Guide to Hybrid Securities
in association with Fitch Ratings

The use of hybrid securities is rapidly increasing across different industries and geographic sectors. But despite the hype, there is still mystery surrounding them. This five-part guide takes an in-depth look at how corporates, banks, insurance institutions and investors are using hybrid ***securities*** *and also answers treasurers' questions.*

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Guide to Hybrid Securities - Part 1: Overview of Hybrid Securities
27 Jun 2006 - in association with Fitch Ratings

The first part of this guide to hybrid securities looks at how this once-specialist asset class has gradually become more accepted as a source of capital. The emergence of hybrids owes much to market and regulatory developments, as well as the methodologies from ratings agencies, which are also considered in this article.

Fitch Ratings has published an exposure draft in order to seek feedback on its plan to streamline and harmonise its approach to allocating equity credit for hybrids and other capital securities across all corporate and financial sectors. To read the draft and provide feedback, please click on this link: Exposure Draft - Equity Credit for Hybrids & Other Capital Securities

Introduction

There has been much debate recently about hybrid securities in the debt capital markets. Are they an attractive long-term investment and sound borrowers' product, or a passing trend in the non-financial corporate arena? This five-part series answers this question and provides treasurers in dynamic and capital-hungry entities with a thorough understanding of the attractions, flexibility, myriad features and risks of hybrid securities.

Hybrids are currently a hot topic. Rapidly increasing issuance across industry and geographical sectors, major regulatory developments and the close attention of the credit rating agencies have combined to place hybrids at centre stage of the global capital markets.

Issuance runs into hundreds of billions of dollars. And hybrids are no longer an exotic or specialist asset class used primarily by regulated financial services issuers. Rather, they have become a distinct and ascendant asset class and a major global source of capital.

Hybrids demand - and reward - the serious consideration of all capital-hungry entities as a flexible and attractive potential alternative, or complement, to either straight equity or straight debt.

In this environment, and with corporate issuance experiencing the most rapid expansion, it is crucial for corporate treasurers, in particular, to be aware of the principles and issues involved.

Definition

Hybrids combine both equity and debt characteristics with the objective of providing manageable, non-dilutive and attractively priced capital.

- Equity, crucially, has no maturity, obligates the issuer to no fixed periodic payments and is the most at risk and lowest ranked of all securities. As a consequence, equity may be relatively expensive and cumbersome to raise and service but provides significant financial flexibility to an issuer and, in particular, the ability to generate leverage.
- Debt, by contrast, has a defined maturity structure, accrues interest and is ranked senior to equity.
- Hybrids, meanwhile, are defined as subordinated bonds with some equity characteristics, such as perpetual or very long-dated maturities or an absence of obligatory fixed period payments.

Flexible Equity/Debt Characteristics

Hybrids, for all their current fashionability, are not a new phenomenon. So, for example, preference shares, that traditional staple of UK corporate finance, are a form of hybrid. Preference shares count as equity but are generally non-participating and entitle the owner to a fixed dividend even if dividends are not paid to ordinary shareholders. They are also usually cumulative, with unpaid dividends in any one year carried forward. They may also be redeemable or convertible.

The contingent nature of preference shares' characteristics - 'generally non-participating', 'usually cumulative', 'may also be redeemable or convertible' - underlines the fundamental flexibility and variability of *all* hybrids.

Hybrids are located across a broad spectrum, whose extremes are defined by the starkly contrasting characteristics of straight equity and debt. Across that spectrum, the characteristics of individual hybrids vary significantly. This flexibility allows individual hybrids to exhibit either equity or debt characteristics in relation to specific variables - maturity, deferability of payments and seniority - and to do so to greater or lesser extents.

This striking feature of flexibility and variability offers attractive, bespoke possibilities, especially to potential issuers and fee-earning investment bankers. Alternatively, it may be viewed as unattractive or risky non-standardisation, especially by sceptical and hard-pressed investors.

An Attractive Source of Capital

Ultimately, of course, both equity and debt are generally represented in the balance sheet of a mature and rational issuer, with an eye on the interests of shareholders, the purposes to which capital is to be applied, to diversification among classes of capital and investors and to the initial costs of issuance and to the continuing post-tax cost of servicing capital.

Shareholders' equity undoubtedly lies at the very heart of corporate identity and the balance sheet. It offers maximum flexibility and the capacity to generate leverage. Debt, meanwhile, is invariably cheaper to issue - and to continue to issue periodically and opportunistically - and also entails a lower post-tax cost of capital.

Hybrids offer a possible Holy Grail of equity flexibility and absence of obligation or increased gearing, with the non-dilution and lower post-tax cost of capital offered by debt issuance.

It's a Holy Grail that issuers and investment bankers have, inevitably, pursued with considerable enthusiasm.

Regulatory and Market Developments

The emergence of hybrids owes at least as much to regulatory developments across jurisdictions as it does to the ingenuity of issuers and investment bankers. And at least as much again to the evolving methodologies of the credit rating agencies, which are considered below.

Financial Institutions

The initial impetus for the recent ascendancy of hybrids dates from the Basel Accords and regulators' endeavours to determine and enforce capital adequacy standards, defining core (Tier 1) and supplementary capital (Tier 2).

In 1996, the US Federal Reserve approved the inclusion of trust preferred securities in Tier 1 capital, up to a limit of 25 per cent of Tier 1 capital. Prolific US bank issuance of trust preferred securities followed in 1996-97.

In late 1998, the Basel Committee amended its definition of Tier 1 capital to include 'innovative' forms of capital up to a limit of 15 per cent, opening the way to the inclusion of hybrids, instruments that were treated as non-cumulative preference shares for capital adequacy purposes but that were still tax-deductible in parallel with debt securities.

In Europe, the introduction of the euro, along with significant industry consolidation across the continent, provided further impetus to acquisitive, capital-hungry banks' issuance of hybrids.

As a result of strong corporate demand for capital, financial market ingenuity and regulatory innovation, between 1996 and 2004 global hybrid issuance approximated US$250bn and annual issuance has simply continued to accelerate in the past two years.

Further impetus, beyond issuers' demand for capital, has been provided by the Federal Reserve's regulatory interpretation that allows bank holding companies to issue 'mandatorily convertible securities' that convert into preferred stock. With perhaps US$50bn of earlier trust preferred securities likely to be refinanced in accordance with the new interpretation in the next year or two, the implications for the burgeoning market are clear.

Regulators intended that such hybrids should absorb losses, such as equity, while issuers and investors often considered such securities to be more like debt. So, for example, trust preferred securities, first issued in 1993, were deliberately structured in order to be treated as equity for financial statement purposes and as debt for tax purposes.

Such discontinuities, both of perception and of substance, conferred significant potential risk. The interposition of the credit ratings agencies provided an analytical framework to handle these discontinuities and thus contributed significantly to underpinning the viability of the emerging hybrid asset class.

Insurance Companies
As with the banking sector, hybrid issuance by insurance companies reflects the sector's burgeoning appetite for capital and has also been facilitated by regulatory initiatives. Solvency II, for example, will align insurance capital requirements more closely with those of the banking sector across the EU and should underpin further buoyant hybrid issuance by insurance companies in the next year.

Banks and insurance companies have now issued hybrids in US, Australian and Singaporean dollars, sterling and euros, with additional Tier 2 issuance in New Taiwan and Canadian dollars, Swiss francs, Norwegian krone and Japanese yen. The asset class and market have become truly global.

The Corporate Sector
Corporate hybrid issuance is the most recent major market trend. Such issuance is generally tax-deductible, non-dilutive and may reduce the issuer's weighted average cost of capital.

Hybrid issuance within the non-regulated corporate sector is expanding, albeit from a narrow base, more rapidly than in either the regulated, banking or insurance sectors. And while hybrid issuance in the financial sector was initially more pronounced in the US than in Europe, the opposite is true for corporate issuance, with Europe developing more rapidly than the US. However, in 2005 euro-denominated hybrid issuance by financial institutions, by value, remained around five times that of corporate issuers.

