Next Generation Hybrid Securities

By Anna Pinedo

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Introduction

Hybrid securities, or securities that have some equity characteristics and some debt characteristics, have been popular for over a decade. Hybrid securities lie somewhere along the equity-debt continuum, but 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.

Hybrid securities include certain classes of preferred stock, trust preferred securities, and convertible debt securities. Issuers like hybrid securities because these instruments often receive favorable treatment by ratings agencies and regulators when they analyze an issuer’s capital structure. Many hybrids also provide a lower after-tax cost of capital for issuers.

Ratings agencies recently changed their methodologies for analyzing hybrid securities, creating defined “baskets” based on the “equity-like” or “debt-like” content of a security. Under the basket approach, a hybrid security meeting specific criteria will qualify for a specified percentage of equity treatment. 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 a hybrid security, was a catalyst for new product development. Product structuring groups around Wall Street set out to build a better hybrid security. What are the key elements of a better hybrid security? A better hybrid security:

- qualifies for favorable equity treatment;
- allows issuers to make tax-deductible payments; and
- qualifies as Tier 1 capital for bank holding companies.

This article discusses the principal structuring considerations relating to hybrid securities. The article does not address accounting issues, which often may be significant.
The Measuring Stick

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 favorable the treatment. From a tax perspective, the more debt-like the hybrid, generally, the more favorable the tax treatment the issuer can obtain. This poses an interesting conundrum.

In thinking about how to structure a security to meet these seemingly contradictory objectives, it is helpful to identify the core elements of common equity (which Standard & Poor’s refers to as “the paradigm equity”) and the core elements of debt. Both Moody’s and Standard & Poor’s identify several characteristics associated with “pure equity,” including no maturity, no ongoing payments that could trigger a default if unpaid, and loss absorption for all creditors. For example, common stock has no fixed repayment obligation or term. In contrast, debt usually has fixed payments and a stated maturity. An issuer can elect to not pay dividends on its common stock, but non-payment of principal or interest on a debt security generally will constitute an event of default. Finally, common stock provides “loss absorption” for an issuer, meaning that common stockholders are the last class of security holders to receive distributions in a liquidation. By contrast, debt holders have a right to receive payments prior to equity holders. In evaluating a hybrid security, both Moody’s and Standard & Poor’s consider whether, how, and the extent to which, the features of a hybrid security replicate these characteristics associated with common equity.

The most common hybrid securities are preferred securities with additional features designed to achieve enhanced economics or other efficiencies. As a general matter, preferred stock is issued directly by an issuer. Preferred stock may entitle the holder to a dividend, subject to declaration by the issuer, and may entitle the holder to some voting rights. As with common stock, non-payment of a preferred stock dividend will not trigger an event of default. However, non-payment may breach a covenant or other contractual undertaking by the issuer. Dividend payments may be cumulative, or non-cumulative. Preferred stock may be convertible, at the option of the issuer or the holder or mandatorily upon the occurrence of certain events. While senior to common stock in liquidation, preferred stock provides some measure of loss absorption in a bankruptcy or other degraded financial situation.

From a tax perspective, the issuer of a hybrid security wants a tax deduction for the associated dividends or coupon payments. A tax deduction will be available if the security is determined to be debt for tax purposes. Whether a security is debt or equity for tax purposes depends on a careful evaluation of the facts and circumstances and is not subject to a bright-line test.

In 1994, the Internal Revenue Service set forth the following list of non-exclusive debt-equity factors: “(a) whether there is an unconditional promise on the part of the issuer to pay a sum certain on demand or at a fixed maturity date that is in the reasonably foreseeable future; (b) whether holders of the instruments possess the right to enforce the payment of principal and interest; (c) whether the rights of the holders of the instruments are subordinate to the rights of general creditors; (d) whether the instruments give the holders the right to participate in the management of the issuer; (e) whether the issuer is thinly capitalized; (f) whether there is identity between holders of the instruments and stockholders of the issuer; (g) the label placed upon the instruments by the parties; and (h) whether the instruments are intended to be treated as debt or equity for non-tax purposes, including regulatory, rating agency, or financial accounting purposes.”

The IRS Notice further states that “[n]o particular factor is conclusive in making the determination of whether an instrument constitutes debt or equity. The weight given to any factor depends upon all the facts and circumstances and the overall effect of an instrument’s debt and equity features must be taken into account.”

