capital remain supportive.

99. To illustrate this further, if we assume that the initial instrument was $250 million, and hence, the residual 20% was $50 million, we may consider it unfeasible to raise equity or issue a replacement instrument for the remaining amount. Accordingly, assuming that a redemption without replacement would have no material impact on the issuer's credit profile, we may continue to ascribe equity content to the issuer's existing and future hybrids. However, if the initial instrument was $1.5 billion, and the remaining 20% was $300 million, we would be less likely to consider redemption without replacement as consistent with having intermediate equity content.

100. **Replacing a hybrid with a larger instrument:** If an issuer issues an intermediate replacement hybrid that is larger than the one being replaced, we may assess the equity content of the full amount of the replacement instrument as intermediate if:

- It meets our criteria for intermediate equity content;
- We do not expect the hybrid issuance to exceed any applicable limits or typical thresholds over the financial forecast horizon; and
- We consider issuer intent supportive of this assessment.

101. **Follow-on issuances:** In some cases, a hybrid we regard as having intermediate equity content may be issued, and then, several months later, the size of the original hybrid is increased by making a follow-on issuance to raise additional proceeds.

102. We generally treat all hybrid follow-on issuances (such as tap issuances and top-ups) as stand-alone issuances for the purposes of assessing equity content. Accordingly, in this case, the follow-on issuance would need to qualify as having intermediate equity content in its own right, including having at least five years from the date of issuance until the first call date.

103. **Assessing improvement of creditworthiness:** For corporate issuers (excluding nonprudentially regulated insurance holding companies), when assessing whether creditworthiness has improved, we look at the company's creditworthiness pro forma for the redemption of the hybrids and any replacement financing. We then compare that to the date when the most recent additional hybrid was issued (excluding refinancings). Although we do not require that the rating has been raised to indicate improved creditworthiness, we do not consider that marginal improvements in creditworthiness offset the impact of redeeming a hybrid without replacing the instrument to be redeemed. Furthermore, in assessing redemptions without replacement, we would typically expect at least five years to have elapsed since issuance. A shorter time frame could lead us to question whether the issuer intends the hybrids to be available to absorb losses or conserve cash when needed.

104. For bank and insurance groups subject to prudential regulatory oversight, we generally anticipate that the regulator would expect the bank or insurance group to hold certain levels of hybrid or higher-quality capital, to maintain its solvency. Therefore, if a bank or insurer (or its NOHC) calls or redeems a hybrid without replacing it, we would generally expect that its creditworthiness would not be harmed, and that the group will continue to maintain sufficient capital adequacy to support its ratings.

Hybrid instruments issued by operating companies

105. Where a group subsidiary issued the hybrid to a third party and we anticipate that the instrument's loss-absorption capabilities will benefit the group, we may include the instrument's equity content in our analysis of the GCP, if the hybrid meets the relevant criteria for intermediate or high equity content.

106. Consider an example where an insurance operating subsidiary issues a hybrid security to a third party. We would expect a close alignment of the operating subsidiary's business risks with those of the broader group. In this case, we would expect the group to benefit because the hybrid would absorb losses or conserve cash at the operating subsidiary, thus reducing or removing any need for support from the group.

Hybrids issued by nonprudentially regulated entities with one or two investors

107. In our view, issuers of hybrid securities will likely find it more difficult to defer coupon payments in times of credit stress if just one or two investors hold the hybrid series and expect to receive the entire payment. Such investors may have a strong influence, which we consider detrimental to the likelihood that the issuer will choose to defer payment to absorb losses or conserve cash for the benefit of more senior debtholders.

108. In some cases, investors in hybrids are under common control. We consider the nature and extent of that control in our assessment. For example, if several funds controlled by a single fund provider invest in a hybrid issuance, we may consider those funds a single investor.

109. We may consider hybrid instruments that have only one or two investors to have equity content if they were issued to the investors during a period of credit stress, giving rise to our reasonable expectation that the one or two investors were aware of the realistic prospect that these hybrids may be required to absorb losses or conserve cash. In this regard, we consider stress to include scenarios where the issuer would otherwise have difficulty raising capital, or we believe that, due to the credit stress facing the company, the hybrid capital is being provided on more favorable

terms than would otherwise be available. In addition, 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, 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.

Make-whole clauses

110. For hybrid instruments, the term "make whole" can be used for different types of clauses.

111. A "make-whole clause," for example, can specify a period during which the issuer may redeem the instrument by paying the net present value of future cash flows until the first call date or the maturity, in addition to the principal amount and any accrued coupons. In such cases, the net present value calculation is typically based on a discount rate that is lower than the coupon rate on a similar hybrid.

112. We do not consider that this type of make-whole clause creates an expectation that the issue will be redeemed during the make-whole period. Accordingly, we do not view it as a call feature in our hybrid analysis, even if it is referred to as a make-whole call clause in the hybrid documentation.

113. Another type of make-whole clause is designed to ensure that hybrid noteholders are compensated if the issuer subsequently issues a new instrument on terms more favorable to the new hybrid noteholders. Such a clause may push up the coupon rate on the original instrument when a similar instrument is issued with a higher coupon rate, for example. Alternatively, it may lower the conversion price for a convertible instrument when common shares are issued at a lower price. Such make-whole clauses are not consistent with intermediate or high equity content, in our view.

