KEY POINTS
- Hybrid securities have proved attractive to issuers seeking a lower after-tax cost of capital and to investors seeking higher yields – resulting in increasing competition among bankers for a share of the hybrid market.
- Innovation relating to, and financial engineering of, hybrid securities has resulted in a panoply of new features.
- Many new hybrids incorporate the concept of a 'scheduled maturity date' and a 'final maturity date', as well as optional or mandatory payment deferral provisions.

Author Anna T Pinedo

Degree of difficulty, 9; style points, 5 (or understanding hybrids)

This article reviews each of the required elements for a hybrid security and focuses on the product refinements and innovations that have characterised the market.

Ever thought an investment banker shared much in common with a figure skater? Maybe the flashy costumes, the jargon, the competitive zeal. Well, we'll come back to all that.

In 2006, issuances of hybrid securities in Europe and the US surpassed even the most exuberant banker's predictions. In 2007, issuances are on track to exceed the prior year's record levels. Hybrid securities are securities that have some equity characteristics and some debt characteristics. The 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 security 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. Success lies in structuring a single security meeting on these seemingly contradictory objectives. It helps if the security has a catchy name, too.

The basic hybrid structuring rules were set in 2005 by the judges – the ratings agencies. Moody's published its 'Tool Kit' identifying a continuum of five baskets, 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 Internal Revenue Service Notice 94-47 that identifies factors associated with debt versus equity.

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 sport became to perfect the hybrid – creating a superior competitive product.

Once the compulsory part of the routine is satisfied, would increasing the degree of difficulty earn a higher score, or merely make the judges cringe and the tax lawyers reach for their 'should' opinion? Would adding a flourish here or there be viewed as an artistic 'improvement' garnering better pricing, or just a stunt? This discussion reviews each of the required elements for a hybrid security and focuses on the product refinements and innovations that have characterised the market.

THE SCORING SYSTEM

Both ratings agencies measure a hybrid against common equity and, in so doing, evaluate: the security's maturity date (if any); the ongoing payment obligations; and the priority of payments relative to those associated with other securities; the corresponding rights to enforce payments. By contrast, the tax analysis focuses more sharply on the rights of the holders of the hybrids. The National Association of Insurance Companies ('NAIC') classifies hybrids based on their characteristics, comparing the features of each hybrid to common equity, preferred equity or debt. Insurance company buyers of hybrids base the risk-based capital charge related to their hybrid holdings on the NAIC's classification. The NAIC caused great consternation in the market during 2006 as a result of its proposed reclassification of certain hybrids. This article does not address the NAIC classifications and instead focuses principally on the ratings agency and tax analyses.

Maturity

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.

Recently issued enhanced trust preferred securities, like the US Bancorp ICONs

(Income Capital Obligation Notes), incorporate significantly longer maturities (60 years) compared to traditional trust preferred securities. Other recent hybrids incorporate the concept of a 'scheduled maturity date' and a 'final maturity date', which was first introduced by JPMorgan. The scheduled maturity date is usually 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 longer final maturity, however, may raise tax concerns because the length of time may create uncertainty regarding the issuer's obligation to repay in the reasonably foreseeable future.

Two recent transactions incorporating the scheduled/final maturity concept also had an additional feature – an extendible final maturity. In the FSA and SunTrust (SunTrust Capital VIII) transactions, the final maturity could be extended upon satisfaction of certain conditions. For example, in the SunTrust transaction, the final maturity could be extended from 60 to 80 years. In order for the issuer to extend past the final maturity date to an extended final maturity date, the securities must on the extension date still be rated investment grade; during a three-year period preceding the extension date, there must not have occurred any event of default relating to outstanding debt or any payment deferrals under then-outstanding preferred stock; and the issuer must deliver a certification to the indenture trustee stating that, as of such date, the issuer believes the likelihood of payment deferral on the hybrid to be remote and expects to be able to satisfy its obligations under the applicable replacement capital covenant.

The popular scheduled/final maturity structure is facing new challenges. On the tax front, the Internal Revenue Service has expressed concerns regarding long-dated (over 60 years) trust preferred securities. On the ratings agency front, Standard & Poor's in its January 2007 report entitled 'Harmonisation of Standards for Minimum Term of Hybrid Capital Issues', noted that it would no longer treat the final maturity date as the maturity date and would instead look at the scheduled maturity as the effective maturity.