For tax purposes, the analysis focuses on the rights of the holders of the hybrid security as compared to the rights of the issuer’s other security holders. In contrast, the ratings agency analysis for equity credit purposes focuses more on the effect of the security on the issuer’s capital structure and cash flows. The equity credit that is afforded to a hybrid security may change over the life of the security, but the tax characterization will remain the same.

Rating Agency Treatment

As discussed above, hybrid securities receive varying degrees of “equity content” from ratings agencies based on their features and their anticipated effect on the issuer’s capital structure. Ratings agencies will limit the overall amount of traditional hybrids to which they give equity treatment when considered relative to the issuer’s overall capital structure, but in general, ratings agencies like hybrids because they have some of the loss-absorbing features associated with common equity securities. To varying degrees, hybrid securities may provide “cushion” within an issuer’s capital structure in bankruptcy or upon the occurrence of other adverse events. Ratings agencies also consider the effect of the hybrid security on the issuer’s cash flows. The analysis of the hybrid security is separate and distinct from the rating agency analysis of the issuer’s overall credit rating.

In its Tool Kit, Moody’s has a continuum of five baskets, from the A basket, which is 0% equity and 100% debt, at the extreme, to the E basket, which is 100% equity and 0% debt, at the other extreme. The A basket would include a preferred stock dividend; convertible within three years; subordinated debt, preferred or senior, with accelerated conversion; optional deferral; and cumulative coupon. In order to assign a hybrid security to a basket, Moody’s assesses the instrument’s equity-like characteristics (measured against the no maturity, no ongoing payments, debt-like characteristics. From a ratings agency perspective, the more equity-like the hybrid, generally, the more favorable the treatment. From a tax perspective, the more debt-like the hybrid, generally, the more favorable the tax treatment the issuer can obtain. This poses an interesting conundrum.

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and loss absorption ideal) and assigns a ranking of strong (most equity-like), moderate, weak, or none (debt-like). The diagram below, from the Moody’s Tool Kit, illustrates the continuum of five baskets.

By comparison, Standard & Poor’s historically used an equity hybrid hierarchy or grid with a scale of 0% to 100% for equity credit, with common stock at 100%. Recently, Standard & Poor’s modified its scale and collapsed the hierarchy into three categories, with slightly different, more straightforward terminology. The three new levels of equity content are:

- “minimal equity content” (formerly 30% or less on the scale);
- “intermediate equity content” (formerly between 40 and 60% on the scale); and
- “high equity content” (formerly 70% or more on the scale).

Minimal equity content instruments include those with “little or questionable permanence; terms or nomenclature that restrict or discourage discretion over payments; and after-tax costs or conversion terms that may become unattractive to the issuer.” Intermediate equity content instruments include “most preferred stock from 30-year trust preferred with five-year cumulative deferral rights to perpetual, tax-deductible preferred with unlimited and/or non-cumulative deferral rights.” High equity content securities, or securities that would receive significant equity credit due to their equity-like features, include instruments with a mandatory component, either regarding deferral of ongoing payments (at appropriately high trigger levels), or near-term conversion into a fixed number of common equity shares (on a basis that would not be deemed unpalatable to the issuer at the time of conversion).  

Special Features of Hybrid Securities

Interest or dividend deferral

Many hybrid securities contain deferral features that permit the issuer to defer the payment of interest or dividends. Usually, an issuer that elects to defer a payment is blocked from paying dividends on its common stock or on more junior securities until all deferred payments are made. Depending on the structure, deferred payments may accumulate; cumulative payments generally accrue interest. Non-cumulative deferral offers are more favorable for the issuer. Generally, the longer an issuer can defer payments, the greater its financial flexibility.