Equity Content Categories

High Equity Content

Mandatory convertible securities

114. If we come to believe that an MCS will not absorb losses through conversion before default or the point of nonviability, we may reassess it as having no equity content, even if we previously considered it to have high equity content. This may occur if the issuer undergoes such a precipitous decline in its creditworthiness that we no longer expect it to be able to convert the hybrid to common equity before becoming a nonviable entity.

115. In some cases, the risk of failure to absorb losses may be mitigated; for example, if the instrument has a contingent capital feature, such as a credit-related trigger that absorbs losses through conversion or some other means, and this feature would be triggered before the issuer became a nonviable entity.

Mismatched mandatory convertibles

116. Mandatory convertible instruments usually convert directly into common stock. An alternative structure, known as equity units, comprises a debt instrument and a forward contract that obliges

the investor to purchase common equity. In the mismatched equity unit version, the debt remains outstanding after the common stock issuance, and the common stock issuance raises a second set of proceeds. If we believe that the issuer will immediately use the equity proceeds to repay the debt, and it meets the other criteria for high equity content, we will assign high equity content to the equity unit at the time of the initial issuance. Otherwise, we treat the two transactions--the initial debt and the subsequent equity issuance--as separate transactions in our analysis, and would only factor in the equity issuance once it occurs.

Intermediate Equity Content

Restriction on the issuer's ability to defer payments

117. To attain intermediate equity content, the instrument must be free from features that would materially delay deferral, such as look-back or similar features that last more than a year. Other examples of such features include:

- A clause that requires coupons to be paid as long as a prudentially regulated issuer meets the minimum regulatory capital requirements to maintain its license;
- A clause that requires coupons to be paid if an issuer has sufficient distributable reserves according to the most recent financial statements;
- A clause indicating that the issuer can defer coupons when a certain condition is met (for example, the issuer can defer coupons as long as it has not made payments on junior or pari passu instruments within a set period) if any resulting delay to the deferral could be material.
- Pusher circularity--a situation where pusher clauses on two or more parity instruments refer to each other, potentially preventing deferral of distributions on any of the instruments.

Treatment of step-ups that use a floating rate

118. For a step-up where a floating rate is used, we assess the credit spread before and after switching the floating rate.

119. Consider a scenario where a fixed coupon of 954bps changes at year 10 to a floating benchmark rate plus 675bps. In this case, we consider the 10-year swap rate at issuance to be a 10-year fixed-interest base rate. Therefore, a 10-year swap rate of 504bps at issuance in our scenario implies a credit spread during the first 10 years of 450bps (= 954bps–504bps). We therefore recognize the step-up as 225bps (= 675bps-450bps).

120. In some markets or under some regulations, the 10-year swap rate (504bps, in this example) is split into the 10-year government bond yield and the swap spread. Assuming a 10-year government bond yield of 442bps, this gives a swap spread of 62bps (= 504bps–442bps). We can also represent the amount of the step-up as below, giving the same result of 225bps.

- Step-up = credit spread in the floating coupon rate after the step-up – (initial credit spread to the 10-year government bond yield – swap spread)

Replacement capital covenants and public statements of replacement intent

121. In some jurisdictions, such as Japan, RCCs are not feasible under local laws. As described in our

definition of material incentive to redeem, issuers other than financial institutions and prudentially regulated insurers in these jurisdictions, an issuer's public statement of intent regarding future hybrid replacement may mitigate steps-ups of up to 100bps for issuers rated 'BBB-' or higher (and up to 200bps for issuers rated below this level).

122. For those issuers, a statement of intent can mitigate a step-up of this magnitude in a hybrid instrument when the following conditions are met:

- The statement of intent is publicly available, typically in the indenture or agreement of the hybrids and in one of the following: the issuer's annual report, an individual press release, or a statement issued at a public investor relations meeting; and
- Any step-up of more than 25 bps will not occur before year 10 and there is no call option before year five.

Look-back periods

123. The concept of the look-back period applies not only to pushers but also to cases where an issuer can choose to defer after breaching certain financial tests. For example, the terms and conditions provide that the issuer may defer payment of interest on a hybrid when it has reported losses in two consecutive years. In practice, this means that the issuer can't defer interest for more than a year after it starts to generate losses. We consider this equivalent to a look-back period of more than one year.

124. When we calculate the length of any look-back period, our calculation typically starts from the date of the last payment on, or repurchase of, a junior or pari passu instrument mentioned in the look-back or pusher clause. Also, our calculation extends only until the last hybrid payment date when the pusher pushes the issuer to pay.

125. For example: A hybrid includes a three-month look-back based on common dividend payments. The hybrid pays in arrears on Jan. 1 and July 1 of each year, and the issuer typically pays common dividends on Jan. 2, April 2, July 2, and Oct. 2. On April 2, 2016, it pays a common dividend. On April 3, the company's business prospects suddenly worsen and the issuer considers deferring payments on the hybrid. However, the pusher clause requires the issuer to pay on the hybrid on July 1 because it has made the April 2 common dividend payment. Therefore, assuming the company pays no further common dividends, it will not be allowed to defer payments on the hybrid until Jan. 1, 2017. As such, the first nonpayment date on the hybrid will occur almost nine months after the previous common dividend payment, or 12 months from the hybrid payment on Jan. 1, 2016. However, we interpret this as a three-month look-back, from April 2, 2016, until July 1, 2016, not a nine-month or 12 month look-back.