Recent hybrids combine this scheduled/final maturity feature 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' (discussed below). By adding this feature, the hybrid obtains more favourable ratings agency treatment. 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.

Call options

Hybrids typically are not callable for some period of time – usually five to ten years. Again, this is intended to ensure that the hybrid will be outstanding for some defined period. A hybrid with a longer period to the call date is considered more equity-like given that it will be part of the issuer's capital structure for longer. Following the Moody's ratings methodology changes, calls have been viewed less negatively than in the past, particularly if the call option is coupled with replacement language. Recent hybrids include 'call provisions' permitting an issuer to redeem the security upon the occurrence of certain special events. The special events now considered standard include the occurrence of a 'tax event', a 'capital treatment event' (in the case of bank holding company issuers) and an 'investment company event'. The terms of these provisions differ from security to security. For example, a tax event is defined as a change in law or regulation that would create more than an insubstantial risk that payments on the hybrid security are no longer deductible by the issuer. A capital treatment event is defined as an amendment, change or proposed change in law or regulation that would create a more than an insubstantial risk of impairing the regulated issuer's ability to treat the hybrid security as Tier 1 capital. Ratings agencies, however, are not comfortable with all call provisions. A transaction for Southern Union Gas incorporated a 'change of control' interest step-up. Because of the step-up feature, the ratings agencies concluded the issuer would be more likely to call the security in that event. Consequently, the issuer received reduced equity credit.

Mandatory deferral provisions

Most hybrids contain a deferral feature that permits the issuer to defer payment of interest or dividends. An issuer has no obligation to pay dividends on its common stock; whereas, an issuer is contractually bound to make interest payments on debt securities. By including a deferral feature, the hybrid becomes more 'equity-like' from a ratings agency perspective. Usually, an issuer that defers payments on a hybrid is blocked from paying dividends on its common stock or securities more junior to the hybrid until all deferred payments have been paid. This feature is known as a dividend stopper provision.

Most hybrids now have optional deferral and mandatory deferral provisions. Issuers can increase the equity content of a hybrid 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 deferral features alone). Using a formulaic approach to payment deferrals, rather than retaining issuer discretion, generates higher equity credit – assuming payments in respect of the hybrids are non-cumulative or may be stock-settled. For operating companies, the triggers must be meaningful to that operating company's business. For example, in an issuance by Burlington Northern Santa Fe Corporation, the issuer was prohibited from paying interest (except from the net proceeds of sales of replacement securities) when for the preceding three calendar quarters the total leverage ratio exceeded a specified amount or when interest coverage fell below a specified minimum. In the case of insurance company issuers, for example, the issuer may be required to defer scheduled distributions based on predefined solvency, earnings and risk-based capital triggers. For bank holding companies, payments may be deferred or suspended if directed by the Federal Reserve, making mandatory deferral provisions less significant.

Optional deferral still provides some financial flexibility for the hybrid issuer, as would common equity. Consequently, ratings agencies will consider the nature of the payment obligations (cumulative versus non-cumulative) in scoring a hybrid with an optional deferral feature. The popular JPMorgan CENts (Capital Efficient Notes) structure includes non-cumulative optional deferral only (lower equity credit), but pairs the optional deferral with an alternative payment mechanism and a replacement capital covenant (both resulting in higher equity credit).

In November 2006, Moody's released its Request for Comment: Rating Preferred Stock and Hybrid Securities. Moody's proposed revising its classification of certain securities, which was subsequently not implemented. The proposal was interesting because it reflected Moody's analysis regarding ongoing payments. Moody's suggested distinguishing more finely (a process called 'notching') among cumulative, non-cash cumulative and non-cumulative obligations, based upon whether non-payment triggered an issuer default and the priority of the holder's claim for payment within the issuer's capital structure. The ratings agency also evaluates the nature of the payment obligations (cumulative/non-cumulative) in conjunction with the other payment characteristics of the security, including the presence of a mandatory or optional deferral provision or an alternative payment mechanism.