Corporate hybrid issuance has been driven chiefly by buoyant levels of M&A activity. Corporate issuance represents a viable alternative to raising equity or debt, or to disposing of other assets. In some cases, hybrid issuance has allowed an acquisition to proceed without a detrimental impact on the acquirer's credit rating and certainly without the dilution of major shareholders' equity. Major shareholders in this regard may be the family owners of private companies or, indeed, governments.

Corporate hybrid issuance may also finance share buy-backs or enhanced dividend payments without materially increasing an issuer's leverage. It may also be issued specifically to finance pension fund deficits, or to reduce debt and to de-leverage the issuer.

Corporate issuance in euros in the past year has been buoyant with all of these factors underpinning one or more of the major issues to have been undertaken.

Credit Where Credit's Due

The commitment of the credit rating agencies to developing methodologies for assessing the credit quality of hybrids has been crucial to the development of the asset class, especially in respect of the non-regulated corporate sector. And the relationship between an actual or potential issuer and its agency(ies) is just as important in respect of hybrids as with all other rated issuance. Also read How To Manage Your Rating Agency Relationship.

Issuance

The credit ratings agencies have been active since the introduction of hybrid securities, evolving alternative methodologies for assigning equity credit to hybrids. However, the majority of early issuance was designed to meet regulatory requirements rather than to satisfy the credit concerns of the agencies.

In 2001, Fitch published guidelines for allocating equity equivalence across a spectrum of hybrids. These guidelines reflected a particular concern with the cash flow flexibility any one hybrid allowed an issuer during periods of stress.

In 2004, more than 200 hybrids with a total value approaching US$50bn were back-tested to assess whether their performance in a period of financial stress was consistent with the Fitch guidelines for equity allocation. This analysis revealed that some hybrids successfully provided equity-like flexibility, or loss absorption characteristics but that others were less effective in this regard.

Major conclusions include:

- Issuers in financial distress either restructured and solved their problems within three years, or liquidated;
- Securities with more than 10 years to maturity, without the right to acceleration, provided substantial liquidity relief and thus full, 100 per cent equity credit is assigned to a security with a maturity of more than 10 years, reducing to 0 per cent at five years to redemption; and
- Equity credit is reduced or even eliminated for hybrids with financial covenants similar to senior debt or that would represent a senior claim against the issuer in the event of bankruptcy.

Fitch has just published a consultation document on a new hybrid securities methodology. The market for these securities has developed, as noted, recently. This development has been accompanied by requests for a simplified approach to equity credit allocation, with a degree of standardisation of rating agency approaches desired. The consultation document therefore specifies that Fitch uses five classes of equity allocation between 0 and 100 per cent, with Class A permitting 100 per cent equity allocation for a hybrid security, class B 75 per cent and thereon down to Class E's 0 per cent. The factors affecting equity allocation are to be found in 'Fitch Exposure Draft: Equity Credit for Hybrids and Other Capital Securities'.

The Fitch Equity-Debt Continuum extends from 100 per cent equity credit for common stock to 0 per cent equity credit for straight debt or for preferred stock with an investor put feature, or for optionally convertible senior debt that is either out of the money and/or with several years to its call date. Between these two extremes, factors and securities are carefully assessed for equity credit.

In addition to the activities of the credit ratings agencies, accountancy regulations have also evolved to account for hybrids, with IAS 32 classifying nearly all hybrid securities as debt.

Investment

Investors have also generally been persuaded of the viability of hybrids. Underperforming equities and low interest rates, in conjunction with regulatory changes, have generated appetite for such securities. Investors are concerned that hybrid issuance should be underpinned by a viable business case and there are residual concerns relating to the non-standardisation of such securities across and within jurisdictions but documentation and technical issues are being rendered consistent, as far as possible.

In parallel with the work of the credit rating agencies, investment banks have developed sophisticated valuation models that have especially supported investor interest in the asset class.

Conclusion

Hybrids are set to remain centre stage. Favourable regulation, the close attention of the credit ratings agencies, the appetite for capital by issuers and for yield by investors and standardisation within the asset class are all set to ensure continued buoyant levels of issuance.

For corporate treasurers, the attractions are clear and include flexibility, minimal impact on gearing, non-dilution, tax-deductibility and reduced weighted average cost of capital.

The second article in this guide to hybrid securities will look more closely at developments and issues within the burgeoning corporate hybrid sector.

Guide to Hybrid Securities - Part 2: Corporate Hybrids

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This second article considers market structure and the reasons for the recent proliferation of non-regulated corporate issuance, especially in Europe. The attractions and purposes of such issuance, as well as the processes and risks, are also considered, as is the streamlined ratings methodology, treating corporate and financial institutional issuance similarly.

Introduction:

Issuance of hybrid securities has been concentrated among regulated financial institutions in the last decade and is now a huge global phenomenon. In 2005, aggregate issuance approached US$150bn, with hybrids denominated across a wide range of currencies.

Since 2003, however, the nascent corporate sector has enjoyed strong growth from a negligible base. Recent corporate hybrid issuance has been especially concentrated in Continental Europe.

In Europe, bank tier one issuance since 2000 averages around 50 issues per year, with an approximate aggregate value of €20bn. Insurance issuance averages around 20 issues per year, with a total value of around €10bn.

Meanwhile, corporate issuance began in 2003 with a couple of issues, reaching double figures in 2005. The aggregate value in 2003 was less than €1bn, while individual issues now range in size from less than €100m to the €1.3bn hybrids from both Bayer AG and Henkel in 2005. Corporate issues in excess of €1bn are comparable in size to the hybrid issues of financial institutions.

So, has the sector now achieved critical mass, at which point both issuers and investors will participate more regularly and with greater confidence? Or is the recent upsurge in activity merely transitory?

Impetus to Issuance:

Hybrids combine debt and equity characteristics. They are structured as subordinated bonds with equity features, such as perpetual or long-dated maturities, or an absence of obligatory fixed period payments.

Crucially, like equity, hybrids are loss absorbing. Defined as subordinated bonds with equity characteristics, hybrids are not a new breed of security. So, for example, preferred stock or a corporate finance staple such as the preference share fall within this definition of a hybrid security.

The principal impetus for the issuance of modern hybrids was provided by the global regulation of financial institutions. The specification of capital requirements for financial institutions, whether from the Federal Reserve, the Basle Accords or the impending Solvency 2, underpinned the development and proliferation of innovative forms of capital such as hybrids. The introduction of the euro, consolidation and growth within the financial sector and the refinancing of debt have all provided further impetus.

If regulation drove the expansion in hybrid issuance by financial institutions, then the intrinsic attractions of capital raised via this asset class have often proven a sufficient inducement to the treasurers of dynamic, capital-hungry, unregulated corporates.

These attractions include:

- Equity flexibility
- Non-dilutive source of capital
- No increase in gearing
- Generally tax-deductible
- Reduced post-tax weighted average cost of capital

The Corporate Sector:

Issuance by financial institutions is - and will remain - a multiple of that from corporates but expansion in corporate issuance is currently more rapid than that in the financial sector.

Furthermore, while issuance among financial institutions emerged from the US and subsequently crossed the Atlantic, the opposite is true for corporate issuance.

While the European corporate sector may currently be the most lively, issuance has also occurred in Australia, with Orica issuing A$500m in early 2006 and in the US, with The Stanley Works issuing US$450m in late 2005 and with Burlington Northern Santa Fe Railway Company (BNSF) and International Lease Finance Company following suit shortly afterwards, each securing equity credit for their issues. Issuance is also feasible for less creditworthy corporates and even for sub-investment grade issuers.