Features that mitigate concerns about APM usage

126. A timely payment APM gives the issuer an incentive to repurchase the stock issued under the APM. Therefore, we typically consider that a hybrid with this feature has no equity content unless it prohibits repurchasing of the stock for at least 12 months from the cure date.

127. Coupled with an optional deferral feature, we consider that a settlement APM discourages issuers from deferring coupon payments. Therefore, we typically consider that a hybrid with this or a similar feature has no equity content.

128. A hybrid instrument that has a settlement APM may achieve intermediate equity content if it incorporates adequate protection to limit the extent of potential equity dilution, such as in the following examples:

- Where the APM requires the issuer (whether legally or on a best-effort basis) to settle any optionally deferred payments by issuing a new instrument, such requirement does not occur prior to five years after the initial deferral and the new issuance;
- If the APM requirement to issue a new instrument occurs only when the issuer chooses to settle after the optional deferral at any time but (1) common shares that are required to be issued for such optional settlement are limited to a maximum 2% of the total number of shares outstanding during the period the deferral continues and (2) additional hybrids that are required to be issued for such optional settlement are limited to a maximum 25% of the initial hybrid principal amount.

Treatment of contingent capital instruments that have mandatory conversion features issued by Australia-regulated financial institutions and insurers

129. Contingent capital instruments that have mandatory conversion features that have been issued by a regulated Australian financial institutions or insurance entity, or a New Zealand financial institution or insurer that is a subsidiary of such an Australian group can generally be eligible for intermediate equity content, on the basis of the current applicable regulatory framework, if they meet all of the following characteristics, even when there are more than three years remaining to the mandatory conversion date:

- The conversion price floor cannot be below 50% of the common share price at the time of the initial issuance;
- The ICR is 'BBB-' or higher;
- The underlying instrument is preferred stock or its equivalent;
- Absent the conversion feature, the instrument would qualify as intermediate equity content under our criteria;
- We expect that the issuer will not reverse the share issuance (via conversion) with share repurchases; and
- We expect that the regulator intends that the issue will remain a component of the issuer's capital base for a long time, both before and after conversion.

130. We could extend this treatment to other jurisdictions in the future if the regulatory expectations are similar to those in Australia.

No Equity Content

131. An instrument that we classify as having no equity content is generally treated as akin to debt in our analysis of the issuer's credit profile. However, if a rating committee considers that a hybrid with no equity content provides a meaningful incremental benefit to an issuer's credit profile, beyond that of traditional debt, our analysis may still incorporate these benefits.

132. For example, if a corporate entity has issued a hybrid that has material credit-supportive features, but no longer qualifies as having intermediate equity content because its effective maturity date is less than 20 years away, we may reflect the benefits of the hybrid in other aspects of our corporate methodology. Similarly, if a corporate hybrid with no equity content includes a PIK feature that is being utilized, and we consider that this materially benefits the issuer's credit profile, we may focus our analysis of the issuer's financial risk profile more heavily on certain supplemental ratios, such as funds from operations cash interest coverage.

Real estate investment trust (REIT) hybrids

133. We typically assign no equity content to hybrids issued by a REIT or a similar tax-driven ownership structure if the instrument includes a dividend stopper that requires that ordinary dividend payments must be stopped before the hybrid coupon can be deferred. In our view, the loss of favorable tax treatment that would result from a failure to distribute taxable income if the dividend stopper was triggered would more than outweigh the cash flow benefit of any coupon deferral. We consider that this gives the issuer a strong incentive to avoid coupon deferral on the hybrid instrument, or to redeem it before deferring hybrid coupons.

134. That said, we may assess REIT hybrids as having intermediate equity content if the hybrid issuer can continue to distribute sufficient taxable income to ordinary unitholders to maintain the REIT's tax status, while deferring on its hybrid coupon payments.

PIK instruments

135. PIK instruments do not typically meet our criteria to be treated as having intermediate or high equity content, for a variety of reasons. In their simplest form, PIK instruments pay interest in kind for a predetermined period (which may be the life of the instrument) and are similar to zero-coupon bonds. Although such issues do not require companies to pay cash during the period, their generally steep interest rate and rapid accretion give the issuer a strong incentive to refinance the issue, undermining its availability to absorb losses or conserve cash. Moreover, issuers often issue PIK instruments to achieve a short-term objective; as such, we are typically skeptical about their willingness to maintain PIK instruments over the longer term.

136. Although PIK (or similar) instruments lack cash payments, which can help issuers to avoid cash outflows for a specified period, we generally consider that paying in kind or accreting on an ongoing basis (as opposed to only in a stress scenario) could harm an issuer's creditworthiness. If an issuer experiences any stress just before a mandatory PIK period ends, the accreted amount could exacerbate the damage to its creditworthiness. In our view, features that allow issuers to defer payments offer most benefit when the flexibility is reserved for periods of financial distress. PIK and similar instruments can also incorporate other features that undermine the potential availability and ability of the instrument to act like equity in a time of stress. For example, they may feature a dividend stopper that applies while the instrument is accreting/paying-in-kind.

