

HYBRIDS: A CASE STUDY

SAVING TAX DOLLARS MAKES CENTS

COMPETING FOR A SHARE of the lucrative hybrid market has become like an Olympic competition. Issuers on both sides of the Atlantic are eager to access the market with a hybrid that will lower their after-tax cost of capital. Investors seeking higher yields in debt-like securities have been purchasing hybrids despite the complexity intrinsic to these securities. By 2006, bankers understood the “technical requirements” for a hybrid. The basic hybrid structuring rules were set in 2005 by the ratings agencies. Moody’s published its “Tool Kit” identifying a continuum of five baskets, from the A basket, which is 0% equity treatment (or 100% debt), at one extreme, to the E basket, which is 100% equity (or 0% debt), at the other extreme. On the tax side, there is less clear-cut guidance, but by now there are some widely shared views on the part of tax practitioners based, at least in part, on Internal Revenue Service Notice 94-47 that identifies factors associated with debt versus equity.

The sport became perfecting the hybrid—creating a superior competitive product. JPMorgan Securities structured a winning product with CENts, Capital Efficient Notes. In July 2006, we represented the underwriters, led by JPMorgan, in the first CENts transaction for Morrison & Foerster client Capital One Financial Corporation. CENts represents a real innovation in hybrids. It was the attainment of what bankers have referred to as the Holy Grail—a hybrid that qualifies for D-basket equity credit from ratings agencies, qualifies for Tier 1 capital treatment for bank holding company issuers, and permits issuers to make tax-deductible interest payments.

In order to replicate the characteristics of an equity security, hybrids have long maturities or are perpetual. From a ratings agency perspective, a longer maturity makes a hybrid security more akin to common equity than debt. From a tax perspective, in order to obtain debt treatment, a security must represent an “unconditional obligation to pay a sum certain on demand or at a fixed maturity date that is in the reasonably foreseeable future.” Tier 1 capital, or core capital, for bank holding companies includes, among other things, common stock and non-cumulative perpetual preferred securities—or securities having no “maturity.” Trust preferred securities are also treated as Tier 1 capital provided they are subordinated to all

subordinated debt, have a minimum five-year interest deferral and the longest feasible maturity; however, bank holding companies are limited in the amount of trust preferred securities that they may include within Tier 1 capital.

The CENts structure incorporates the concept of a “scheduled maturity date” and a “final maturity date.” The scheduled maturity date usually is set at 30 years and the final maturity date may be set at up to 80 years. The shorter scheduled maturity makes the hybrid more “debt-like” from a tax perspective, while the longer final maturity satisfies the rating agencies. The scheduled/final maturity feature is combined with an additional feature. The issuer’s obligation to repay at the scheduled maturity is limited; the issuer must then repay amounts due only to the extent the issuer has raised proceeds from the issuance of “replacement capital.” By adding this feature, the hybrid obtains more favorable ratings agency treatment.

CENts also provides for optional deferral of interest payments on the hybrid security, which provides issuers with some financial flexibility. In the CENts structure non-cumulative optional deferral only (lower equity credit), is paired with an alternative payment mechanism and a replacement capital covenant (both resulting in higher equity credit).

Capital One Financial Corporation was pleased with the first CENts deal and followed that up with a second CENts deal in February 2007. In between, quite a number of issuers, including insurance companies and bank holding companies, have tapped into CENts to raise tax-efficient funding. Ben Franklin would have approved of CENts, as he was the first to observe that a penny saved is truly a penny earned.