

KEY POINTS

- Leading financial institutions appear to have selected hybrid securities as their preferred method of financing and recapitalising.
- Newer model hybrids are proving resilient in the current economic downturn.

Author Anna T Pinedo

Exceptionally intelligent design

Product designers – from carmakers to nappy manufacturers – all seem preoccupied with sustainability. Are their designs promoting sustainability? Of course, they're probably thinking about sustainability in the environmental context. But at its essence, sustainability is about a process or state that can be maintained indefinitely, that conserves resources as a result of its inherent efficiency. So, whether we're discussing a hybrid car or a hybrid security, the defining objectives are similar – efficient and reliable operation. Hybrid securities are tax-efficient, regulatory and rating agency-qualifying capital that lower an issuer's cost of capital and that, in times of financial distress, conserve cash for the issuer. Beleaguered by massive write-downs, financial institutions recently have turned to the hybrid securities market to raise capital and bolster their financial ratios. In 2007, hybrid issuances exceeded \$110bn and in the first few months of 2008, US financial institutions already have raised over \$61bn through hybrid issuances.

THE DESIGN CHALLENGE

Hybrid securities are securities that have some equity characteristics and some debt characteristics. These securities are structured to obtain favourable equity treatment from ratings agencies, permit issuers to make tax-deductible payments, and qualify as Tier 1 capital for bank holding companies. The benefits of a hybrid depend on its 'equity-like' or 'debt-like' characteristics. From a ratings agency perspective, the more equity-like the hybrid, generally, the more favourable the treatment for the issuer. From a tax perspective, the more debt-like the hybrid, generally, the more favourable the tax treatment for the issuer. An efficient hybrid achieves these seemingly contradictory objectives.

There has been a fair bit of certainty about the basic elements of a hybrid since 2005 when Moody's published its 'Tool Kit' identifying a continuum of five baskets,

This article considers whether developments in the hybrid market have resulted in sustainable financial products that are efficient and reliable in the face of a market downturn.

from the A basket, which is 0 per cent equity treatment (or 100 per cent debt), at one extreme, to the E basket, which is 100 per cent equity (or 0 per cent debt), at the other extreme. Standard & Poor's followed suit with its pared-down 'minimal equity content', 'intermediate equity content' and 'high equity content' categories. 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 IRS Notice 94-47 that identifies factors associated with debt versus equity.

Ratings agencies measure a hybrid against common equity and, in so doing, evaluate: the security's maturity date (if

on these 'extras' resulted in a lack of transparency. Issuers and investors found it difficult to distinguish among the 'new and improved' structures, especially with all their additional bells and whistles. Complexity made comparisons and valuations difficult. The opaqueness of some structural enhancements also caused consternation for the ratings agencies, which reacted by refining their guidelines and cutting through some of this clutter. By mid-2007, particularly well-engineered hybrids had emerged.

EFFICIENCY AND RELIABILITY

For issuers, such as financial institutions

"Financial institutions recently have turned to the hybrid securities market to raise capital and bolster their financial ratios."

any), or permanence; the ongoing payment obligations; and the priority of payments relative to those associated with other securities and the corresponding rights to enforce payment obligations. By contrast, the tax analysis focuses more sharply on the rights of the hybrid security holders.

In 2006 and early 2007, there was product innovation as financial engineers introduced new features, such as longer maturities, bifurcated maturities and interest deferral triggers, that would receive equity credit, while preserving debt for tax treatment. Accompanying these real innovations, there also were some modest enhancements – such as the introduction of call or step-up features, fixed-to-floating structures, alternative payment mechanisms and replacement capital covenants. Bolting

experiencing write-downs, which need to raise capital, hybrids often are the most efficient approach. Even financial institutions that are seeking capital from sovereign wealth funds are structuring these sovereign investments in the form of hybrids. Financial institutions appreciate that ongoing payments on debt securities are tax-deductible, making debt cheaper than equity from a funding perspective. On an after-tax basis, common stock is more expensive for an issuer.