Corporate issuance, with cyclical industries predominating, may be undertaken for a variety of purposes, including:

(i) Non-dilution: Several of the largest corporate deals have been on behalf of German issuers. This partially reflects the existence of large shareholders who do not wish to have their shareholding diluted by the issue of additional equity. Family controlled companies that have issued hybrids include Porsche, Claas KGAA and Otto Group.

Government-owned entities may also have restricted access to the capital markets. The first hybrid issued by such an entity was on behalf of Sweden’s Vattenfall, the energy company issuing €1bn to enthusiastic investors and with the ratings agencies attributing equity credit in excess of 50 per cent.

(ii) Acquisition: Hybrids have become viable in financing acquisition, complementing the issue of equity or debt or the disposal of assets.

The Porsche and The Stanley Works hybrids were both intended to finance acquisitions and issuance need not detrimentally impact creditworthiness. In addition to which, hybrid issuance is less expensive than the issue of equity, does not dilute shareholdings and is generally tax deductible.

So, for example, Vattenfall's June 2005 €1bn issue allowed the company to prepare for acquisition, while the equity credit allowed the company to increase its debt capacity without jeopardising its rating. Indeed, Vattenfall retained its single-A rating with an improvement in credit outlook. In this case, hybrid issuance was actually associated with an improvement in credit perception.

At the very least, progressive corporate treasurers need to be prepared to assess the opportunistic viability of hybrids in such circumstances, especially in an environment where levels of M&A activity remain buoyant.

(iii) Financing Other Corporate Activities: Hybrid issuance may be devoted to specific purposes other than acquisition. Henkel's €1.3bn hybrid was issued to finance pension obligations. Such liabilities are long-term and contingent and thus, if the equity credit assigned to the hybrid exceeds that assigned to the pension liability, such issuance may improve creditworthiness. Certainly the credit outlook for Henkel improved as a result of such issuance.

Hybrid issuance may also finance share buy-backs or enhanced dividends without necessarily increasing leverage. Share repurchase programmes have been financed by hybrid issuance by BNSF in the US, CIT Group and others.

(iv) Managing the Balance Sheet: The retirement of expensive equity and its replacement with cheaper long-term hybrid issuance may insulate corporates from predators as well as strengthen the balance sheet. Bayer's €1.3bn hybrid, issued in July 2005, was aggressively priced but successfully launched. Following the major acquisition of Roche-OTC for €2bn, the hybrid bolstered Bayer's financial ratios and thus, creditworthiness.

Thomson SA of France also issued hybrid securities to repay senior debt and arguably its €500m issue in September 2005 was the only major European hybrid not to find favour among investors last year.

(v) Reducing Weighted Average Cost of Capital: Underpinning many of these purposes for hybrids and considerations is the reduced cost of capital. The interest expense of hybrids is tax deductible. The same is not true of equity dividends. The calculation offsets the after-tax differential between the hybrid and straight debt against the almost certainly greater differential between the current cost of equity and the after-tax cost of the hybrid.

The Credit Ratings Agencies:

Regulation underpinned the evolution and proliferation of hybrids issued by financial institutions. Thereafter, the agencies play an important role in the sector that will be considered in part three, while tax and other legal considerations are also always significant.

The ratings agencies were, however, central to the very birth of the corporate hybrid market, although regulation, too, plays a role. So, for example, the 2005 introduction of International Financial Reporting Standards (IFRS) for listed companies in the EU requires clear and distinct balance sheet treatment for equity and debt. This is consistent with the approaches of the agencies.

With the agencies recognising the equity characteristics of corporate hybrids and attributing equity credit to such securities, hybrids were decisively differentiated from conventional debt. Once the ratings agencies developed methodologies for assessing hybrids and attributing equity credit, issuers were able to exploit the opportunities and advantages offered by hybrid issuance. These developments had converged and reinforced one another by 2005, providing the impetus for mushrooming issuance that year.

The agencies' methodologies seek to account for the mix of variables that defines each individual hybrid, including maturity, deferability of payments and seniority. As a consequence and despite the market's attempts at standardisation, each individual hybrid will have specific and possibly unique characteristics, requiring careful consideration both by the agencies and by investors.

The Fitch Ratings Methodology:

(i) 2001: Fitch Ratings published 'Hybrid Securities: Evaluating the Credit Impact', establishing guidelines for equity credit across the spectrum of hybrids, except commercial banks. Crucial to the attribution of equity credit was the cash flow flexibility provided by the hybrid that would sustain the issuer during a period of stress.

(ii) 2004: To assess the validity of the 2001 papers, its guidelines and the prominence given to cash flow flexibility, Fitch back-tested 209 issues on behalf of 89 US corporate issuers and with an aggregate value of approximately US$48bn during 2000-2003, a period of financial stress.

The analysis concluded that "some of the securities provided equity-like flexibility or loss absorption for their issuers, as originally expected, but other securities proved to be less effective than previously thought."

The analysis also revealed that issuers in financial distress either restructured and solved their problems within three years, or liquidated; that securities with more than 10 years to maturity provided sufficient protection to warrant 100 per cent equity credit, reducing to 0 per cent at five years to redemption and; that equity credit should be reduced or eliminated where covenants rendered hybrids equivalent to senior debt in the event of bankruptcy.

(iii) 2006: In June 2006, Fitch published 'Fitch Exposure Draft: Equity Credit for Hybrids and Other Capital Securities', seeking responses to proposals prior to the publication of a new methodology.

The proposals are founded on the principle that equity credit can only be attributed to a security that both permits loss absorption and deferability of ongoing cash payments without triggering a default.

The proposals include streamlining and harmonising the approach to allocating equity credit for hybrids and other capital securities across all corporate and financial sectors. Previously, financial and corporate sectors were considered separately. In pursuit of transparency and consistency, it is proposed that the two strands will now be unified.

The proposals also include the elimination of both the banking sector's four classes and the corporate sector's finer but arguably unwieldy 0-100 per cent continuum. These two will be replaced by a single, debt-to-equity continuum comprising five classes. Class A (high quality) represents 100 per cent equity and class E (poor quality) 0 per cent equity, with 25 per cent steps between classes.

Fitch also proposes a unified, flat 30 per cent tolerance limit on the amount of hybrids and other capital securities that can be included on an issuer's balance sheet and be considered for equity credit. The proposals also include more detailed consideration of maturity, deferability (especially around 'look-back' provisions), optionality and convertibility.

These proposals and the methodology that will follow should render analysis and equity credit more transparent and consistent, to the advantage of all market participants.

Conclusion:

There is a powerful, regulatory incentive for financial institutions to issue hybrids. The same is not true for the corporate sector. For the corporate sector to flourish, issuers must find continuing compelling reasons for such issuance. Equity credit and the lower cost of such issuance compared with the cost of issuing equity are certainly supportive, as are the gradual standardisation, transparency and consistency of documentation, market practice and the activities of the agencies.

On the other hand, issuers and their advisors must always strive to satisfy several constituencies, including regulators, legal and tax authorities, the agencies and finally, investors. Investor appetite underpinned the buoyant corporate hybrid activity of recent years. However, that appetite arose in an environment of low interest rates that will not persist indefinitely. In addition to which, investment grade corporate hybrid spreads over LIBOR that may be double the spread required to issue subordinated debt and perhaps four times the spread required to issue senior unsubordinated debt may simultaneously seem expensive to issuers but rather tight to investors whose risk includes deferrable coupons and long maturities.

Corporate hybrid securities are certainly not merely transitory. At the very least, they increase the options available to creative and dynamic companies with an appetite for capital. However, the considerations outlined above, combined with corporate hybrids' prevalence in just a few markets (for example, parts of Europe with concentrated shareholdings), indicate that the asset class has yet to fully entrench itself.

Guide to Hybrid Securities - Part 3: Financial Institutions

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Banks and insurance companies are more established and regular issuers of hybrid securities across the globe. Developed in response to evolving regulatory regimes and buoyant appetites for capital, the sector continues to predominate. The third part of the series looks at the sector and its future prospects.