Under revised rating agency guidance, payment deferral features receive greater equity benefit. An issuer can increase the equity content of a hybrid security by making payment deferrals mandatory, or automatic, upon reaching certain triggers that are meaningful to the issuer given its financial position. The use of a formulaic approach to payment deferrals, rather than retaining issuer discretion, will generate a score of “strong” (rather than “moderate”) from Moody’s. Securities with optional deferral features are categorized as

**Moody’s A-E Continuum**

- **A**
  - 0% Equity (100% Debt)
  - All dated subordinated debt (with maturity less than 49 years)
  - Preferred or subordinated debt
  - Perpetual or long-dated (i.e., 49-60 years)
  - Typically non-call 5 or 10 years
  - Optional deferral
  - Cumulative
  - Replacement language required

- **B**
  - 25% Equity (75% Debt)
  - Preferred
  - Perpetual or long-dated (i.e., 60 years)
  - Typically non-call 5 or 10 years
  - Optional deferral
  - Non-cumulative
  - Replacement language required

- **C**
  - 50% Equity (50% Debt)
  - Preferred
  - Perpetual
  - Typically non-call 5 or 10 years
  - Mandatory deferral
  - Non-cumulative
  - Replacement language required

- **D**
  - 75% Equity (25% Debt)
  - Preferred
  - Perpetual
  - Typically non-call 5 or 10 years
  - Mandatory deferral
  - Non-cumulative
  - Replacement language required

- **E**
  - 100% Equity (0% Debt)
  - Mandatory convertible
  - Conversion within 3 years
  - Subordinated debt, preferred or senior, with accelerated conversion
  - Optional deferral
  - Cumulative coupon
“moderate” (rather than “weak”). These rankings assume that payments on the hybrids are non-cumulative or may be settled in stock.

Perpetual or long-dated maturity

In order to replicate equity, many hybrid securities have extremely long maturities (the recent Lehman Brothers E-CAPS, for example, has a 60-year term) or are perpetual. A perpetual security that becomes a permanent part of the issuer’s capital structure (subject perhaps to an issuer call option) more closely replicates common stock and, therefore, achieves better equity credit. In some instances, it becomes difficult to distinguish—for purposes of assigning out equity credit, as well as from a tax perspective—between a security with an extremely long maturity and a perpetual security.

In its recent refinements to the Moody’s Tool Kit, Moody’s noted that treatment of undated hybrids with cash calls (the right, not the obligation, to repay the hybrid security) had changed, and that these instruments are now viewed less negatively than in the past. Previously, a call was viewed negatively because it detracted from the security’s permanence within the issuer’s capital structure. Moreover, the rating agency could not evaluate the instrument (if any) that the issuer would use to replace the hybrid upon exercise of the call. Moody’s revised view shifts scoring of a cash call on undated hybrids to “weak” (from “none”) and if there is a call subject to replacement of the security by a similar or more equity-like security, the scoring remains “moderate.” The rating agency criteria is somewhat different for banks and insurers given that the activities of these issuers already are subject to regulatory oversight and supervision.

Obligation to issue equity securities

Many hybrid securities are convertible—either on an optional basis or by their terms. Mandatory convertible securities are viewed by the ratings agencies as more equity-like because there is no potential refinancing requirement or repayment from the issuer’s cash flow. Securities convertible at the holder’s option signal the issuer’s intent to issue equity in the future. However, given the uncertainties associated with whether the security will be converted, the ratings agencies accord less equity credit to convertible debt or preferred stock. A hybrid security with a contemporaneous forward contract (essentially a synthetic mandatory convertible security) that provides for the issuance of equity in the future also may be helpful for obtaining enhanced equity credit.

Ratings agencies have been focused on “replacement language” in hybrid securities, which indicates either the issuer’s intent or its contractual undertaking to replace or “refinance” the original hybrid security with securities having similar or higher equity content.

Subordination

Hybrid securities generally are subordinated to debt (in the case of preferred stock) or to other debt (in the case of junior subordinated debt securities). As a result, hybrid securities provide loss absorption. The Moody’s refinements now characterize preferred securities and certain types of subordinated debt as “strong” (rather than “moderate”) in recognition of their loss absorption characteristics.

Tax Considerations

In order to be efficient from a tax perspective, payments on a hybrid security must be tax deductible, or constitute debt for federal tax purposes. In Europe, the hybrid capital market has flourished in part because many jurisdictions permit interest deductions on perpetual debt securities—making it easier to create hybrid securities that result in interest deductions for the issuers.