From the perspective of financial ratios, issuing a long-dated security that is treated like equity by ratings agencies, makes a hybrid less 'expensive' for the issuer. In order to replicate equity securities, hybrids have long maturities or are perpetual. From a ratings agency perspective, a longer maturity

Feature

	COMMON STOCK	PREFERRED STOCK/DEPOSITARY SHARES	OPTIONAL CONVERTIBLE PREFERRED STOCK	MANDATORY CONVERTIBLE PREFERRED STOCK	MANDATORY CONVERTIBLE UNIT	CONVERTIBLE SUBORDINATED DEBT UNIT	TRUST PREFERRED SECURITIES	ENHANCED TRUST PREFERRED SECURITIES	UNIT STRUCTURE (WITS/HITS)
Structure	Common stock	Preferred stock or depositary shares representing an interest in preferred stock	Preferred stock convertible into common stock Conversion premium approximately 20%	Preferred stock convertible into common stock Conversion premium approximately 20%	Remarkable trust preferred and a forward purchase contract on common stock	Convertible subordinated debt	49-year trust preferred	60-year trust preferred with 30-year scheduled maturity date	Remarkable trust preferred security and a forward purchase contract to purchase the issuer's perpetual preferred stock
All-in Coupon	Dividend rate	Dividend rate	Dividend rate (Preferred stock prior to conversion; common stock thereafter)	Dividend rate (Preferred stock prior to conversion; common stock thereafter)	Prior to remarketing: Rate on trust preferred plus contract adjustment fees; <i>Subsequently</i> : Remarketed rate on trust preferred; no cap on remarketed rate	Rate on debt can be zero coupon or can include contingent interest	Rate on junior subordinated debt	Rate on junior subordinated debt	<i>Prior to remarketing</i> : Rate on trust preferred plus contract adjustment fees; <i>Subsequently</i> : Remarketed rate on trust preferred; no cap on remarketed rate
Term	Perpetual	Perpetual	Perpetual	Mandatory conversion into common stock after conversion date	Prior to remarketing; trust preferred, then common stock, which is perpetual	30 years	49 years	60 years; possible earlier scheduled maturity date	60-year NCI5 trust preferred (with 30-year scheduled maturity) perpetual preferred stock
Call/Redemption	Subject to corporate repurchase programme	Call/non-call period negotiated May be redeemable subject to Federal Reserve approval	Not redeemable	Not redeemable prior to mandatory conversion date	Trust preferred not redeemable	Negotiated call provisions	At any time	At year five or ten, and if certain events occur prior to such time, additional make-whole amount to be paid	Trust preferred redeemable after five years Preferred stock callable shortly after issuance subject to Federal Reserve approval
Status/Subordination	N/A	Senior to common stock, <i>pari passu</i> with certain series of preferred stock, senior to junior stock	Senior to common stock, <i>pari passu</i> with certain series of preferred stock, senior to junior stock	Senior to common stock, <i>pari passu</i> with certain series of preferred stock, senior to junior stock	Underlying junior subordinated debt is senior to common stock and preferred stock	Subordinate to senior debt, <i>pari passu</i> with general trade creditors	Junior to all existing and future senior, subordinated and <i>pari passu</i> to junior subordinated debt	Junior to all existing and future senior, subordinated and <i>pari passu</i> to junior subordinated debt	Underlying junior subordinated debt is junior to all existing and future senior, and future senior, subordinated debt
Optional Payment Deferral	N/A	N/A	N/A		Yes, five years on trust preferred, but no later than maturity date	No	Yes, five years on junior subordinated debt, but no later than maturity date	Yes, ten years on junior subordinated debt, but no later than maturity date	Yes, five years on trust preferred, but no later than maturity date
Dividend Payment	Non-cumulative	Non-cumulative on preferred stock and depositary shares	Non-cumulative		Cumulative on underlying debt	N/A	Cumulative distributions	Cumulative distributions	Non-cumulative on preferred stock
Conversion Rights	No	No	Convertible at pre-set price; Convertible at holder's option; Mandatorily convertible by issuer; may be subject to stock price triggers; Convertible upon certain acquisitions and reorganisation events	Mandatorily convertible into common stock after three years at pre-set price Optional conversion by holder at any time	Mandatorily convertible	Convertible at holder's option	No	No	None of the component securities are convertible
Dividend Stopper	No	Yes	Yes	Yes	Yes	No	Yes	Yes	Yes
Mandatory Stock Sale	N/A	N/A	Net stock or gross settlement feature	Converts into common stock at three-year mark	Yes, at three-year mark (forward settlement)	No	Yes, under the alternative payment mechanism	Yes, at five-year mark (forward settlement)	Yes, at five-year mark (forward settlement)
Fed/Capital Treatment	Tier 1	Tier 1, up to 50%	Tier 1, up to 50% until converted	Tier 1	Tier 1, up to 25%	Tier 2	Tier 1, within 15% limit	Tier 1, within 15% limit	Tier 1, up to 25%