Introduction

Issuance of hybrid securities by regulated financial institutions was the foundation of the modern hybrids market and it now makes up the overwhelmingly dominant part of it. Issuance from this sector, which includes both banks and insurance companies, has expanded dramatically in the past decade.

Increased issuance has been underpinned by a variety of factors, including:

(i) The global regulatory environment;
(ii) Institutions' voracious appetite for capital;
(iii) Increasing sophistication of the capital markets;
(iv) Corporate finance activity within the sector, itself reflecting:
a) consolidation within the finance sector and
b) introduction of the euro;
(v) Refinancing redeemed securities; and
(vi) Supportive initiatives from the credit ratings agencies.

Hybrid issuance by banks and insurance companies is now a huge global phenomenon. The market is global, deep, liquid and sophisticated.

In 2005, aggregate issuance approached US$150bn, with hybrids denominated across a wide range of currencies, including Tier 1 issuance in US, Australian and Singaporean dollars, sterling and euros and Tier 2 issuance in New Taiwan and Canadian dollars, Swiss francs, Norwegian krone and Japanese yen.

Issuance by unregulated corporates is currently both expanding more rapidly than that of financial institutions and attracting greater attention. However, such issuance, belated and from a negligible base, remains a mere fraction of the hybrid issuance of financial institutions.

There are notoriously few certainties in the world and Sean Connery's James Bond is not alone in finding wisdom in the phrase *'Never say never again'*. However, it is a certainty that corporate hybrid issuance will *never* approach that of financial institutions.

Corporate issuance is destined to remain essentially opportunistic, as a tactical alternative, or adjunct, to the issuance of equity or conventional debt.

For financial institutions, however, regulation, in particular, has woven hybrid capital into the very fabric of financial institutions' balance sheets. The hybrid has become a firmly established and major source of capital for financial institutions.

Hybrid issuance by financial institutions is a highly specialised and technical area. Issuing institutions, their agents (other major banks) and investors (often other major banks or insurance companies) are all expert practitioners.

Such specialisation and expertise, in conjunction with the ubiquity of hybrids throughout the sector, implies that an introductory article on the asset class will be of limited direct value to market participants.

As a consequence, this article provides some regulatory background, considers some recent and prospective developments in the sector and finally, examines some issues common to all hybrid issuers and market participants.

Regulation

Banks

Global financial services regulation - and especially that relating to capital adequacy - has probably been the single most important driver of hybrid issuance by financial institutions.

For the past quarter of a century, financial services regulators have sought to determine and enforce capital adequacy ratios as the principal free market mechanism for underpinning banks' prudence, viability, risk management and creditworthiness. The US led the way, following the domestic S&L and international debt and banking crises of the 1980s. Similar approaches evolved elsewhere across the globe, as regulators sought robustness and consistency.

The Basel Accord was adopted across the G-10 nations by the late 1980s. It articulated a risk-based framework for regulating international banks. The Accord has subsequently been accepted in more than 100 further jurisdictions.

Crucially, the Accord established two forms of capital: Core, or Tier 1 and Supplementary, or Tier 2. Hybrid issuance did not immediately flourish in the wake of the Accord, although preferred stock was included in institutions' regulatory capital.

In 1996, however, the US Federal Reserve approved the inclusion of trust-preferred securities up to a limit of 25 per cent of Tier 1 capital. This opened the floodgates in the US and huge issuance of trust preferred securities on behalf of US banks followed in 1996-97.

In late 1998, the Basel Committee amended its own definition of Tier 1 capital to include 'innovative' forms of capital up to a limit of 15 per cent, opening the way to the inclusion of hybrids in Tier 1 capital. Hybrids, combining equity and debt characteristics, were treated as non-cumulative preference shares for capital adequacy purposes but were still tax-deductible in parallel with debt securities.

Further impetus has been provided by the Federal Reserve's subsequent regulatory interpretation that allows bank holding companies to issue 'mandatorily convertible securities' that convert into preferred stock. Major US issues underpinned by this recent interpretation include Wachovia's US$2.5bn and Bancorp's US$1.25bn hybrids, both issued during the first quarter of 2006.

As a result, principally, of a range of risk-based and market-oriented regulatory initiatives, between 1996 and 2004, global hybrid issuance approximated $250bn.

Insurance Companies

The regulation of insurance companies has followed a similar risk-based methodology in responding to issuers' appetite for capital and the requirement for clear, entrenched and enforceable capital adequacy.

Recently, for example, Solvency 2, has aligned European insurance companies' capital adequacy requirements more closely with those of the region's banking sector. This regulatory initiative should underpin further buoyant hybrid issuance by European insurance companies in the next year.

Recent Developments and Prospects

Refinancing redeemed securities

Banks remain major issuers and are active in raising finance to maintain levels of regulatory capital. However, the refinancing of redeemed securities seems certain to underpin strong *incremental* levels of hybrid issuance in the next couple of years. Estimates suggest that around US$50bn of hybrids may be refinanced during this period as, for example, those Tier 1 securities issued in the wake of new regulations from the Federal Reserve in 1997 are called after 10 years.

Regulation

The extension and convergence of financial services regulation, bolstered by the introduction of International Financial Reporting Standards, has also allowed hybrid issuance to be contemplated for reasons and in ways that extend beyond the initial regulatory impetus. This phenomenon underlines the maturity, innovation and sophistication of the market.

Thus the Basel and Solvency regimes have prompted both innovative structures and also issuance in a variety of jurisdictions. Issuers and their advisors seek constantly and creatively to negotiate the sometimes competing requirements of the tax and regulatory authorities and of the credit ratings agencies and to maximise the flexibility and equity credit, while minimising the cost of capital.

So, for example, with only the UK formally elucidating a concept of Tier 1 capital for insurance companies, both Aegon and AXA have issued significant volumes of Tier 1-type hybrids, with explicit provisions in the event that such structures and Tier 1 language are unsustainable. Equally, issuers may now consciously issue at group rather than operational corporate level in response to moves to eliminate double gearing. At the same time, Tier 2 issuance is being extended into jurisdictions such as Bulgaria and Kazakhstan.

A fly in the ointment

Meanwhile, the March 2006 ruling by the US National Association of Insurance Commissioners (NAIC), relating to the risk classification of hybrids held in regulated insurance companies' investment portfolios, casts a potentially dark shadow over the market.

The NAIC ruled that certain hybrids, with very long or perpetual maturities and non-cumulative deferrals, will be classified in the same risk category as common stock, requiring equal volumes of capital to be maintained against these holdings as against investments in common equity. This ruling, with potentially major effects, is being explored. Should it finally be implemented, it will surely cause the death of the massive US Yankee hybrid market, as insurance investors withdraw from the market and go elsewhere.

The Credit Ratings Agencies

The serious involvement of the agencies has been absolutely crucial in the development of the corporate hybrid market. However, regulation was more crucial in stimulating and underpinning issuance by financial institutions.

The agencies are, nevertheless, very significant in this latter market. Indeed, while corporate hybrid issuance may be supported by the assessment of one or two of the major agencies, nearly all major banks seek the assessment of the three major agencies as a matter of course. This reflects the greater size of such hybrids and the depth, sophistication, huge levels of primary and secondary activity and developed market practice within the financial institutions sector.

The agencies have also been proactive in reassessing and developing their hybrids methodologies. This further underpins the market at a crucial time, with banks and holding companies seeking enhanced equity credit for their hybrid issues as a raft of refinancing looms and in an environment of innovative hybrid structures (even as the market seeks to standardise as far as possible), relatively low interest rates and tight spreads.

Methodologies differ between agencies. But underlying such differences, each approach seeks to assess rigorously and account consistently for the mix of variables that defines each individual hybrid, including maturity, deferability of payments and seniority.