Assigning An Issue Credit Rating To A Hybrid Instrument

Deferral Triggers And Impact On Notching For Corporates And Prudentially Regulated Insurance Entities

137. When hybrids have multiple deferral triggers, the notching is based on the trigger that we expect to be reached or exercised first.

138. We do not impose a limit on the number of notches that we may deduct for payment risk. Examples of where more than one notch may apply--either at issuance or later--include:

- Instruments with optional loss absorption and cash conservation, where the issuer is experiencing greater financial distress or cash availability is constrained;
- Instruments where the ICR from which it would be notched includes support that would not be attributable to the hybrid instrument; or

- Instruments that have a mandatory coupon deferral trigger that could be reached when the entity is still a going concern and that it materially increases payment risk.

139. Mandatory triggers include those related to an issuer's financial statements and financial statement metrics that can be reached when the entity is still a going concern (that is, a going-concern trigger). Examples may include features requiring coupon deferral if the issuer's earnings have been below a certain threshold, or if distributable items are insufficient to cover the coupon.

140. When rating hybrids, we consider how much payment risk is already incorporated into the ICR. We expect that as the risk of nonpayment increases--for example, as a mandatory deferral trigger point approaches or we gain increasing confidence that an optional deferral could be exercised--hybrid instrument ratings will generally follow a measured transition to default. This could come through the lowering of the ICR, resulting in a lower hybrid rating based on standard notching; the widening of the notching between the hybrid rating and the ICR; or a combination of both.

141. When we anticipate that coupon deferral is likely within the next 12 months, we apply our 'CCC' criteria to rate the hybrid instrument.

142. Where the ICR would encompass a deterioration in creditworthiness that makes a deferral more likely (for example, reduced solvency level) and would be at or close to default when a deferral trigger would be breached, then wider notching between the hybrid and ICR is not as necessary.

143. In circumstances where ICR is more resilient to these deteriorations, but the risk of default via deferral increases, then notching can widen, to manage the transition of the hybrid rating.

144. For insurance hybrids, in order to assess the relationship between ICR and hybrid rating, we consider how both would respond to stress or volatility. This is informed by a number of factors, including:

- The insurer's risk appetite and business profile;
- The actions that management could take to preserve or repair capital (for example, purchasing reinsurance or implementing hedges);
- Volatility (historical and expected) of an insurer's regulatory solvency;
- Insurer's target solvency levels and group support;
- Current and expected proximity to mandatory deferral triggers;
- Expectations regarding regulatory actions; and
- Market conditions and the insurer's operating environment.

145. Based on our understanding of these factors, we believe that certain jurisdictions, such as the European Economic Area, Switzerland, Australia, Bermuda, Canada, and the U.S., the minimum notching described in the criteria would generally be sufficient to reflect the incremental payment risk for hybrids issued by insurers with regulatory solvency ratios of at least 165%. In these jurisdictions, the capital regulatory solvency capital requirement is calibrated to a robust level (for example, it may be based on a one-in-100- or one-in-200-year confidence level).

146. For hybrid instruments issued in these jurisdictions by insurers with solvency ratios of below 140%, we anticipate that payment risk will be higher and that the rating will typically be below investment grade. Ratings may be higher than indicated above in circumstances where the factors mentioned in paragraph 63 specific to a company or a particular regulatory regime--for example, Canada's Life Insurance Capital Adequacy Test--result in solvency ratios that may be less

sensitive to shocks, or payment risk otherwise significantly less, than would typically be expected.

147. For other markets, where the regulatory solvency requirement that will trigger coupon deferrals is calibrated to a less-onerous 95th percentile confidence level, standard notching would typically apply for hybrids issued by insurers with solvency ratios in excess of 3x the trigger level. For hybrid instruments issued in these jurisdictions by insurers with solvency ratios of below 2x the trigger level, we expect the rating will typically be below investment grade. As in other jurisdictions, ratings may be higher than indicated here if company- or market-specific factors lead us to consider an issuer's solvency ratio less sensitive to shock than may otherwise be expected.

148. Conversely, we may apply wider notching when payment risk is greater than that indicated in the previous examples. Consider, for example, an 'A+' rated issuer in a jurisdiction with robust capital requirements. It has a solvency ratio of 170%, but exhibits significant exposure to catastrophe risk which could lead to material volatility in its regulatory solvency. In this situation, we may widen the notching on the hybrid rating to reflect the potential for a decline in solvency and increased payment risk.

149. For prudentially regulated insurance entities, if the predefined regulatory solvency ratio trigger is set at a level where, upon a breach or likely breach, the regulator might require or expect measures to be taken that are intended to help preserve or repair the insurer's solvency position, we would typically classify these as going-concern level triggers. For example, if an insurance operating company within a prudentially regulated insurance group issues a hybrid with a mandatory deferral trigger based on a group solvency ratio, we treat this as a going-concern trigger if it corresponds to a going concern level for the operating entity.

150. Where insurance hybrids have mandatory deferral triggers based on a group solvency ratio, we may apply a different notching to hybrids issued by an insurance holding company than we apply to hybrids issued by an operating company in the same group, if we consider the payment risk is materially different. For example, in cases where we rate an insurance holding company lower than its operating subsidiaries to reflect the holding company's reliance on distributions from operating subsidiaries to honor its obligations, we may consider a group solvency ratio trigger to be at the point of nonviability for the holding company, but at a going-concern trigger level for the operating subsidiaries. In such situations, we may consider the lower rating on a holding company's hybrids already reflects the increased payment risk and additional notching may not be required. We may also assess the holding company's other sources of income and liquidity to service the financial obligation when determining whether that trigger is set at the point of nonviability. We may also assess the holding company's other sources of income and liquidity to service the financial obligation when determining whether that trigger is set at the point of nonviability.