Tax Treatment (Issuer)²	Dividends on common stock not deductible	Dividends on preferred stock/ common stock not deductible	Dividends on preferred stock/ common stock not deductible	Dividends on preferred stock/ common stock not deductible	Interest on trust preferred will be tax-deductible Contract adjustment fees not deductible Dividends on common stock not deductible No gain or loss upon forward settlement	Interest (or OID) on debt will be tax-deductible Common stock dividends on common stock can be structured as contingent convertible to obtain higher current tax deductions	Interest on Junior Subordinated Debt Securities will be tax deductible	Interest on Junior Subordinated Debt Securities will be tax deductible	During first five years, interest on Trust Preferred will be tax-deductible During first five years, contract adjustment fees not deductible Dividends on Preferred Stock not deductible No gain or loss upon forward settlement
Tax Treatment (Holders)	30% withholding tax on dividends; reduced rate if tax treaty applies; sovereigns may benefit from statutory exemption Dividends to US corporations generally eligible for the DRD ³ ; dividends to US individuals generally eligible as QDI ⁴	30% withholding tax on dividends; reduced rate if tax treaty applies; sovereigns may benefit from statutory exemption No gain or loss upon conversion Dividends to US corporations generally eligible for the DRD; dividends to US individuals generally eligible as QDI	30% withholding tax on dividends; reduced rate if tax treaty applies; sovereigns may benefit from statutory exemption No gain or loss upon conversion Dividends to US corporations generally eligible for the DRD; dividends to US individuals generally eligible as QDI	30% withholding tax on dividends; reduced rate if tax treaty applies; sovereigns may benefit from statutory exemption No gain or loss upon conversion Dividends to US corporations generally eligible for the DRD; dividends to US individuals generally eligible as QDI	Trust preferred may be subject to contingent payment debt instrument rules unless contingent interest included Generally no withholding tax on trust preferred Contract adjustment fees may be subject to 30% withholding tax No gain or loss to holder on forward settlement 30% withholding tax on dividends on common stock; reduced rate if tax treaty applies; sovereigns may benefit from statutory exemption	Debt not subject to contingent payment debt instrument rules unless contingent interest included Generally no withholding tax on trust preferred Contract adjustment fees may be subject to 30% withholding tax No gain or loss on conversion 30% withholding tax on dividends on common stock; reduced rate if tax treaty applies; sovereigns may benefit from statutory exemption	Generally no withholding tax on interest	Generally no withholding tax on interest	Trust preferred may be subject to contingent payment debt instrument rules Generally no withholding tax on trust preferred Contract adjustment fees may be subject to 30% withholding tax No gain or loss on forward settlement 30% withholding tax on dividends; reduced rate if tax treaty applies; sovereigns may benefit from statutory exemption
Moody's Treatment⁵	Basket E	Basket C or Basket D with replacement capital covenant ⁶	Basket C or Basket D with replacement capital covenant ⁶	Basket E ⁴	Basket A	Basket C	Basket D	Basket C or Basket D	
SEI Treatment⁷	100%	100% up to 50% of ACE	100% up to 50% of ACE	100% up to 33% of ACE	Depends on terms	100% up to 12-18% of ACE	100% up to 18% of ACE	100% up to 33% of ACE	
Balance Sheet	Equity	Equity	Equity	Equity	Usually debt	Debt	Debt	Equity as to forward, debt as to trust preferred	
Dilution	Yes	Yes	Yes	Yes	No	No	No	No	
Anti-Dilution Adjustments	No	Yes; Adjustments for increases in cash dividends; distributions in common stock or other property; issuance of stock purchase rights; certain self tenders; or self-tenders; or subdivisions, splits or combinations	Yes; Adjustments for increases in cash dividends; distributions in common stock or other property; issuance of stock purchase rights; certain self tenders; or self-tenders; or subdivisions, splits or combinations	Yes; Adjustments for increases in cash dividends; distributions in common stock or other property; issuance of stock purchase rights; certain self tenders; or self-tenders; or subdivisions, splits or combinations	No	No	No	No	

1 Based on current guidance.

2 For a US entity based on current guidance.

3 Dividends received deduction.

4 Qualifying dividend income.

5 Based on currently available information.

6 If the conversion into common stock is net settled, the transaction will not receive the same equity credit from the rating agencies or the Federal Reserve.