The Fitch Ratings Methodology

In 1999, Fitch articulated its methodology in 'Rating Preference Stock and Hybrid Securities of Financial Institutions'. This methodology was subsequently revisited to account for empirical evidence relating to the performance of securities issued by 'stressed' banks. On balance, the evidence indicated that such issues deserved more equity credit than had traditionally been granted.

In 2001, Fitch published 'Hybrid Securities: Evaluating the Credit Impact', establishing guidelines for the attribution of equity credit to all hybrids, *except* commercial banks.

In June 2006, in search of simplicity, consistency and transparency and taking into account a considerable volume of empirical evidence relating to the performance of hybrids in a variety of market circumstances, Fitch published its consultative 'Exposure Draft - Equity Credit for Hybrids and Other Capital Securities'.

Crucially, the consultative draft proposals streamline and harmonise the approach to allocating equity credit for hybrids and other capital securities across *all* corporate and financial sectors. The previous, different and separate approaches to financial and corporate sectors were unified.

The draft is founded on the principle that equity credit can only be attributed to a hybrid that both permits loss absorption and deferability of ongoing cash payments without triggering default.

The proposals eliminate the finance sector's previous four classes and the corporate sector's finer but arguably un-wieldy 0-100 per cent continuum. These are replaced by a single, far simpler, debt-to-equity continuum comprising five classes. Class A (high quality) represents 100 per cent equity and Class E (poor quality) 0 per cent equity, with 25 per cent steps between classes.

The draft also proposes a unified, flat 30 per cent tolerance limit on the amount of hybrids and other capital securities eligible for inclusion on an issuer's balance sheet and considered for equity credit. The proposals also include important and detailed consideration of maturity, deferability (especially around 'look-back' provisions), optionality and convertibility.

Fitch recognises that there are strong incentives for banks to avoid coupon deferral, largely relating to reputation and consequent access to credit markets. So, for institutions that are fundamentally creditworthy, notching for hybrids has been tight (one or two notches for investment grade), reflecting limited - but non-negligible - incremental credit risk attaching specifically to the hybrid. However, notching widens, further down the credit curve.

The Fitch draft is genuinely consultative, with the agency especially seeking responses relating to the following:

- The granularity of the Class A-E scale.
- The proposed limit on hybrids and capital securities of 30 per cent of eligible capital.
- The value of mandatory deferral provisions.
- Effective maturity, relating to calls, step-ups and replacement.

Conclusion

Reflecting a variety of factors, hybrid issuance by financial institutions will remain a huge, global phenomenon. The sector will always overwhelm the corporate sector, although its viability and scale, along with unified and streamlined methodologies, will be to the advantage of the corporate sector.

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Issuance is of little value in the absence of investor appetite. Part Four in this series considers hybrid investors.

Part Five will address readers' questions. With the issuers of hybrids covered in parts two and three and with the consultative Fitch Exposure Draft explicitly seeking responses from interested parties, readers are invited to submit questions and comments for Part Five, which will cover frequently asked questions. Please send your questions to Bija Knowles - bijak@gtnews.com

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Guide to Hybrid Securities - Part 4: Investor Appetites and Objectives

25 Sep 2006 - in association with Fitch Ratings

Investors are hungry for yield and return but are also preoccupied with the security of principal. Hybrids combine elements of both debt and equity and this fourth article explores how investors continue to evaluate the attractions, viability, risk profile, marketability and pricing of hybrids.

Hybrid issuance runs into hundreds of billions of dollars. And as hybrids are no longer an unknown or exotic asset class, the market is global, sophisticated and well established.

There are two, distinct sectors. Issuance by financial institutions dominates, although the non-regulated corporate sector has experienced explosive growth recently.

Issuance has been stimulated by global regulatory developments (especially issuance by financial institutions), issuers' insatiable appetite for capital and buoyant levels of corporate finance activity, the increasing sophistication of the capital markets, the necessity to refinance existing debt and the initiatives of the credit rating agencies.

Meanwhile, investors' curiosity has been stimulated by periods of underperformance and volatility in equity markets and by low interest rates and tight credit spreads across the globe, by structural shifts in asset allocation among pension and other funds towards fixed income securities, by trends towards standardised hybrid documentation and again, by the constructive involvement of the credit ratings agencies.

Some of these developments underpinning burgeoning issuance and investment appetites may not persist in the longer term.

So, while hybrid issuance by financial institutions, founded on robust regulatory regimes, is undoubtedly here to stay, issuance by non-regulated corporates remains essentially opportunistic and less securely established. Nevertheless, 2006-7 will undoubtedly see huge volumes of hybrid issuance, as securities issued 10 years earlier are refinanced. But such volumes will only be feasible if investors are prepared to participate actively in the market.

The Investor's Conundrum

Hybrids offer clear, definable benefits to issuers. Benefits include a variety of advantageous regulatory, tax, legal and accounting treatments, along with constructive credit rating perspectives.

Hybrids are flexible, tax-deductible and non-dilutive. They accrue equity credit and may reduce the issuer's gearing and weighted average cost of capital.

To achieve such benefits, hybrids incorporate equity characteristics such as perpetual or very long-dated maturities and an absence of obligatory fixed period payments. These characteristics are not immediately appealing to fixed income investors.

For the moment, spreads over conventional debt may be sufficient to entice investors. However, it would require very few instances of issuers having recourse to such equity characteristics for investors to conclude that limited spreads are insufficient enticement. A zero-coupon, genuinely perpetual instrument is, after all, a uniquely undesirable investment.

With investors hungry for return and yield but preoccupied with the security of principal and with certainty, are hybrids an attractive or viable asset class? Part of the answer is to recognise that there is no single, homogenous hybrid investor.

Just as issuers may be divided into regulated financial institutions and non-regulated corporates, so investors may be divided, very broadly, into conventional institutional investors on the one hand and hedge funds and bank trading and prop desks on the other. The risk and return parameters and time horizons of such contrasting investors are very different, generating quite different approaches to the asset class.

Hybrid Sectors Revisited

Differences between the hybrids of regulated financial institutions and those of non-regulated corporates are so significant that they might usefully be considered separate asset classes by investors.

Both are hybrids, with issues spreading across the same spectrum of structural characteristics. However, hybrid issuance by financial institutions - and especially bank tier one issues - and the associated market have three major distinguishing features:

- Financial institutions are subject to far greater regulatory supervision.
- They face greater incentives relating to coupon payment and the maintenance of both credit quality and reputation because of their need for continued, regular access to the capital markets.
- Regulation and standardised covenants underpin issuance and the market is, therefore, huge, deep and liquid.

These features provide cautious investors with relative certainty and security. Of course, yields are lower as a result.

Tim Barker, head of credit research at Morley Fund Management, weighs these considerations as follows: "We've been investing in the tier one hybrids of financial institutions for almost as long as they've been available - for more than 10 years. After some initial scepticism, we took a pragmatic view. The capital structure is highly regulated and we treat such securities, very broadly, as homogenous. The market is large and liquid, which means that there are plenty of comparables against which to assess any one issue. Of course, there are differences in structure and documentation and the devil is, as always, in the detail. And that means we're always very thorough in our analysis."

With both issuance and investors divisible usefully into two distinct - if broad - categories, a 2x2 matrix presents itself:

Investor	Tier One/Financial Institution	Tier Two/Corporates
Institutional investor	1	2
Hedge fund or bank Trading/prop desk	3	4

The more active quadrants are 1 and 4. However, there are both mainstream, institutional investors consistently or opportunistically active in quadrant 2 and more aggressive investors, with shorter-term investment parameters, who exploit opportunities arising in quadrant 3.

Mainstream Institutional Investment

The investment process

Mainstream institutional investors are not restricted to quadrant 1. So, for example, Dirk Frikkee, global head of credit at ABN AMRO asset management, confirms that ABN AMRO has been investing in corporate hybrids "since summer of last year, with the issuance of Vattenfall."

