General Criteria:

Methodology: Use Of 'C' And 'D' Issue Credit Ratings For Hybrid Capital And Payment-In-Kind Instruments

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*(**Editor's Note:** This article has been superseded by "Hybrid Capital: Methodology And Assumptions," published July 1, 2019, but may still be in use in certain markets.)*

1. On Dec. 19, 2014, S&P Global Ratings published its criteria "Principles For Rating Debt Issues Based On Imputed Promises" (Imputed Promises Criteria). Among other provisions, the criteria indicate that we assign the 'D' long-term issue credit rating and no longer the 'C' rating to issues on which cash coupon payments have been deferred, eliminated, or, in some cases, paid in kind, as permitted under the terms of the issue, or in certain cases of principal write-down. This criteria article provides additional guidance for determining when we will apply the 'D' rating to such instruments.

2. This paragraph has been deleted.

SCOPE OF THE CRITERIA

3. These criteria apply to the issue credit ratings we assign to payment-in-kind (PIK) instruments issued by entities. These criteria also apply to hybrid capital instruments, such as preferred stock, deferrable subordinated notes, "kikin" (a form of deferrable subordinated debt capital unique to Japanese mutual life insurers), trust preferred securities, and other instruments with deferrable coupon or deferrable principal repayment dates, rated under our criteria for corporate (including project finance), governments (including international public finance, U.S. public finance, multilateral lending institutions, and sovereigns), financial institutions, and insurance issuers. This article does not apply to issuer credit ratings (ICRs). These criteria do not apply to structured finance and covered bonds transactions that experience actual realized interest shortfalls in such cases, the "Structured Finance Temporary Interest Shortfall Methodology" applies

4. Hybrid capital generally refers to an instrument that has characteristics of both debt and equity. S&P Global Ratings considers an instrument as a hybrid capital instrument if, and only if, without causing a legal default or liquidation of the issuer, it can absorb losses via either nonpayment of the coupon or a write-down of principal, or can convert into common equity or another hybrid capital instrument.

SUMMARY OF THE CRITERIA

5. The issue credit ratings on hybrid capital instruments, or on any debt instrument with a coupon deferral or cancellation feature or principal write-down or deferral feature, are generally lowered to 'D' when payments are deferred or reduced on a permanent basis according to terms of the instrument. This includes: deferral of interest or dividends on a non-cumulative instrument (where missed coupons are not repaid in the future); write-down of principal; or conversion to common equity due to a credit event. In these criteria, "coupon" refers to periodic distributions, regardless of how they are described under the terms and conditions of the instrument (including such descriptions as "coupons," "interest," or "dividends").

6. The issue credit ratings on hybrid capital instruments with cumulative deferral provisions (such as cumulative preferred stock), or economically equivalent structures that also allow temporary coupon deferral without interest on deferred interest, will be lowered to 'D' upon deferral. The exception is if we expect that the deferral period a) will be short term, typically one year or less, and b) will be in accordance with the terms of the instrument.

7. For instruments that may make payment in kind, or economically equivalent structures (such as capitalized interest options), paying in kind does not in and of itself result in a rating change to 'C' or 'D'. However, we may still lower the issue credit ratings due to issuer credit deterioration, as reflected in a lower issuer credit rating or stand-alone credit profile.

8. The lowering of an issue credit rating assigned to a hybrid capital instrument to 'D' does not result in a lowering of the ICR to 'SD' nor 'D' if the payment default is in accordance with the instrument's terms and conditions, or if the instrument forms part of regulatory capital for a prudentially regulated issuer.

9. This paragraph has been deleted.

10. This paragraph has been deleted.

METHODOLOGY

Permanent Shock Absorbers: Hybrid Capital Instruments That Allow For Non-Cumulative Deferrals, Write-Down Provisions, Or Debt/Equity Conversions

11. Even when the terms of an instrument permit nonpayment of interest, conversion to common equity, or write-down or deferral of principal in such a way that this constitutes a "permanent shock absorber" under our criteria, the occurrence of any of these is a breach of the terms of the imputed promise we impute to rate the instrument (which is to pay cash on the originally scheduled due date). In such a case, the instrument is rated 'D'. For more on our definition and rating criteria for permanent shock absorbers, see Imputed Promises Criteria, paragraphs 36-38.

12. Therefore, a write-down of principal, even if in accordance with the terms of a hybrid capital instrument, results in a 'D' rating if it causes a permanent diminished payment. Also, the conversion of a debt instrument into common equity due to a credit related trigger, even if in accordance with the terms of the instrument, results in a 'D' rating unless the current market value of the shares received upon conversion equals or exceeds the original principal amount. We lower the issue credit rating to 'D' if any portion of distribution payments or principal is deferred or reduced on a permanent basis even if this is according to the terms of the instrument, or if an

instrument is subject to a distressed exchange.