7 Based on currently available information.

8 Adjusted common equity.

Feature

makes a hybrid more akin to common equity than debt. From a ratings agency perspective, a long-dated hybrid provides greater financial flexibility for the issuer because it poses no refinancing risk, or at least the refinancing risk is far out in the future. In order to obtain debt for tax treatment, a security must represent an 'unconditional obligation to pay a certain sum 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 also are treated as Tier 1 capital provided that they are subordinated to all subordinated debt, have a minimum five-year

can increase the equity content of a hybrid security by making payment deferrals mandatory, or automatic, upon reaching triggers that are meaningful to the issuer given its financial position. For 'D basket' treatment from Moody's, generally the hybrid should contain a mandatory deferral provision (if one were to consider interest deferral features alone). Using a formulaic approach to payment deferrals, rather than retaining issuer discretion, generates higher equity credit – assuming that payments in respect of the hybrids are non-cumulative or may be settled in stock.

Rating agencies will evaluate the nature of the issuer's payment obligations (cumulative versus non-cumulative payments) in conjunction with the other payment characteristics of the hybrid

of more junior or parity securities or through payment-in-kind. In bankruptcy, however, the security holder's claim is limited to a maximum deferred interest amount.

The most successful hybrids to have emerged – enhanced trust preferred securities and tandem securities (a forward contract to buy a perpetual non-cumulative security issued along with a long-dated subordinated note) – incorporate the best structuring innovations into relatively simple products.

THE EVOLVED DESIGNS

Enhanced trust preferred securities incorporate significantly longer maturities or bifurcated maturities (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 appear more 'debt-like' from a tax perspective, while the longer final maturity satisfies the rating agencies. From a ratings agency perspective, Standard & Poor's will view the scheduled maturity as the 'effective' or 'final' maturity for the purposes of its analysis.

The issuer's obligation to repay at the scheduled maturity is limited; the issuer must then repay amounts due only to the extent that the issuer has raised proceeds from the issuance of 'replacement capital.' The replacement language may indicate either the issuer's intent or its contractual undertaking to refinance the original hybrid with securities having similar or higher equity content or with other 'qualifying securities.' By adding this feature, the hybrid obtains more favourable ratings agency treatment. The ratings agencies are concerned about the permanence of the security in the issuer's capital structure.

The issuance of replacement capital ensures that a similar or more equity-like security will remain part of the issuer's capital structure upon repayment of the original hybrid at its scheduled maturity date. The very popular JPMorgan CENs (Capital Efficient Notes) structure includes non-cumulative optional deferral-only (lower equity credit), but pairs the optional deferral-

"By including a deferral feature, the hybrid security becomes more 'equity-like' from a ratings agency perspective."

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.

Ratings agencies have always believed that in times of stress, hybrids will provide 'loss absorption' for the issuer, since hybrids are deeply subordinated instruments with payment deferral provisions. Most hybrids contain a deferral feature that permits the issuer to defer the payment of interest or dividends.

An issuer has no obligation to pay dividends on its common stock; whereas, an issuer generally is contractually bound to make interest payments on debt securities. By including a deferral feature, the hybrid security becomes more 'equity-like' from a ratings agency perspective. Generally, the longer an issuer can defer payments, theoretically, the greater its financial flexibility.

Most hybrids now have optional deferral and mandatory deferral provisions. Issuers

security, including the presence of a mandatory or optional deferral provision.

Hybrids generally are deeply subordinated within the issuer's capital structure. Like an equity security, non-payment of distributions does not result in an event of default. In fact, a hybrid security holder has limited rights against the issuer for deferred interest payments. Recent hybrids have limited a security holder's right to proceed against the issuer to recoup deferred payments.

In certain structures, deferred interest may be permanently cancelled if certain conditions are satisfied and, as a result, the holder of the hybrid security may forfeit its claim for deferred interest amounts. In other structures, the treatment of deferred payments is bifurcated. After some deferral period, the issuer must pay deferred interest through the issuance of capital (an alternate payment mechanism) up to a cap. An alternate payment mechanism requires that deferred distributions on the hybrid can only be paid out of the proceeds from the issuance

Biog box

Anna T Pinedo is a partner in Morrison & Foerster's New York office. She concentrates her practice on securities, derivatives and innovative financial products, and represents both issuers and financial intermediaries in financing transactions.

Email: apinedo@mof.com

Feature



only with an alternative payment mechanism and a replacement capital covenant (both resulting in higher equity credit).