The €1bn issue did not compromise Vattenfall's single-A rating and came alongside significant issuance from other major corporates, including Bayer, Thomson and Henkel. Such activity underlined the momentum within the corporate sector and perhaps even the critical mass required for the sector to be securely established and viable.

Barker, Frikkee and other investors confirm that investment in hybrids is consistent with institutional investors' prevailing investment approaches, often with a bottom-up focus on fundamental value and underlying creditworthiness and with a rigorous examination of the documentation.

Frikkee says: "The process follows our 'normal' credit process, intensive analysis of the credit. We need to be comfortable with the credit, that it is stable or improving, given the fact that most issuance has been at low triple-B, with risk of downgrade to high yield."

And so, for ABN AMRO, according to Frikkee, such securities fit into most bond portfolios that allow investment grade corporate bonds and, due to the higher yield, they offer a higher return or higher risk trade off.

Considerable care and diligence are, however, certainly required when contemplating such securities. Corporate hybrids are rated perhaps one to three notches below the same issuer's senior unsecured debt, reflecting the intrinsically risky combination of subordination, coupon deferral, and maturity extension. Such issues are generally rated towards triple-B, strongly contrasted with the single-A rating of most tier one issuance by banks. Fitch's recent exposure draft proposing a fresh methodology for hybrids is likely to result in less notching down of these securities than other ratings agencies. Fitch's template hybrid notching policy establishes this, certainly for corporates with investment grade IDRs.

Other institutions prefer to avoid the corporate sector. So, for Morley Fund Management's Barker, the assessment of financial institutions is enhanced by the depth of the market and the existence of comparables - a feature currently absent from the corporate sector. And for Morley Fund Management, as for many other mainstream institutional investors, Barker argues that "a fairly high degree of scepticism concerning corporate hybrids applies, although slightly less so where the entity is quite heavily regulated; for example, euro issuance by utilities."

According to Barker, hybrids undoubtedly offer "another element within the risk-return equation" but with limited incentive for systematic investment in corporate hybrids: "We're always concerned with the underlying business case for issuance. With some, we're concerned from a fundamental perspective, with the underlying entity in danger of a downgrade. Certainly issuance intended to support a weak rating is unappealing. We're mindful of parent/issuer ratings and we'd always be concerned to avoid a downgrade from investment to sub-investment grade, which, for some funds, would immediately trigger a review of the security with a view to sale."

Barker concludes that "such securities are not usually for stable, mature funds. The equation is simply skewed against them, in our judgment," while other institutional investors view hybrids issued by corporates with fragile ratings as "a potentially lethal cocktail." After all, a one notch downgrade at senior debt level can translate into several notches - and significant risk and loss - at subordinated levels.

Four steps forward

Current developments supporting investors and investment, especially in corporate hybrids, include:

- Increasingly standardized documentation.
- Evolution of valuation models.
- Inclusion of hybrids in fixed-income indices.
- Increased liquidity in the market.

Documentation

Documentation and associated covenants have tended towards standardization, especially among financial institutions. But as Barker notes, "Among non-hybrid high yield issues, documentation is always demanding. Investors need to be very clear about what's permitted or disbarred." This contrasts the limited explicitness of some corporate documentation with, for example, the quite thorough approach of Linde.

Valuation models
Valuation models, often derived from the Black and Scholes approach to options valuation, proliferate. Such models are gradually contributing to investors' decision-making processes. Frikkee observes: "The valuation aspect is difficult. The valuation lies between senior debt and equity. With only a few traded (corporate) names, this remains an issue. There are various models that predict fair value and the assumptions in these models determine the outcome."

Indices
Indices now include hybrid securities. For example, 4% of the Euro IBOX index is now accounted for by corporate hybrids. Clearly, once an asset class is included in an index, failure to invest implies divergence from the index and is an implicit strategic investment decision.

Five per cent of an index is ordinarily considered the critical level at which failure to invest exposes an investor to significant risk. Once euro issuance accounts for 5% of the index, investors will be even more focused on the asset class and any explicit or quasi-indexation will release a large volume of funds for investment.

Liquidity
Liquidity is particularly strong among the tier one issuance of financial institutions and especially among issues with step-up features dated 10 years hence rather than five years.

Liquidity has also improved among corporate hybrids. Frikkee says: "Compared to other corporates, they are very liquid in normal markets, as they are also used by trading oriented accounts, such as hedge funds and trading desks of banks. Due to their riskier nature and high volatility, they are very illiquid in periods of turmoil, like we had in May/June 2006."

Such securities - especially the larger issues - also tend to trade well in the primary market, with significant over-subscription quite common but liquidity diminishes once such securities are seasoned. And liquidity is also constrained by banks' reluctance to diverge from a balanced trading book of inventory in individual issues.

Illiquidity often corresponds with higher and more volatile spreads and it is precisely this kind of feature that entices hedge funds and banks' trading and prop desks, with their shorter term and more aggressive investment parameters (see below).

And one step back?
A significant potential disincentive to investment by insurance companies arose from a ruling by the US National Association of Insurance Commissioners (NAIC), in March 2006. The NAIC ruled that some categories of hybrids would be classified in the same risk category as common stock. This would require equal volumes of capital to be maintained against such hybrids as against investments in common equity. Such provision would have a massive impact on the viability of such investment by insurance companies, who account for perhaps 25% of investment in the market. In the wake of the decision, issuance stagnated and hybrids lost 3% in March, while corporate bonds fell by less than half that amount.

Perhaps not…
The ruling is, however, being explored and it now seems that the NAIC may allow insurance companies to account for hybrids as debt, or preferred stock, rather than as common equity. As a consequence, hybrids outperformed corporate bonds by around 20 basis points in July in their strongest performance of the year to date.

Investors clearly prefer favourable rulings but if nothing else, certainly prefer clear and consistent rulings. This regulatory equivocation is certainly not to the market's advantage.

Hedge Funds and Trading Approaches

The more aggressive and trading-oriented investment approaches of hedge funds and bank trading and prop desks are predicated on a conjunction of the sector's (i) higher spreads and (ii) greater volatility of prices and spreads (high beta), along with (iii) Libor as the basis for both the cost of funds and the assessment of investment viability.

Estimates suggest that such funds may account for 50% - and perhaps even as much as 75% - of trading volumes among hybrids.

Hedge fund and bank trading and prop investors are especially tempted by quadrant 4 (above), with such securities' greater spreads, spread and price volatility (beta) and potential for momentum. So, for example, during 2005 the spread on the Vattenfall issue tightened by more than half a percentage point, while that on the Thomson issue widened by almost one and a half percentage points. Such magnitudes and differentials offer significant trading opportunities.

Barker, of Morley Fund Management, explains: "As a rule of thumb, If you like the underlying credit - although, credit quality is perhaps generally less significant for hedge fund investors - you go for the most junior security available. That provides you with the most yield for the same probability of default, although such securities tend to be more volatile price-wise."

The activities of hedge funds and other trading accounts have also been enhanced by the evolution of credit default swaps (CDSs) and an associated market.

CDSs allow investors both to hedge hybrid exposures as well as to short the market, the latter being a crucial hedge fund investment technique. Such instruments will be crucial to the further development of a liquid and sophisticated market, just as parallel instruments have been in other asset markets.

Credit Ratings Agencies

For the analysis of issuance by financial institutions, the credit ratings agencies are central. Most of such issuance is rated by three agencies and the associated market is huge, liquid and transparent,

Meanwhile, among the smaller, non-regulated and less homogenous corporate sector, Frikkee, of ABN AMRO, notes: "Agencies have been more involved by talking to issuers and investment banks, who are lead managing the deals. For us, it is important to know whether the ratings methodology of an agency is stable. Our own research is more important to determine whether we believe the bonds offer opportunities and where ratings will go next. Understanding the credit is more important than working with agencies."