Starting Point For Notching For Insurance Subsidiaries Of Banking Groups

151. When the ICR of an insurance subsidiary of a banking group includes additional loss-absorbing capacity (ALAC) support, but we do not expect such support to benefit a hybrid issued by the insurance subsidiary, the starting point for notching would exclude the ALAC support.

152. Consider a situation where an insurance entity is rated 'A', based on an SACP of 'bbb' and three notches of uplift for group support as a strategically important subsidiary of a banking group. The banking group has a GCP of 'a+', which benefits from one notch of ALAC support; the group SACP is 'a'. If we determine that ALAC support does not apply to hybrid instruments issued by the insurance subsidiary, but that group support applies to the hybrid, we would remove the ALAC support in determining the starting point for notching and limit uplift for group support to one notch below the group SACP. Thus, the starting point would be 'a-'. If neither ALAC nor group

support applies to the hybrid, the starting point is the SACP--'bbb'.

Rating The Hybrid Instrument: Additional Considerations For Banks

Standard notching: Further details on Step 1b

153. We deduct a notch for a hybrid with restrictions on coupon deferral because these instruments offer a bank the legal right to defer paying coupons.

Standard notching: Further details on Step 1c

154. We deduct a notch where we consider a mandatory contingent capital clause applies. Such a clause may be included in an instrument's documentation or the relevant regulatory or legal framework may imply an equivalent clause. We do not deduct a notch if a contractual clause is discretionary and we do not expect regulators to enforce it.

155. The deduction would generally apply to Tier 3 instruments when we consider that there is incremental default risk due to the instrument's possible conversion or write-down relative to the default risk represented by the SACP. For example, we would typically not apply the 1c notch if the Tier 3 instrument was only expected to absorb losses after the full conversion or write-down of more junior instruments, including Tier 1 and Tier 2 regulatory capital instruments, and if the bank's SACP adequately captured the Tier 3 instrument's risk of conversion or write-down.

Additional notching: Further details on Step 2a

156. Examples of a mandatory going-concern regulatory capital-based trigger described as a specific regulatory capital ratio include where the hybrid documentation states the loss absorption on an instrument is mandatory if a specified capital ratio falls below a defined level expressed as a number, for example, 10%, or where the regulation or legislation defines a mandatory loss absorption trigger ratio as a number, such as 10%.

157. We typically treat the entry of a capital ratio into a regulatory capital conservation buffer range as a discretionary trigger. The notching for this risk is in step 2b instead of step 2a.

Additional notching: Further details on Step 2b

158. Where we see risks such as those listed below, and we consider that these are not fully captured in the starting point or the standard notching or step 2a, we typically deduct one notch, but can increase this to two or three notches, depending on our view of the likelihood of the clause being triggered.

- If reporting a loss in a particular accounting period leads to mandatory deferral on an instrument and prevents the bank from using its reserves to offset the impact of the loss;
- If a bank is at risk of insufficient distributable reserves for a regulator to permit payment on a hybrid capital instrument--even though nondistributable reserves are available;
- If there is a risk of a statutory or regulatory ruling that prohibits or restricts coupon payments, as has occurred, for example, when the European Commission required banks to stop coupon payments or otherwise bail-in bank hybrid capital instruments after ruling that the banks had received state aid;

- If we see a heightened risk of a bank or regulator activating a discretionary deferral clause. For example, when a bank's regulatory capital position means that it is at heightened risk of being subject to restrictions on capital distribution applicable for ratios within the ranges specified by Basel III's conservation buffer. This notching typically applies only to hybrids issued by banks whose regulatory capital levels are within the buffer ranges. However, we would also apply this notching if we see a heightened risk that a bank's regulatory capital will fall into the capital conservation buffer range that applies to that bank, and that this would trigger a decision by the bank or regulator to stop payments; or
- If we see an increased likelihood of default for a hybrid issued by an NOHC because: 1) we believe there is an heightened probability that the dividends or coupons the NOHC relies on to service its instruments will be curtailed; 2) the NOHC has a higher likelihood of regulatory intervention that would be detrimental to creditors than the operating bank; or 3) the starting point is the GCP or Group SACP rather than the ICR and has not fully reflected the increased likelihood of default arising from the NOHC's structural subordination.

Bank nondeferrable subordinated debt (NDSD) hybrids

159. We rate bank NDSD as hybrids in countries where the regulatory and legal frameworks, including bank resolution regimes, could cause NDSD debt to be converted into bail-in capital, or cause untimely or partial payment of coupon or principal without provoking a legal default or the bank's liquidation. In such jurisdictions, the government is unlikely to support the payment of NDSD, even though it may support a bank's senior debt.

160. Consequently, we use the section under the heading "Starting point for standard notching for banks and bank NOHCs" to determine the appropriate starting point for the issue credit rating on NDSD that is considered a hybrid. To determine whether Table 2 applies for a bank NDSD, we assess whether the legal and regulatory frameworks allow the authorities to instigate restructuring of a failing bank to the detriment of the NDSD holders.