Alternative payment mechanisms

From a ratings agency perspective, a mandatory convertible security is considered 'equity-like' because the security by its terms converts into equity without requiring refinancing or repayment by the issuer. In contrast, a security that is convertible only at the holder's option receives less equity credit because it signals only the possibility of a future equity issuance. Consistent with this analysis, a 'unit security', like the Wachovia WITS, which is comprised of a hybrid with a contemporaneous forward contract on the issuer's perpetual preferred stock, receives enhanced equity credit.

Most recent hybrids contain an alternative payment mechanism. An alternative payment mechanism requires that deferred distributions can be paid only out of proceeds from the issuance of more junior or parity securities or through payment-in-kind. Incorporating a contractual requirement on the issuer's part creates a synthetic mandatory convertible or pay-in-kind security, at least as to the deferred payment component of the hybrid. This mechanism ensures that the issuer will be required to issue replacement capital in order to make deferred distribution payments, effectively accomplishing the same result as 'replacement language'.

Traditional trust preferred securities permit the issuer to defer interest payments for a maximum deferral period. However, once the maximum deferral period is exhausted, the issuer's continued payment failure becomes an event of default. In new hybrids, reaching the maximum deferral period is not an event of default – it merely triggers the alternative payment mechanism. The length of the deferral period varies from deal to deal – typically from two to five years.

In transactions with an alternative payment mechanism, the issuer's obligation to pay deferred interest amounts is not absolute. The issuer has no obligation to sell securities in order to pay deferred interest during a 'market disruption event'. A market disruption event includes: a trading halt on US securities exchanges generally or with respect to the issuer's stock; a failure to obtain a regulatory body's consent (in the case of regulated issuers) to issue stock despite reasonable attempts to do so; or an event that causes an issuer's offering document to be materially defective.

In addition to varying the triggers, issuers vary the kind of security that must be sold. Payment obligations may be settled through the issuance of common stock, warrants or 'benign' preferred securities. Benign preferred securities are non-cumulative, perpetual and callable with binding replacement language or non-cumulative, perpetual and callable with mandatory deferral triggers and intent-based replacement language. Some alternative payment mechanism provisions include caps limiting the number of shares of common stock and/or shares of preferred stock that an issuer must sell in order to satisfy its obligations. The caps are articulated differently – they may be based on a market capitalisation test or on a percentage of the aggregate principal amount outstanding on the hybrids.

Replacement capital covenants

Ratings agencies focus on 'replacement language' in hybrids, which indicates either the issuer's intent or its contractual undertaking to refinance the original hybrid with securities having similar or higher equity content, or 'qualifying securities'. Qualifying securities must be issued within six months of the redemption of the hybrid security. In the case of bank holding companies, which are highly regulated institutions, the ratings agency analysis differs because the existence of regulatory oversight substitutes the need to incorporate contractual safeguards in the hybrid. Regulators have the power to intervene in a financial institution's operations and make determinations regarding the institution's capital structure and capital adequacy. Consequently, for regulated institutions, replacement language, for example, is less significant in that regulators would require that an issuer substitute the hybrid with a similar or more equity-like instrument.

Most hybrids now have contractually binding rather than intent-based replacement language. Intent-based replacement language merely indicates the issuer's intention, but not the legal obligation, to issue qualifying securities. A contractually binding replacement covenant will increase the hybrid's equity content. The issuer enters into a replacement capital covenant for the benefit of the holders of a class of the issuer's more senior debt. Pursuant to the covenant, the issuer agrees for some period (usually 30 years) not to replace the hybrid except with securities having equal or better equity content (as opposed to

Biog box

Anna T Pinedo is a partner in Morrison & Foerster's New York office. She has concentrated her practice on securities and derivatives and represents issuers, investment banks and financial intermediaries in financing transactions. Email: apinedo@mofo.com

replacing with additional senior debt). The issuer preserves the right to redeem the hybrid, provided the redemption or purchase price would not exceed specified percentages of the net proceeds received by the issuer from sales of qualifying securities. The issuer may, subject to satisfaction of certain conditions, replace the security that it identifies as subject to the replacement capital covenant, referred to as the covered debt, from time to time. The covenant is intended to create a right of action on the part of the covered debt holders against the issuer if it were to violate the covenant, resulting in harm to the covered debt holders. The covered debt usually is a class of the issuer's subordinated debt given that the holders of subordinated debt would be more likely to be negatively affected if the issuer were to redeem the hybrid with a more senior security.