Another successful hybrid structure is the mandatory convertible security structured as a unit comprised of two securities, or a perpetual non-cumulative security paired with a fixed-term cumulative security. An example is a non-convertible trust preferred security paired with a forward stock purchase contract. The forward stock purchase contract commits the issuer to deliver, and investors to purchase, a variable number of shares of common stock of the issuer some time from issuance.

In January 2006, Wachovia Corporation, a bank holding company¹, issued through a trust an investment unit (Wachovia Income Trust Securities, or 'WITS') that consisted of a subordinated debt security with a 37-year term and a five-year forward stock purchase contract on Wachovia perpetual preferred stock. The subordinated debt security is issued by a trust that holds remarketable junior subordinated notes of the issuer and a forward purchase contract on non-cumulative perpetual preferred stock. Interest on the notes is deferrable and cumulative.

After a certain period of time, the subordinated debt security can be remarketed, and the proceeds from the remarketing will be used to exercise the forward contract to purchase the non-cumulative perpetual preferred stock. If the note is not remarketed, then the trust can deliver the notes to the issuer as payment for the non-cumulative perpetual preferred stock. The contractual replacement language requires that funds for redemption originate from proceeds of the issuance of common stock, other perpetual or long-dated non-cumulative preferred stock, or certain other allowed instruments received within 180 days of redemption. Redemption is subject to regulatory approval.

This essential structure has been tinkered with in recent hybrid transactions, including, for example, State Street's January 2008 issue of APEX (Automatic Preferred Enhanced Capital Securities) securities, which provides for a shorter period to remarketing and additional flexibility around the remarketing. From a tax perspective, the components (the note and the forward contract) are treated

as two separate instruments, but interest on the note is deductible for federal income tax purposes. From a ratings agency perspective, this structure provides substantial equity credit, and for bank holding companies, also results in Tier 1 capital.

While there has been some tightening in the ratings agencies' views on hybrid features, especially their views of replacement capital covenants, and European regulators are taking a closer look at the total amount of

"Some of the most highly sophisticated, litigation-savvy issuers have concluded that hybrids represent an attractive combination of efficiency and reliability."

hybrid instruments that should be included in bank Tier 1 capital, these structures have proved resilient.

EVOLVED ENOUGH?

An unanswered question remains: do hybrids actually provide 'shock absorber' in times of financial turmoil. We have certainly been experiencing financial turmoil in recent months. However, there have been few issuers with hybrids that have actually deferred payments on their outstanding hybrids. Standard & Poor's conducted a study of how hybrids have performed in financial distress scenarios.

While this study may be a useful departure point for thinking about hybrid loss absorption and performance in times of distress, it focuses only on which issuers deferred and when they did so. The most prolific hybrid issuers have been regulated financial institutions; however, a regulated entity, such as a bank, will not, in all likelihood, ever get to the point of deferral without prior regulatory intervention.

The results of the study, which was by its nature limited, were mixed – in instances where issuers invoked the payment deferral feature on their hybrids, they did so only immediately prior to, or concurrently with, a bankruptcy filing. One explanation is that issuers may be reluctant to defer payments on hybrids, even when they are legally permitted to do so because they fear the

'headline risk' associated with doing so. The reputational damage associated with payment deferral may prove terminal and the cost savings associated with deferring payments may not be enough to make deferral worthwhile. Other issuers with hybrids faced such a rapid deterioration in their financial condition that payment deferral on hybrids is unlikely to have been meaningful in addressing the issuers' financial condition. The Standard & Poor's study considered

principally prior generation hybrids, which arguably may not have had the enhanced equity features, payment deferrals and subordination characteristics of the newer model hybrids. In short, trying to assess the utility of hybrids based on a limited history is unlikely to be as informative as some current events.

The capital markets have been exquisitely challenging of late. The worse they get, the more leading financial institutions appear to select hybrid securities as their preferred method of financing and recapitalising. Citigroup, Merrill Lynch and Morgan Stanley are top of mind in this regard. Ratings agencies and investors have responded positively to their hybrid transactions.

What can be learned from these current events? I think it is safe to say that some of the most highly sophisticated, litigation-savvy issuers have concluded that hybrids represent an attractive combination of efficiency and reliability. Issuers and investors expect that these hybrids will perform well in tough times. On the subject of evolved enough, they have voted with their feet. ■

1 Under US law, a bank holding company is an entity that directly or indirectly owns, controls or has the power to vote 25% or more of a class of securities of a US bank. Bank holding companies are required to register with the Board of Governors of the Federal Reserve System, referred to in this article as the Federal Reserve.