Investors also express some frustration at significant divergence both across methodologies and individual credit assessments by the agencies, although, as Barker notes, "If a regulator such as NAIC is confused, it's no wonder that other elements within the market are too."

Certainly investors take even greater responsibility for internal credit research when assessing hybrids than other sectors. After all, as Barker notes: "It's important to assess carefully the reasons for issuance and at 400 basis points over, corporate hybrid issuance and investments are truly high yield."

Conclusion

Hybrid issuance and investment are complex and evolving activities, encompassing several sub-sectors. But overall, a combination of regulatory and other environmental factors, combined with buoyant appetites both for capital and for viable investment assets, should ensure that hybrids continue to demand close attention. It's the very existence of such sub-sectors, which cut across both issuance and investors, that underpins the continuing viability of hybrids.

The fifth and final article in the series will deal with treasurers' questions. You are invited to submit your questions to Bija Knowles (bijak@gtnews.com).

Guide to Hybrid Securities - Part 5: Treasurers' Frequently Asked Questions and Answers

06 Nov 2006 - in association with Fitch Ratings

Treasurers need to be well informed about hybrids. The market is dynamic and institutions are active in promoting the asset class across industrial sectors. The fifth and final part of the series responds to treasurers questions that have arisen during this series of articles.

Introduction

The first four parts of this series considered the growth of the hybrid securities market into a vast, global phenomenon, the structure of hybrid securities and reasons for issuance and investment, as well as the fragmentation of the market. Among issuers, financial institutions dominate, with hybrid issuance underpinned by regulation and woven into the very structure of the market. Corporate issuance is a more recent, far smaller and essentially opportunistic phenomenon. Investors range from mainstream institutional investors to hedge funds and banks' trading desks and they have different preferences in regulatory environments, risk appetite, permissible spreads and volatility.

For this fifth and final article we asked treasury professionals to send in their questions on hybrid securities. The questions range from the general to the specific, with the more specific questions relating to the corporate sector, perhaps reflecting its less developed nature. The questions are rounded off with enquiries, raised in various forms by a large number of readers, around pricing and liquidity. Experts from Fitch Ratings answered the questions, with additional input from Joern Felgendreher of DWS/DEAM, Dirk Frikkee of ABN Amro and Tim Barker of Morley Fund Management.

Treasurers' Questions

Q: *Is there a uniform definition of hybrid capital? Or are there many ad hoc definitions, so to speak, across the financial community?*

Fitch Ratings: There's no uniform definition of hybrid capital. What the market today refers to as a hybrid security typically means a deferrable bond which is subordinated or deeply subordinated. But if you place the question in a wider context, hybrid capital could have a very broad meaning, even including a preferred stock. So no, there's no uniform definition but there is a commonly used market language these days in which hybrid means a deferrable bond.

Also, many people assume that hybrid means a security that is loss absorbing but under our methodology that's not necessarily the case. A loss absorbing security may get zero percent equity credit and so again, there's really no uniform definition. Even a common assumption such as this does not contribute to a uniform definition.

Q: *How does the market treat corporates that pass on a hybrid coupon payment, as they have the right to do? Are there instructive parallel or comparative examples from other types of securities, present or past?*

Fitch Ratings: There's no hybrid precedent so far - the corporate market is relatively new, with its first issuance in Europe in 2003 and no one has deferred or announced that it's even considering deferring for the moment.

But we have been in a very strong credit environment throughout the past two to three years and that might change at any moment. If the credit cycle turns - and that's an ongoing discussion at the moment and certainly credit profiles are unlikely to improve significantly from here - then passing on a hybrid coupon might become an issue.

And our assumption is that the market will view such an event as default, with price and spread implications. We, as a ratings agency, take a different view. For us, if the issuer exercises its legitimate right under documentation that it has put out to the market and on the basis of which it has sold securities, then deferral is not default. For us, it's a legitimate exercising of rights. Nevertheless, we would take it as a clear signal of increased risk in respect of that issuer because we assume that only in the event of financial crisis or a liquidity crunch would such a course of action be undertaken.

***Q:** Can you change your mind regarding how the hybrid is treated, in accounting, or in any other terms?*

Fitch Ratings: If you're asking whether Fitch can change its mind then yes, to some extent because of course, we've recently revised our methodology. So the agencies may revise their approach according to how the market evolves. And at different stages in credit cycles, ratings may move in different ways and as hybrid securities themselves change, then, yes, our views can change. But this isn't something that happens very frequently. Reviewing our methodology every two to three years is probably about right. And even that doesn't mean you'll change your views but in what's still quite a rapidly evolving market sector, reviewing the methodology with that kind of regularity seems to make sense.

***Q:** Can corporates ask for hybrids to be treated differently over time?*

Fitch Ratings: Corporates certainly might structure hybrids in order to receive a certain level of equity credit according to their knowledge of the agencies' methodology. Corporates, in discussion with their bankers, are well aware of the relevant features and the equity credit likely to be attributed. But then, of course, they are bound by the documentation relating to the issue.

***Q:** With major corporates across Europe having to follow IFRS/IAS, are there actually any significant differences across European jurisdictions/markets in terms of accounting or taxation?*

Fitch Ratings: On accounting, no, because IFRS is the standard that corporates are required to adhere to across the EU. On taxation, I think there are differences, reflecting each jurisdiction's specific tax regime. And you would expect to see that reflected in the structuring of hybrid securities, with the hybrid tweaked to ensure that the coupon is deductible, for example, in the particular jurisdiction. So, some differences in tax treatment but not in accounting.

***Q:** How well do corporates understand what hybrids offer in terms of an alternative source of capital? CFOs are presumably aware of hybrids but are CEOs or board members? Might any such shortfall contribute to a bit of market 'sluggishness'?*

Fitch Ratings: On the Continent, the level of issuance indicates that there's a good level of understanding and awareness of what hybrids may offer in terms of an alternative source of capital.

In the UK, no corporate has yet issued a hybrid instrument. But I've certainly attended conferences where UK treasurers have spoken about the reasons for issuance. So at the treasury level, again, I think there's a good degree of awareness. Now one reason for an absence of UK issuance might be that one of the principal reasons for issuance has been to finance M&A activity and in the recent past, UK corporates have tended to be subject to such activity from overseas, rather than contemplating and financing it themselves. But UK CEOs and board members are probably a bit less aware of them than treasurers. But I'm also sure that if a treasurer thought hybrid issuance made sense, then the board would soon be fully aware of the advantages and parameters relating to such issuance.

Q: *The first corporate hybrids were issued in 2003 (by Linde and Michelin). But only one was issued in 2004 (by Claas), before the ratings agencies' focus on the market reinvigorated it once more in 2005. Were there reasons for this single issue in 2004, perhaps a wait-and-see approach to this new market, or was this simply a question of chance? Were participants, perhaps, waiting for clarification and guidance from the agencies?*

Fitch Ratings: In short, yes, I think that the ratings agencies' focus on the market did, indeed, reinvigorate it during the last couple of years. But we've also seen a more leveraged environment emerging during that period, with more M&A activity in 2005 and 2006 in Europe. And that, too, has increased corporates' use of hybrids. Some companies have also used hybrids as a ratings defence mechanism. Others have used hybrids to finance pension fund liabilities.

Q: *How do you calculate weighted average cost of capital (WACC) when you give equity credit to a hybrid? It's argued that a hybrid may lower WACC but if the hybrid secures equity credit, doesn't that mean that WACC increases?*

Fitch Ratings: The hybrid goes into the WACC as one component of the total capital structure. So, you take the senior debt coupon and weight that by the quantum that the senior debt has in the capital structure. You take the hybrid coupon and weight that by the percentage that the hybrid represents of the total capital structure. And finally, take the equity cost, which is an assumption anyway, from a model, usually capital asset pricing. So the hybrid is one component of the calculation of WACC.

