

THE ELUSIVE D BASKET

HITTING THE TRIFECTA

HYBRID SECURITIES, or securities that have some equity characteristics and some debt characteristics, have been popular for over a decade. MIPs, QUIPS, TOPrs, perpetual trust preferreds and DECs are all examples.

Hybrids lie somewhere on the equity-debt continuum. Where exactly, is the subject of great debate. In fact, over its life, a hybrid security may exhibit different proportions of equity-like or debt-like traits—sliding along the continuum. Hybrids include certain classes of preferred stock, trust preferred securities and convertible debt securities. Issuers like hybrids because these securities often receive favorable treatment by rating agencies and regulators when analyzing an issuer’s capital structure. Many also provide a lower after-tax cost of capital for issuers.

Rating agencies recently changed their methodologies for analyzing hybrid securities. The rating agencies created defined buckets or “baskets” for securities based on the “equity-like” or “debt-like” content of a hybrid security. Under this basket approach, a hybrid security meeting specific criteria has the certainty of qualifying as a “D basket” for 75% equity treatment within an issuer’s capital structure, or an “E basket” for treatment as an equity security.

This change, which provides additional clarity relating to the amount of “equity credit” awarded in evaluating an issuer’s capital structure in connection with the issuance of hybrid securities, was a catalyst. Product structurers around Wall Street set out to build a better hybrid security. We received clear instructions on the goal: A hybrid security that would qualify for the D-basket, or maybe, for the E-basket. A hybrid security that would allow issuers to make tax-deductible payments. A hybrid security that would qualify as Tier 1 capital for banks.

Working with our tax, bank regulatory and capital markets colleagues, our client has introduced a product that represents the next generation hybrid security. Close collaboration and feedback from the rating agencies and regulators will continue to be essential to refining this new security. At its core, this new trust preferred security has the essential winning attributes.