As noted above, there is little clear-cut guidance to distinguish between debt and equity for tax purposes. Courts and the IRS have considered instances where long-term obligations were upheld as debt. However, courts and the IRS also have emphasized that it is important to consider all the facts and circumstances, including whether an instrument contains “significant equity characteristics” and whether those characteristics are outweighed by the instrument’s debt characteristics. Debt-like traits that courts have considered include the source of payments for the instrument (payments from profits or payments conditioned upon earning would suggest an equity-like instrument), whether holders have the right to enforce payment of principal and interest (if a holder has an enforceable right to payments, the security is more debt-like), and the likelihood of repayment by the issuer. Courts consider the level of subordination of the instrument compared to other indebtedness, and also whether the instrument has a fixed maturity. These characteristics are evaluated in the context of the issuer’s business history and other facts and circumstances, such as the nature of the issuer’s business, the issuer’s financial condition, and how likely it is that the issuer will be in existence when the security is scheduled to be repaid.7

Bank regulatory considerations

Banks have particular concerns when it comes to hybrid securities. Bank hybrid capital instruments constitute capital for regulatory capital purposes, but are treated as debt for tax purposes.

The Basel Accord, or Basel I, sets forth criteria for measuring capital adequacy. Basel I divides bank capital into two categories: Tier 1, or core capital, and Tier 2, or supplementary capital. Tier 1 capital includes common stock, non-cumulative perpetual preferred stock, disclosed reserves, and minority interests in the equity accounts of consolidated subsidiaries. Tier 2 capital includes undisclosed reserves, asset revaluation reserves, general provisions/loan loss reserves, hybrid (debt/equity) capital instruments (like mandatory convertible debt and cumulative perpetual

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preferred stock, term subordinated debt, and intermediate term preferred stock. Under Basel capital requirements, banks are required to maintain certain ratios between Tier 1 and total capital to assets. 

In 1996, the Federal Reserve Board determined to treat trust preferred securities as Tier 1 capital, subject to a limit of 25% of a bank holding company’s Tier 1 capital. Trust preferred securities were considered Tier 1 capital if they (1) were subordinated to all subordinated debt, (2) had a minimum five-year interest deferral, and (3) had the longest feasible maturity. In 2005, the Federal Reserve Board revised its treatment of trust preferred securities for bank holding companies subject to Basel I by providing that these securities could not exceed 15% of Tier 1 capital. A combined limit of 25% applied to trust preferred securities and certain mandatory convertible securities described as “securities that consist of the joint issuance by a bank holding company to investors of trust preferred securities and a forward purchase contract, which the investors fully collateralize with the securities, that obligates the investors to purchase a fixed amount of the bank holding company’s common stock, generally in three years.”

In January 2006, the Federal Reserve Board issued a letter to Wachovia Corporation regarding the regulatory capital treatment of a new security, the Wachovia Income Trust Securities (discussed below), in relation to these 15% and 25% limits. The letter concluded that these trust preferred securities, which are mandatorily convertible into non-cumulative perpetual preferred stock, would count as a form of qualifying mandatory convertible preferred security outside of the 15% basket as Tier 1 capital.

Ratings agencies view hybrid capital issuances by bank holding companies somewhat differently because these issuers are so highly regulated. As a general matter, regulators impose limits on the inclusion of hybrids in capital. Also, redemption of a hybrid security typically is subject to prior regulatory approval. In contrast to other non-regulated issuers, Standard & Poor’s notes, for example, that a mandatory payment deferral feature in a bank hybrid security is not a material factor in assessing equity credit because regulators retain authority over payment deferrals.

The rating agency approach is consistent with, and mirrors in most respects, the regulatory approach to hybrids. A Tier 1 instrument generally receives a category 2 “strong” classification by Standard & Poor’s and a Tier 2 instrument generally receives a category 2 “adequate” classification. Moody’s notes that it recognizes the benefit of regulatory oversight in the context of assessing the “no maturity” prong, explaining that “[s]pecifically for an undated hybrid with a cash call, the benefit of regulatory oversight is recognized if we believe that regulators will: not allow a hybrid to be called if the bank [or insurer] is in financial distress; and generally require that a hybrid be replaced with a similar or more equity-like security due to regulatory tiering of the capital structure.”

Regulated insurance companies also are subject to regulatory capital limits for hybrids. Ratings agencies consider the insurance regulators’ views in assessing equity credit for hybrid securities issued by insurance companies. Most insurance companies issue hybrid securities through their holding company, rather than through the regulated entity. In these cases, rating agencies do not consider the benefits of regulatory supervision to be as significant.