13. For a hybrid capital instrument that has a provision for a temporary, instead of permanent, write-down of principal, if–-as we expect will almost always be the case--the use of such a provision results in a permanent diminished interest payment we lower the rating to 'D'.

Temporary Shock Absorbers: Hybrid Capital Instruments That Allow For Cumulative Non-Compounding Deferrals

14. For hybrid capital instruments with cumulative deferral features (such as cumulative preferred stock), or economically equivalent structures that allow temporary interest deferral without interest on deferred interest, we impute a ratable promise of repayment of the deferred amount within one year of the deferral date, and we lower an instrument's issue credit rating to 'D' unless we expect (a) repayment to occur within one year and in accordance with terms (including any penalty interest, for example) and (b) the next year of coupons to be honored in full and on scheduled dates. (For the criteria on instruments that allow temporary interest deferral with interest on deferred interest, see section on payment-in-kind instruments, paragraph 19.) For more on our definition and rating criteria for temporary shock absorbers, see Imputed Promises Criteria, paragraphs 33-35.

15. As a result, in practice, we expect to generally lower issue credit ratings to 'D' upon deferral since, in our experience, arrears are settled, if at all, sufficiently late as to turn the future interest promise into an illusory one.

16. If, however, we make a case-specific analysis that the deferral period will be short term, typically one year or less, within which we expect all arrears to be settled, then the issue credit rating is not 'D' and reflects our opinion of the risk of the coupons not being reinstated within this time period. In these cases, we derive the issue credit rating by applying "Criteria For Assigning 'CCC+', 'CCC', 'CCC-', And 'CC' Ratings," published Oct. 1, 2012, if the conditions in paragraphs 13-14 are met; and otherwise, by applying our general hybrid capital criteria.

17. For a hybrid capital instrument that is current on coupons, paragraphs 11 to 15 above do not affect our criteria for "notching" its issue credit rating. Notching refers to the number of notches that an issue is rated below the ICR or stand-alone credit profile (SACP), based on our analysis of the nonpayment risk and/or subordination features associated with the instrument. In line with existing criteria, all deferrable instruments are rated at least one notch below the ICR or SACP because of their deferral risk. If deferral becomes an increasingly likely prospect on a hybrid but not on senior debt, the gap between the ICR or SACP and the issue credit rating on a hybrid capital instrument widens to reflect the heightened risk of deferral.

18. The 'C' issue credit rating is assigned to hybrid capital instruments (and other subordinated instruments) only to reflect subordination, notably for all issuers with an ICR of 'CCC-' or lower, or for all banks with an SACP of 'ccc' or lower, since we notch at least three notches down for a hybrid capital instrument at these rating and SACP levels.

Temporary Shock Absorbers: Payment-In-Kind (PIK) Instruments

19. For instruments with PIK features or economically equivalent structures (such as capitalized interest options) that allow interest to be met with a non-cash payment, a PIK event is a breach of the imputed promise only if we have virtual certainty that repayment will not occur by the maturity date. Absent this virtual certainty, however, we may lower PIK instrument ratings on the occurrence of such an event due to issuer credit deterioration, as reflected in a lower issuer credit

rating. The rationale for this treatment is that such instruments are generally expected to repay both principal and interest, along with the payment-in-kind or capitalized interest, in line with the likelihood the issuer will repay its other financial obligations.

20. These criteria align our rating approaches on traditional PIK and PIK toggle instruments.

21. A PIK feature does not cause an instrument to be rated lower than the issuer credit rating of the issuer. However, notching for subordination or recovery will apply.

Debt Obligations With Deferrable Principal Repayment Dates (Other Than Hybrid Capital Instruments)

22. As indicated in "Principles For Rating Debt Issues Based On Imputed Promises," if the terms of an instrument specify a final maturity date, as well as an earlier, projected principal repayment schedule--sometimes referred to as the expected maturity date or the target amortization schedule--the imputed promise is principal due at final maturity (or "legal maturity date"). Examples of such instruments include leveraged loans with cash sweep features that provide for projected repayment earlier than scheduled payment.

23. For a debt obligation with a scheduled principal repayment date that has a deferral feature, used, for example, as a temporary shock absorber in the case of debt service shortfalls, the issue credit rating is not moved to 'D' if the deferral of principal is for one year or less and the debt instrument maturity is maintained within its final maturity under the terms of an instrument. If we expect a principal repayment to be delayed for more than one year past a scheduled but deferrable repayment date, we would lower the issue credit rating to 'D' to reflect the sustained loss absorption.