161. For example, in some jurisdictions, the authorities could order the write-down of principal or transfer a nondeferrable subordinated instrument to a different legal entity from that carrying the senior debt, while also protecting the senior creditors. Such flexibility may be written into legislation, or be indicated by previous regulatory actions or the statements of those authorities.

162. Although the authorities may have power to force a default on NDSD to protect senior creditors in some jurisdictions, as described above, it may be uncertain whether they will use this option. In rare circumstances, a government may indicate its intention to prevent losses on NDSD. Under our rating methodology, we would then notch down from the ICR, instead of from the SACP.

APPENDIX B: GLOSSARY

Alternative coupon-settlement mechanism (ACSM)/alternative payment mechanism (APM): A provision that:

- Requires the issuer (usually on a best-effort basis) to settle deferred payments (resulting from either a mandatory or optional deferral feature) with the proceeds of issuing a new instrument ("settlement APM"), or
- Allows the issuer to avoid a mandatory deferral by issuing a new instrument before the hybrid payment date and using the proceeds to make timely hybrid payment ("timely payment APM").

The terms ACSM and APM are interchangeable.

Banks: As used in this criteria, includes banks, other deposit-taking institutions (including entities such as building societies), finance companies, bank nonoperating holding companies, and securities firms.

Basel III or equivalent measures: A regulatory framework that includes a regulatory capital buffer for banks, defined using a range of ratios. Under such a framework, as soon as a bank's regulatory capital ratio falls within the buffer range, it is required to reduce or restrict distributions on its capital instruments.

Callable/call option: Allows the issuer to redeem a hybrid capital instrument at a specified price at a specified time. Our assessment of equity content is not affected where an instrument is callable following an external event.

Callable capital: A common, but not universal, characteristic of MLIs and multilateral insurance institutions that refers to the portion of the entity's capital subscriptions that is not "paid-in" but that each shareholder has committed to provide in certain circumstances (generally, only to prevent a default on an MLI's debt). It therefore differs from hybrid capital that is paid-in by investors when the hybrid instrument is issued.

Contingent capital: An instrument that absorbs losses by converting into common equity or writing down principal following activation of a trigger. The conversion or write-down may be mandatory or optional and the trigger may be activated while the issuer is still a going concern (going-concern contingent capital) or in a nonviability situation (nonviability contingent capital).

Conventional nondeferrable subordinated debt for a bank: A nondeferrable subordinated instrument that has the same default risk as senior debt, has no contingent capital clause, and does not absorb losses before a legal default of the issuer.

Defer, deferability, and deferral: As used in this criteria article, refers to all cases where coupon payments are cancelled, not paid, or only partially paid on the payment date. This applies when timely full payment is at the issuer's discretion or prohibited either under the terms of the instrument or by the regulator.

We use these terms to cover situations where payments are suspended and the issuer is obliged to at least make efforts to settle the cumulative deferred payments, as well as cases where payments are cancelled, omitted, or forgone and the issuer is not obliged to make any attempt to settle the payment, once deferred.

Dividend stopper: Prevents an issuer from making payments on, or repurchasing pari passu or more junior instruments after deferring payments on a hybrid instrument, unless it has cured the arrears and resumed payments on the deferred instrument.

Effective maturity: The effective maturity of an instrument is the earlier of the following:

- The legal maturity date.
- The date at which an investor put option or similar feature is exercisable.
- The scheduled maturity date. We recognize a scheduled maturity as the effective maturity if the terms require an issuer to take all commercially reasonable effort to refinance an instrument on a particular date and to repeat the attempt periodically if the issuer is unsuccessful at refinancing the issue.

- The date on which there is a Material Incentive To Redeem the instrument.
- The date when our view of issuer intent leads us to consider redemption likely, even without a material incentive to redeem, and to consider replacement with an equal or higher equity content instrument unlikely.

Equity unit: A type of mandatory convertible security, structured as a unit, that combines two components:

- A forward contract that requires the investor to purchase--and the company to sell--the company's common shares at a predetermined price (or formula); and
- A company's debt (or preferred stock) security with a maturity or call date that may or may not match the common stock issuance date under the forward contract.

External event: External events include:

- Changes to tax law that result in the loss of tax deductibility of interest on a hybrid instrument or increase the withholding tax payable;
- Accounting changes that affect the initial equity classification of the instrument;
- Regulatory changes that reduce equity content or capital eligibility;
- Revisions to rating agency criteria that reduce the instrument's equity content; and
- Changes in control.

Tax law, accounting, and regulatory changes are considered external events unless a change has been announced at the date of issuance that we expect to affect the hybrid issuance on implementation.

Going concern: Generally refers to an issuer that is able to function; has enough resources to continue to meet its financial obligations as they fall due; and, in the case of prudentially regulated financial services entities, doesn't face the threat of liquidation, insolvency, or nonviability. If an issuer is not nonviable, we consider it a going concern.