Registration

Hybrid securities may be issued pursuant to a registration statement or an exemption from registration, such as that provided by Rule 144A. If an offering relies on Rule 144A and involves the issuance of securities by a trust, the trust can rely on an exemption for offerings to an unlimited number of investors who are “qualified purchasers” in order to avoid registration as an investment company under the Investment Company Act of 1940.

Recent Hybrid Issuances

Most of the recent issuances of new hybrid securities are based on structuring concepts that were first developed a decade ago. These core concepts have been modified to reflect rating agency changes, regulatory capital changes, and accounting developments. This section briefly reviews several of the newest hybrid offerings.

Trust preferred securities

To issue trust preferred securities, an issuer first organizes a Delaware statutory trust and then purchases and holds all of the common interests in the trust. The security offered to investors represents an undivided preferred beneficial interest in the trust. The trust sells these beneficial interests and invests the offering proceeds in a subordinated long-dated debt security (for conventional trust preferred securities, usually at least 30 years) of the issuer—frequently a bank holding company. The trust preferred security and the issuer’s subordinated debt security will have substantially identical terms. The issuer of the debt security has the option to defer interest payments without triggering an event of default for a period of (usually) five years. Distributions on the securities typically are cumulative. The diagram on the following page illustrates the basic trust preferred security, or TRUPs.

For tax purposes, the trust is a pass-through and its income is not subject to separate tax. The interest payments on the underlying debt securities are treated as tax deductible. The issuance of the trust preferred securities is not dilutive to the issuer. For bank holding companies (subject to the limitations discussed above), these securities count as Tier 1 capital for regulatory purposes.

Trust preferred securities are assigned equity credit due to their deep subordination (the underlying debt securities are junior subordinated notes), long maturity, interest deferral feature, and equity conversion option. The basic trust...
preferred security is viewed by Standard & Poor’s as having 40% of the equity content of common stock. If the issuer adds a convertibility feature, the treatment may improve to 60% equity content. Conventional trust preferred securities receive A-basket treatment from Moody’s.

**Enhanced trust preferred securities**

In December 2005, through a statutory trust (USB Capital VII), U.S. Bancorp issued income capital obligation notes, or ICONs. Investors purchased trust preferred securities, representing beneficial interests in a statutory trust, the sole assets of which are the ICONs. Interest on the ICONs is fixed and payable quarterly, with optional deferral of interest payments for up to five years. During an interest deferral period, U.S. Bancorp cannot pay dividends on its more junior securities. If the deferred interest is not paid for at least five years, U.S. Bancorp must use commercially reasonable efforts to sell common stock or perpetual non-cumulative preferred stock in an amount sufficient to pay the deferred interest, unless it is prevented from doing so by the occurrence of a “market disruption event,” such as a general securities trading halt, or the failure to obtain regulatory consent to issue shares of common stock and/or perpetual non-cumulative preferred stock. Failure to pay interest after ten years is an event of default. These last two features are among several that distinguish ICONs from traditional trust preferred securities.

The ICONs rank junior to all current and future indebtedness of U.S. Bancorp. They have a maximum term of 59 years (longer than traditional trust preferred securities), but are redeemable, subject to prior regulatory approval, after the fifth anniversary of issuance. U.S. Bancorp has agreed with holders of its more senior debt through a declaration of covenant that it will not redeem the ICONs within 30 years unless, within 180 days prior to the date of redemption, it replaces the ICONs with securities having substantially similar regulatory and other terms and conditions.

The ICONs are treated as Tier 1 capital for regulatory capital purposes, subject to the 25% basket. For rating agency purposes, the ICONs received C-basket treatment from Moody’s. On the maturity criteria, the securities’ term and contractual replacement language justify a “strong” ranking. On the ongoing payments criteria, the issuer may defer distributions for up to ten years, with an alternative settlement of deferred payments taking place after five years, yielding a “weak” ranking. On loss absorption, the securities are junior subordinated debt, yielding a “moderate” ranking. ICONs are a Category 2 Intermediate-Strong for Standard...
& Poor’s. Again, the presence of contractual replacement language was important.