Impact On The ICR Of A 'D' Issue Credit Rating On A Hybrid Capital Instrument

24. The lowering of a hybrid capital instrument rating to 'D' does not result in a lowering of the ICR to 'SD' nor 'D' if the payment default is in accordance with the instrument's terms and conditions, or if the instrument forms part of regulatory capital for a prudentially regulated issuer.

Exchange Offers And Similar Restructurings On Hybrid Capital Instruments

25. An exchange offer or similar restructuring on a hybrid capital instrument (see "Rating Implications Of Exchange Offers And Similar Restructurings, Update," published May 12, 2009, for the definition of an exchange offer or similar restructuring) may reflect the possibility that, absent the exchange offer taking place, the issuer would exercise the coupon deferral or a loss absorption feature in accordance with the terms of the instrument. In such instances, we would lower the instrument's issue credit rating to 'C' on announcement of the offer and to 'D' on completion of the offer. The impact on the ICR is as discussed in paragraph 24 above.

GLOSSARY

26. PIK debt: These obligations are typically issued by corporate entities with ICRs of 'BB+' and lower. PIK debt can pay interest in cash or in kind in certain circumstances. PIK means that the investor,

in lieu of cash, receives more of the same note, or that the note's principal is increased. There are several forms of PIK debt. In their simplest form, PIK notes pay interest in kind from the outset, and for the life of the instrument. Some PIK debt initially requires cash interest payments, but gives the issuer the option of paying in kind later. In other cases, payments are initially PIK, but then must be made in cash after a prespecified period.

27. Toggle notes: These notes are a specific form of PIK debt designed to facilitate switching back and forth between cash payments and PIK distributions, at the issuer's discretion. The issuer increases remuneration for those periods when the PIK option is utilized.

REVISIONS AND UPDATES

This article was originally published on Oct. 24, 2013. These criteria became effective on Oct. 24, 2013.

Changes introduced after original publication:

- Following our periodic review completed on Oct. 16, 2014, paragraph 18 in this article was partly superseded by "Bank Hybrid Capital And Nondeferrable Subordinated Debt Methodology And Assumptions," published Jan. 29, 2015, which clarifies that notching by at least three notches applies to deferrable hybrid capital instruments because notching for some nondeferrable bank hybrid capital instruments could be two notches down at those rating and stand-alone credit profile levels.
- Following our periodic review completed on Oct. 16, 2015, we updated our contact information and criteria references, deleted outdated material that appeared in paragraph 10, and moved information on the effective date in paragraph 9 to Appendix B.
- Following our periodic review completed on Oct. 16, 2016, we updated our contact information and criteria references and deleted outdated material that appeared in the appendix. We consolidated Appendix B and Appendix A.
- Following our periodic review completed on Oct. 10, 2017, we added the "Revisions And Updates" section and moved the information in the appendix into that section. We then deleted the appendix.
- Following our periodic review completed on Oct. 2, 2018, we updated our contact information.
- On March 18, 2019, we republished this criteria article to make a nonmaterial change to a criteria reference. Specifically, we removed "2008 Corporate Criteria: Rating Each Issue," published April 15, 2008, from the list of partly superseded criteria because it was superseded by "Reflecting Subordination Risk In Corporate Issue Ratings," published March 28, 2018.

RELATED CRITERIA AND RESEARCH

Superseded Criteria

- How The Expansion Of The 'C' Rating Definition Affects Its Use For Hybrid Capital And Payment-In-Kind Instruments, Aug. 1, 2008

Partly Superseded Criteria

- Rating Implications Of Exchange Offers And Similar Restructurings, Update, May 12, 2009 (supersedes references to the use of the 'C' issue credit rating in the answer to question 14)
- Hybrid Capital Handbook, Sept. 15, 2008 (supersedes references to the use of the 'C' issue credit rating in the section titled "Rating The Issue: Default And Distress")

Related Criteria

- Structured Finance Temporary Interest Shortfall Methodology, Dec. 15, 2015
- Bank Hybrid Capital And Nondeferrable Subordinated Debt Methodology And Assumptions, Jan. 29, 2015
- Principles For Rating Debt Issues Based On Imputed Promises, Dec. 19, 2014
- Criteria For Assigning 'CCC+', 'CCC', 'CCC-', And 'CC' Ratings, Oct. 1, 2012
- Rating Implications Of Exchange Offers And Similar Restructurings, Update, May 12, 2009
- Hybrid Capital Handbook: September 2008 Edition, Sept. 15, 2008

This report does not constitute a rating action.