Hybrid documentation: The material that we examine when reviewing the structure of a hybrid instrument. It includes, but is not limited to, the hybrid offering circular, prospectus, and the information memorandum or agreement that contains the legal terms and conditions of the hybrid. We also review associated documentation that is relevant to how the issuer will use the instrument, such as guarantees, deeds, waivers, covenants, and other contractual and transactional documentation. Documentation for other hybrids from the same issuer (or a group member) may be relevant if the instruments are linked. We also review published statements that do not constitute part of the legal terms and conditions, but that influence issuer behavior (such as language relevant to replacement intent). This body of material establishes the features of the instrument and whether it could be eligible for equity content.

Look-back and look-back period: A hybrid capital instrument feature, also referred to as a pusher or mandatory payment provision, that prohibits the issuer from deferring coupons on the hybrid instrument for a specified period (the look-back period) after a certain event. Possible events include payment of a dividend on, or repurchase of, common equity or any instrument ranked pari passu with the hybrid instrument. A particular risk is that look-back clauses on two or more parity instruments may refer to each other, which could prevent deferral of distributions on

any of these instruments (look-back circularity).

Mandatory convertible securities (MCS): Securities that will be converted automatically into the issuer's common equity upon a predetermined date. MCS also includes equity units. In either case, the initial instrument could either be a loss-absorbing instrument or debt with fixed payment obligations. If an instrument mandatorily converts into common equity upon breaching a specific trigger, we consider the instrument to be a hybrid contingent capital instrument.

Material incentive to redeem: We consider the date on which the issuer has a material incentive to redeem a hybrid instrument on a particular date or event to be the effective maturity of the hybrid instrument.

Examples include:

- A discrete call followed by an extended noncall period. For example, an instrument that has a call option on a specific date and is not callable for more than five years thereafter.
- A material increase in the cost of servicing the instrument, for example, by materially increasing the coupon rate or credit spread (such a feature is often referred to as a step-up). This may include implicit step-ups linked to changes in the benchmark interest rate.

We assess coupon rate step-ups using the sector-specific approach below (see "Treatment of step-ups that use a floating rate" in Appendix A for our treatment of step-ups that use a floating rate). If the coupon rate steps up multiple times, we assess the cumulative effect.

For banks, we consider that any step-up constitutes a material incentive to redeem. For corporates and insurers, the incentive to redeem is material at a step-up of:

- Above 100 basis point (bps) for issuers rated 'BBB-' or higher, and above 200 bps for issuers rated 'BB+' or lower, in all cases regardless of whether it is mitigated by a Replacement Capital Covenant (RCC), or by issuer statements regarding intention to replace the hybrid; or
- 26 bps-100 bps (or 26 bps-200 bps for issuers rated 'BB+' or lower) unless it is mitigated by an RCC, or by an issuer's public statement of intent regarding future hybrid replacement in jurisdictions where RCCs are not feasible under local laws (see "Replacement capital covenants and public statements of replacement intent" in Appendix A for more details). For prudentially regulated insurers, an RCC is necessary when step-ups of this magnitude occur within the first 10 years of issuance. When market spreads rise dramatically, 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.

Nonviability: Generally applies to a prudentially regulated financial services entity that is in breach of, or about to breach, prudential regulatory requirements that could result in regulatory actions such as a withdrawal of its license, a required cessation of business, or a regulatory determination that the issuer is nonviable. See "contingent capital" for "nonviability contingent capital" (NVCC).

Payment-in-kind instruments: An instrument that can pay interest in kind. Typically issued by corporates rated 'BB+' and lower, PIK instruments have several forms. In the simplest form, PIK instruments pay interest in kind from the outset and for the life of the instrument. Instead of interest being paid in cash, the investor receives more of the same note, or the note's principal is increased, in accordance with the terms. Some PIK instruments initially require that the issuer make interest payments in cash, but allow a switch to paying in kind under certain circumstances.

Others initially require payment in kind, and switch to cash after a specified period. Toggle notes are another form of PIK instrument, for which the issuer can choose to switch between paying interest in cash or in kind.

Prudentially regulated entities: Companies (or groups of companies) that are subject to regulation and supervision that includes assessment of the adequacy of their capitalization.

Pusher: In a hybrid capital instrument, typically refers to a feature where any payment on, or repurchase of, a junior or pari passu instrument during a certain period (the "look-back period") would require, or "push," the issuer to continue timely payment on a hybrid. Most pushers are economically equivalent to a look-back feature. Some instruments use the term to mean a clause under which, if the issuer makes any payment on, or repurchases, junior or pari passu instruments, it must settle any payments it has already deferred on the hybrid instrument. This is often referred to as a "settlement pusher." We do not use the term "pusher" in this way. A settlement pusher feature does not restrict the issuer's ability to start deferring interest and does not create any circularity. Table 4 compares settlement pushers, look-back features, and common Dividend Stoppers.

Table 4

Comparison Of Common Dividend Stoppers, Pushers (Of Timely Payment)/Look-Backs, And Settlement Pushers

Hybrid features	Trigger event	Effect	Impact on equity assessment
Common dividend stopper	Deferral on hybrid	No common stock dividend	Neutral in general, potentially negative for real estate investment trusts
Pusher (of timely payment)/Look-back	Repurchase of or payment on junior or pari passu instrument	Obligation to make timely payment on hybrid	Negative if look-back exceeds one year or creates circularity
Settlement pusher	Repurchase of or payment on junior or pari passu instrument	Obligation to settle already deferred hybrid payment, if any	Neutral in general

Redemption: A hybrid is redeemed when the issuer repays the principal and retires the instrument. In this article, the words "redeem" and "redemption" refer to repayment of principal before the official maturity date, unless specifically noted otherwise, and include a repurchase of the instrument, except in the context of call options. An issuer may repurchase an instrument through a buyback on the open market, a tender offer, or an exchange with another instrument.