In terms of reducing WACC, that's not entirely correct. What is more accurate to say is that it has a lower impact on WACC compared to straight equity.

Q: *If the hybrid is accounted for as equity, are coupon payments then considered as dividends in the income statement, or are they placed under interest expense? And surely, the hybrid has to be accounted for as debt in the balance sheet in order to have coupon payments classified as an interest expense.*

Fitch Ratings: Coupon payments are accounted for as interest payments, not as dividends, unless it's a preferred dividend arising from a preferred stock. But for hybrid securities, it's an interest expense. In accounting terms, IFRS judges hybrids to be debt and so such payments are accounted for as interest expense. So, yes, that's correct, a hybrid is accounted for as debt in the balance sheet.

Q: *How can you get tax deductibility if you account for the hybrid as equity, as seems to be the case for the hybrids issued by Dong, Suedzucker and Otto?*

Fitch Ratings: Again, this depends very much upon the jurisdiction. As a general rule, to secure tax deductibility, you have to have some kind of maturity and also, you cannot completely waive the coupon payments. Meaning that if the coupon is deferred, there has to be at least some alternative kind of compensation for the investor written into the structure. If an investor is prepared to accept 'well, either I'm paid or I'm not', then you're very close to a common dividend. And that's where the tax man, depending on jurisdiction, has some concerns, that the hybrid might effectively be equity. So, for example, this is where the Alternate Coupon Settlement Mechanisms came from. The issuer can waive the payment but if he does so, he may be obliged, or entitled, to stock settle, ie, to deliver stock or further hybrid securities to the investor.

***Q:** What special covenant, or Danish Rule, allowed Dong to issue a 1000 year bond? Are there any legal, technical or other material differences between 1000 year and perpetual maturity?*

Fitch Ratings: All I can say is that there's no material or technical difference for us between 1000 years and perpetuity, although there may be a legal one.

***Q:** How was it possible for Vattenfall, for example, to account for its hybrid as debt when it was allocated 75% equity credit? Shouldn't it be harder for a corporate to account for a hybrid as debt if the agencies allocate such a high level of equity credit? We've heard that Vattenfall had its hybrid accounted for as equity when it was sold but reversed the decision, somehow, such that it was subsequently accounted for as debt. Is that what happened? And if so, how was it done?*

Fitch Ratings: Firstly, Fitch didn't grant Vattenfall 75% equity credit (so that must have been another ratings agency). But it's a sensible point. Yes, it should be hard to account for a hybrid as debt with such a high level of equity credit but again, this partly comes back to accounting treatment. IFRS says it's debt and ratings agencies' criteria are not fully in line with accounting criteria and treatment. And hence what might seem like an anomaly here.

The question 'Shouldn't it be harder…?' is getting at whether there should be a link between the agency treatment and the accountancy treatment. There is none so far. The accountancy profession takes quite a different route from the ratings agencies. At Fitch, we look at financial flexibility and strong financial flexibility achieves high equity credit. Whereas, perhaps the accountancy profession takes a more technical approach. They ask whether it meets certain criteria by codified rules: is it a perpetual instrument, can the payments be waived? And the security then falls into either one camp or the other. It's an entirely different perspective. The ratings agencies, lawyers, accountants and tax authorities all have different perspectives. And issuers look to optimize across these different areas.

Moving on, we didn't rate the hybrid at the point of issuance and so I can't really comment on the second part of the question and any possible reversal of terms and decisions. But obviously it's possible that they would have offered the security to the market in different possible formats until they found one that suited both them and investors.

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The remaining questions, looking at pricing and liquidity are answered by Joern Felgendreher of DWS/DEAM, Dirk Frikkee, global head of credit, of ABN Amro and Tim Barker, head of credit research, of Morley Fund Management.
***Q:** Could you comment on the pricing of hybrids, both in the primary and secondary markets, how fair value and spreads are established and what valuation models are used in the market?*

Felgendreher: Regarding pricing and valuation, there's no single, unique model. On valuation, JPMorgan has done some good research on hybrids in general and one intuitive way to look at hybrid valuation is through their 'rock-bottom spread model'.

***Q:** Although there are many valuation models, often deriving from a Black and Scholes approach to options valuation, do you agree that the pricing and valuation of corporate hybrids remain far from an exact science? [The complexities of pricing and valuation were also addressed in* Part 4: Investor Appetites and Objectives]

Frikee: The valuation aspect is difficult. The valuation lies between senior debt and equity. With only a few traded corporate names, this remains an issue. There are various models that predict fair value and the assumptions in these models determine the outcome.

Barker: It's really not much of a science. There are models, some using Black and Scholes, which yield rich/cheap analysis but they're not always accurate. CSFB takes a theoretical approach but my understanding is that the computer power required isn't available to everyone. But the model yields credible results.

JPMorgan and BNP Paribas have developed models that analyse elements of optionality. The BNP model breaks risk down into rational chunks and tries to price each element separately but, ultimately, pricing is always undertaken with reference to what the market will bear.

A very rough rule of thumb in the market is that a hybrid will trade somewhere around four times the level of the corporate's senior credit default swaps (CDSs). Price negotiation will typically open at around that level. And as the market matures, comparables also become more relevant, although it's important to remember that structures have evolved significantly since 2003 and so comparability is still in its early stages.

Morley always starts with credit fundamentals and the assumption that, realistically, the risk of default for a hybrid is just about the same as for a senior bond. And on issuance, it's difficult to know how successfully the funds will be applied and what the implications for the issue might be.

This imprecision in pricing and valuation may lead to a degree of scepticism about the corporate hybrid market. But it's worth remembering that similar scepticism greeted banks' Tier One issuance just a decade or so ago and that sector is now well established. Inclusion in the euro indices has enhanced the sector's viability, while the high beta of these securities is well known and either a clear enticement or a disincentive to investors.

Q: *How good is the secondary market liquidity in hybrid securities and which institutions provide it?*

Felgendreher: Liquidity for hybrids in the secondary market is quite good, especially among Tier One issues from financial institutions. In the corporate sector, meanwhile, traders quote most hybrids on a 2-3 basis point bid/ask spread, which seems fair given absolute spread levels of around 250 basis points. It's usually easy to trade €10m in both directions. Of course, liquidity can sometimes contract in periods of stress or fast-moving markets and price action. Trades of €50m are a bit more complicated but can, for example, often be executed through two traders. The major trading banks in the European hybrids market are JPMorgan, BNP Paribas, ABN Amro, UBS, Deutsche Bank, CSFB and HSBC.

Frikee: Compared to other corporate debt securities, hybrids are very liquid in normal markets, as they are also used by trading oriented accounts, such as hedge funds and trading desks of banks. Due to their riskier nature and high volatility, they are very illiquid in periods of turmoil, such as May/June 2006.

Conclusion

The Tier One hybrid issuance of financial institutions is here to stay. It's a huge, mature sector; global, well regulated and fully integrated into both the financing armoury of the banks and the strategies of the myriad investors active in the sector.

The corporate sector has experienced rapid recent growth but from a low base. And even now, for example, no British corporate has had recourse to hybrid issuance. It's also important to recognize that corporate hybrids have not yet experienced a full credit cycle and have operated, since 2003, in a favourable and generally improving credit environment. Should this nascent market be hit by a downturn in credit conditions it's certainly possible that the market could be stopped in its tracks.

However, the increasing depth, breadth and sophistication of the market suggests that there's momentum and underlying viability. Hybrids offer corporates an alternative financing approach, somewhere between equity and debt and with their own clear and specific attractions.

The aim of this series of articles has been to underline the specific features of hybrids, their advantages and the viability of the sector and finally, to empower treasurers as they contemplate hybrid issuance as one option in the increasingly complex and competitive global capital markets.