**REIT preferred securities**

Beginning in the mid to late 1990’s, a number of bank holding companies sponsored real estate investment trusts, or REITs. Generally, the bank holding company would organize a REIT and contribute cash and mortgage-related assets in exchange for the REIT’s common stock. The REIT offered non-cumulative perpetual preferred stock to the public, and used the offering proceeds to purchase additional mortgage-related assets from the bank holding company. Income on the REIT’s mortgage-related assets is distributed to the holders of the REIT securities, including the preferred stockholders. The REIT deducts the dividends paid on the preferred and common stock. The income stream resulting from the mortgage-related assets is not subject to the corporate level tax. The transaction results in Tier 1 capital for the bank holding company.

In February 2006, Washington Mutual completed a financing in reliance on Rule 144A involving an issuance by a Delaware statutory trust of Fixed-to-Floating Rate Perpetual Non-Cumulative Trust Securities, Automatically Exchangeable in Specified Circumstances into Depositary Shares representing Preferred Stock of Washington Mutual, Inc. The trust securities are beneficial interests in Washington Mutual Preferred Funding Trust I, a statutory trust, which holds fixed-to-floating rate perpetual non-cumulative preferred securities (bearing terms identical to the trust securities) issued by Washington Mutual Preferred Funding LLC. The limited liability company, a partnership for income tax purposes, purchased an interest in a real estate mortgage investment conduit, or REMIC, for federal income tax purposes. The REMIC owns mortgage loans contributed by Washington Mutual Bank.

Since the REMIC is a pass-through entity and Washington Mutual Preferred Funding LLC is a partnership for tax purposes, the income stream on the mortgage loans is effectively carved out from corporate income tax. Washington Mutual is a federal savings bank regulated by the Office of Thrift Supervision, which, unlike the Federal Reserve Board, does not treat trust preferred securities as Tier 1 capital. The preferred securities are non-cumulative; however, if dividends are not paid, then the parent company, Washington Mutual Inc., covenants not to pay dividends on its publicly traded common stock. The preferred securities also are subject to conversion into perpetual non-cumulative preferred stock of the parent company upon the occurrence of certain regulatory events. Washington Mutual agreed that if it repurchases or redeems trust securities, it will do so only if and to the extent that the total redemption or repurchase price is equal to or less than designated percentages of the net cash proceeds that it receives during the 180 days prior to the redemption date from the issuance of other securities having similar equity content.

Moody’s assigns D-basket treatment to this security. On maturity, the security ranks “strong.” On ongoing payments, the security ranks “moderate.” There is an optional dividend deferral and payments are non-cumulative. On loss absorption, the security ranks “strong.”

**Unit transactions (debt/forward structures)**

Another conventional hybrid structure is the mandatory convertible security structured as a unit consisting 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 company, 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.16 The subordinated debt security is issued by a trust, the Wachovia Capital Trust III. The trust holds REMICs and contributes cash and mortgage-related assets in exchange for the REIT’s common stock. The WITS and the perpetual preferred stock have a 5.8% coupon. Interest on the notes is deferred and is cumulative. After five years, the subordinated debt security can be redeemed, and the proceeds from the redemption will be used to exercise the forward contract to purchase the non-cumulative perpetual preferred stock. If the note is not redeemed, then the trust

The diagram below illustrates the basic features of this transaction:
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 be 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.

Standard & Poor’s views the WITS as two separate transactions. The issuer benefits from payment deferral, although Standard & Poor’s notes that the term of the notes is too short to obtain equity credit. However, the non-cumulative perpetual preferred stock has strong equity-like characteristics. Moody’s assigned the WITS D-basket treatment. On maturity, the securities receive a “strong” ranking. On ongoing payments, distributions are deferrable for seven years and must be settled using common stock. The forward contract obligates Wachovia to sell non-cumulative perpetual preferred stock to holders in five years. The perpetual preferred is immediately callable subject to binding replacement language. As to ongoing payments, the WITS receive a “moderate” ranking. On loss absorption, the WITS rank “strong.” From a tax perspective, the components (the note and the forward contract) are treated as two separate instruments. Interest on the note is deductible for federal income tax purposes.17

In March 2006, U.S. Bancorp used a similar structure to offer, through a trust (USB Capital IX), its Fixed-to-Floating Rate Normal ITS, or income trust securities.18 The diagram below summarizes the principal features of these transactions.