Replacement capital covenant (RCC): A legally binding commitment to replace a redeemed hybrid with a new instrument of equal or greater equity content.

Sliding step-up: A feature where a step-up date is altered following a defined event, such as a rating change. Step-up dates may slide in to an earlier date or slide out to a later date. Alternative names for such a feature include a dynamic step-up date.

Step-up: A feature where the coupon rate or credit spread on a hybrid capital instrument increases at a future date, usually as an incentive for the issuer to call the instrument. We typically calculate the step-up as the difference in the credit spread where a rate resets during the life of the instrument.

Tier 1, Tier 2, and Tier 3 instruments (banks only): Tier 1 and Tier 2 are prudential regulatory classifications of hybrid capital instruments and are used to determine how the instrument may be included in regulatory capital measures. Tier 3 is not always a regulatory classification. It can also refer to instruments that the issuer has structured to be senior to Tier 1 and Tier 2 instruments, but junior to senior unsecured instruments, in the event of a resolution.

Where a regulator does not classify a nonbank financial institution's instruments as being Tier 1 or Tier 2 capital, although they are classified as being part of regulatory capital, the concept becomes irrelevant to our determination of equity content. We therefore classify the instruments as having high, intermediate, or no equity content based on whether they are otherwise consistent with the characteristics of these equity content categories. If the regulator were to introduce these concepts, we would reclassify the equity content of these instruments accordingly.

Toggle note: A specific type of PIK instrument designed to facilitate switching back and forth between cash payments and PIK distributions, at the issuer's discretion. The issuer increases remuneration during those periods when it pays interest in kind.

KEY CHANGES

- A hybrid is no longer eligible for high or intermediate equity content if it has a feature (such as a sliding step-up date) that revises the effective maturity to an earlier date if the issuer is downgraded. If a downgrade happens, the hybrid could lose equity content sooner than it would have without the feature, which could reduce the issuer's flexibility to manage its refinancing and call decisions in a stress scenario. In particular, such a feature could make investors more likely to expect that, even after a downgrade, a hybrid issuer would still exercise its call option on the first call date.
- We amended paragraphs 15 and 29 to address this topic. We also added a definition of a sliding step-up to the glossary section.
- We have not changed our treatment of hybrids that have a sliding step-up feature that pushes the effective maturity date out to a later date if the issuer is upgraded, as long as the date cannot subsequently slide back in.

IMPACT ON OUTSTANDING RATINGS

We expect nine hybrid capital instruments, issued by three corporate entities, to be reclassified as having no equity content, rather than intermediate equity content. Based on our preliminary testing, we don't expect any impact on our issuer credit ratings on these entities, or on our issue credit ratings on the hybrids, as a direct result of the criteria change.

RELATED PUBLICATIONS

Fully Superseded Criteria

- Hybrid Capital: Methodology And Assumptions, March 2, 2022

Related Criteria

- Alternative Investment Funds Methodology, Aug. 30, 2024
- Methodology For Rating Non-U.S. Public-Sector Funding Agencies, July 26, 2024
- Multilateral Lending Institutions And Other Supranational Institutions Ratings Methodology, July 26, 2024
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- Insurer Risk-Based Capital Adequacy--Methodology And Assumptions, Nov. 15, 2023
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Contact List

ANALYTICAL CONTACT

Gregg Lemos-Stein, CFA
New York
+ 212438 1809
gregg.lemos-stein@spglobal.com

ANALYTICAL CONTACT

Eric Tanguy
Paris
+ 33 14 420 6715
eric.tanguy@spglobal.com

ANALYTICAL CONTACT

Volker Kudszus
Frankfurt
+ 49 693 399 9192
volker.kudszus@spglobal.com

ANALYTICAL CONTACT

Salla von Steinaecker
Frankfurt
+ 49 693 399 9164
salla.vonsteinaecker@spglobal.com

METHODOLOGY CONTACT

Michelle M Brennan
London
+ 44 20 7176 7205
michelle.brennan@spglobal.com

METHODOLOGY CONTACT

Takamasa Yamaoka
Tokyo
+ 81 3 4550 8719
takamasa.yamaoka@spglobal.com

ANALYTICAL CONTACTS

Alexander Ekbom
Stockholm
+ 46 84 40 5911
alexander.ekbom@spglobal.com

ANALYTICAL CONTACTS

Allyn Arden, CFA
New York
+ 1 (212) 438 7832
allyn.arden@spglobal.com

ANALYTICAL CONTACTS

Minh Hoang
Singapore
+ 65 6216 1130
minh.hoang@spglobal.com

METHODOLOGY CONTACTS

Ron A Joas, CPA
New York
+ 1 (212) 438 3131
ron.joas@spglobal.com

METHODOLOGY CONTACTS

Peter Kernan
London
+ 44 20 7176 3618
peter.kernan@spglobal.com

METHODOLOGY CONTACTS

Mark Button
London
+ 44 20 7176 7045
mark.button@spglobal.com