In order to receive enhanced equity credit by virtue of including a covenant, the ratings agencies require that the covenant cover a designated class of subordinated debt meeting certain criteria regarding size and maturity, or, if there is no subordinated debt, then a class of senior debt meeting the same criteria and an undertaking that the issuer will include any newly issued subordinated debt meeting the criteria as covered debt. The covenant must define a qualifying security having the same or more equity-like characteristics as the original hybrid. The covenant must be accompanied by an enforceability opinion from outside counsel.

Structurers have begun to tinker with various elements of the replacement capital covenant. For example, issuers may vary the nature of the securities included as qualifying securities. Qualifying securities may include some or all of the following: common stock, rights to acquire common stock, mandatorily convertible preferred stock, debt exchangeable for equity, qualifying non-cumulative preferred stock and real estate investment trusts ('REITs') preferred securities in addition to qualifying capital securities. Issuers also have begun to vary other elements. For example, in a WPS Resources transaction, the replacement capital covenant was modified by the addition of an 'applicable percentage' concept for hybrids. WPS Resources is required to issue only 50 per cent hybrids to redeem at the call date, as opposed to redeeming with all hybrids. However, in connection with its January 2007 report, S&P noted that it will no longer permit the 'applicable percentage' concept to apply to securities other than common stock in the replacement capital covenant for hybrids.

Subordination

Hybrids generally are deeply subordinated within the issuer's capital structure. As a result, hybrid securities provide some measure of loss absorption within the issuer's capital structure. As with an equity security, non-payment of distributions does not result in an event of default. In fact, a hybrid has very limited events of default and, as a result, a hybrid security holder has limited rights against the issuer for deferred interest payments. The subordination of hybrids within the issuer's capital structure varies depending on the transaction structure. Certain hybrids are subordinated to 'traditional trust preferred securities' and other subordinated debt and rank *pari passu* with trade creditors.

As discussed above, an issuer may voluntarily defer payments for a specified maximum deferral period. Several recent structures have limited further a security holder's right to proceed against the issuer to recoup deferred payments. Deferred interest may be permanently cancelled if certain conditions are satisfied and, as a result, the hybrid holder may forfeit its claim for deferred interest amounts. In other structures, the treatment of deferred payments is bifurcated. For example, in the Citigroup (Citigroup Capital XV) ETRUPS transaction, investors have a somewhat better claim on deferred interest payments. Interest payments may be optionally deferred for five years. After five years of deferral, Citigroup must pay deferred interest through an alternate payment mechanism up to a share issuance cap. After year five, the cap goes away. As a result, the issuer cannot cancel deferred interest after ten years of deferral. In bankruptcy, the security holder's claim is limited to a maximum deferred interest amount.

CONCLUSION

Greater clarity from the ratings agencies paved the way for the newest wave of hybrids. Bankers understood the core requirements necessary for a hybrid security to obtain equity credit and the features that would result in differences among basket classifications. Nonetheless, structuring a hybrid remains a careful balancing act, since a successful hybrid embodies a basic paradox. Focusing on equity credit alone may create risk for the tax treatment, where a debt-like security is the desired goal.

Against this backdrop, the competition for dominance in the hybrid market has been fierce. Just like landing all of your jumps, engineering a product that incorporates the basic requirements outlined above (long maturity, payment deferral, replacement language, etc) only buys you entry into the semi-finals. In order to progress beyond that, you need to add new jumps, or increase the level of difficulty of the jumps, or throw in some spins. Additional product innovation is required in the way of enhancements permitting greater flexibility for the issuer, or enhancements garnering improved equity credit. But then what? Once an innovation is introduced, and it is tested and proven to pass ratings agency and tax muster, it quickly finds its way into the next generation of hybrids and becomes the new standard. Some widely accepted innovations, like payment deferral features with alternative payment mechanisms, have now become old hat. Everyone is doing it, and the playing field is leveled again. Back to testing the limits, adding new features or nuances. Does too much engineering threaten the integrity of the overall routine? Each of the subtly different features may make hybrid securities difficult for investors to analyse and compare. Ratings agencies have begun to consider whether bankers have become too greedy with the enhancements and have proposed changes to their classifications. Having listened to the IRS's expressions of concern over long maturities, tax practitioners may become more conservative. Market participants will be eagerly watching for the next enhancement or innovation that adds to the hybrid repertoire. ■