**E-CAPS**

In August 2005, Lehman Brothers issued Enhanced Capital Advantaged Preferred Securities, or E-CAPS, in a private placement. Unlike many of the other new hybrid securities, which improved upon prior structures, the E-CAPS structure is innovative. The objective was to create a non-cumulative perpetual instrument (the preferred securities) payable from term securities that are treated as debt for federal income tax purposes. E-CAPS accomplished this result using a “stacking” structure, composed of two elements: a limited liability company (treated as a partnership for tax purposes) in which investors buy perpetual non-cumulative preferred securities (treated as partnership equity), and an investment by the limited liability company in subordinated debt of the issuer. The diagram on the next page summarizes the principal features of the E-CAPS.

The E-CAPS are issued by a trust, the sole assets of which are preferred equity interests in a limited liability company controlled by Lehman Brothers Holdings, Inc. The sole assets of the limited liability company are floating rate 30-year subordinated debentures of Lehman Brothers Holdings that roll over into a new 30-year debt security. E-CAPS holders receive a pro rata share of the payments that the LLC makes on its preferred interest, which mirror Lehman’s payment on the debentures. Lehman guarantees the payments on the E-CAPS and the preferred interests. The E-CAPS themselves are perpetual but the underlying debt has a 60-year term. Interest is deferrable for up to 12 years and deferred payments may be settled in stock. The securities are callable five years after issuance. Payments are cumulative only under certain circumstances. The transaction includes intent-based replacement language, indicating the issuer intends to replace the securities with securities having the same or higher equity content.

From the Moody’s perspective, E-CAPS receive D-basket treatment. On the maturity criteria, E-CAPS have a 60-year maturity with replacement language, yielding a “moderate” rating. On the ongoing payments criteria, the E-CAPS have a
mandatory dividend deferral tied to certain triggers—receiving a “strong.” From a loss absorption perspective, the securities are junior subordinated debt, receiving a “moderate.”

More recently, the National Association of Insurance Commissioners (or “NAIC”) Securities Valuation Office, which provides guidance regarding the reporting treatment of securities by regulated insurance companies, including the classification of instruments as debt or equity by insurance company buyers, considered the characterization of E-CAPS. The NAIC determined that regulated insurance companies that purchased and are holding Lehman E-CAPS should classify those instruments as “common stock” for reporting purposes on their financial statements. Given that insurance companies are frequent issuers, as well as purchasers, of hybrid securities, the NAIC classification has provoked much discussion among market participants relating to the association’s classification process and the possible classification of other hybrid securities products that are being marketed. The NAIC is currently considering its classification process.

Conclusion

The interaction of issuers seeking lower after-tax funding costs or regulatory capital or other benefits, with bankers and product structurers eager to produce the next enhancement to hybrid securities, inevitably will result in more innovation. The most recent hybrid securities issuances have introduced new elements, like intent-based or contractual replacement language and mandatory or optional deferral triggers, which are quickly becoming part of the financial products engineering lexicon. Incorporating new elements and building on many of the features of prior generations of hybrid securities, the most recent series of products offer greater benefits for issuers. As these new securities are subjected to scrutiny by investors, regulators, and ratings agencies, as well as market stress, it will be interesting to observe which products and features achieve permanence.

Notes

2. See Moody’s Investors Service “Refinements to Moody’s Tool Kit: Evolutionary, not Revolutionary!” (Feb. 2005) and “Refinements to Moody’s Tool Kit: An Addendum for Banks and Insurers” (Jan. 2006). See also Standard & Poor’s “Corporate Criteria—Equity Credit: What it is, and How You Get It; Factoring Future Equity Into Ratings; Tax-Deductible Preferreds and Other Hybrids; A Hierarchy of Hybrid Securities” (Mar. 3, 2005) and “Corporate Criteria: Streamlining Hierarchy for Hybrid Securities” (June 20, 2005).


5. Id.


7. These and other factors are identified in IRS Tax Action Memo (TAM) 199910046 (Nov. 16, 1998).


14. See Section 3(c)(7) of the Investment Company Act of 1940.

15. See Registration Statement on Form S-3 (File No. 333-124535).

16. See Registration Statement on Form S-3 (File Nos. 333-131237 and 333-131237-01).


18. See Registration Statement on Form S-3 (File No. 333-132297).