

General Criteria:

Methodology And Assumptions: Assigning Equity Content To Hybrid Capital Instruments Issued By Corporate Entities And Other Issuers Not Subject To Prudential Regulation

January 16, 2018

(Editor's Note: This article has been superseded by "Hybrid Capital: Methodology And Assumptions," published July 1, 2019, but may still be in use in certain markets.)

OVERVIEW AND SCOPE

1. These criteria explain how S&P Global Ratings assigns equity content to hybrid capital instruments issued by corporate entities and other issuers not subject to prudential regulation. Publication of this article follows our request for comment, "Request For Comment: Hybrids Issued By Corporate Entities And Other Issuers Not Subject To Prudential Regulation: High Equity Content Instruments And Impact Of Early Refinancing," published on Oct. 30, 2017.
2. To understand how and why these revised criteria differ from the RFC, see "RFC Process Summary: Hybrid Capital Instruments Issued By Corporate Entities And Other Issuers Not Subject To Prudential Regulation," published Jan. 16, 2018. For guidance on how to apply these criteria, see "Guidance: Assigning Equity Content To Hybrid Capital Instruments Issued By Corporate Entities And Other Issuers Not Subject To Prudential Regulation," also published Jan. 16, 2018.
3. Additionally, upon publication, the criteria related to "Request For Comment: Hybrid Capital: Methodology And Assumptions," published Nov. 26, 2018, will supersede these criteria.
4. The criteria apply to hybrid securities issued by corporate entities as well as insurance holding companies that we assess are not subject to consolidated prudential regulation that includes the adequacy of their capitalization. They also apply to certain financial services finance companies and financial market infrastructure companies, as well as asset managers, in line with "Issue Credit Rating Methodology For Nonbank Financial Institutions And Nonbank Financial Services Companies," published Dec. 9, 2014 (see table 1 of the Dec. 9, 2014, criteria article for more details).

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Key Publication Dates

- Original publication date: Jan. 16, 2018
- Effective date: These criteria are effective immediately, except in markets that require prior notification to, and/or registration by, the local regulator. In these markets, the criteria will become effective when so notified by S&P Global Ratings and/or registered by the regulator.
- These criteria address the fundamentals set out in "Principles Of Credit Ratings," published on Feb. 16, 2011.

5. This paragraph has been deleted.

METHODOLOGY AND ASSUMPTIONS

A. The effect of management intent on equity content

6. The criteria for assessing equity content take account of our assessment of the entity's future capital structure, including management's financial policies and intentions. Our assessment of management intent reflects the reality that corporate financial policies and management teams can change over the life of the instrument, and therefore, indicates our view of the likely behavior of the issuing entity. In assessing the credit implications of any actual transaction, issuer-specific considerations can always trump any generalized conclusions based on the structure of the instrument. To clarify: even where the terms and conditions of a hybrid capital instrument are consistent with the criteria for "intermediate" or "high" equity content, the instrument can still receive "minimal" equity content if there are indications that management lacks the intention to position and maintain the instrument as a form of loss-absorbing capital for a sufficiently long period of time. Examples of such circumstances include:
- The entity's past or expected future behavior concerning hybrid issues suggests a lack of long-term commitment to the balance sheet or lack of willingness to defer payments;
 - S&P Global Ratings' assessment of the issuer's financial policies indicates that the hybrid's overall effect on the entity's credit profile would be muted by other considerations, such as the potential impact on the dividend stream to a holding company if a dividend stopper is triggered by nonpayment of the hybrid coupon;
 - The entity seeks (or indicates an intention) to circumvent any restrictions on optional calls through on-market repurchases, or there are reasonable grounds to believe that the entity could do so in the future; and
 - Any information indicates that the hybrid security, or a similar replacement security, will not remain a sufficiently permanent feature of the entity's capital structure.
7. In addition to assessing management intention by reviewing a management's behavior and policies, we believe that intention can be reinforced through contractual terms that are clear, concise, and certain. For example, we consider the implications of a replacement capital covenant (RCC) executed on or prior to the issuance of the hybrid instrument to be more predictable than

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those where issuers commit to future execution of an RCC.

8. Likewise, the fewer (if any) and more limited in scope the call options or carve-outs are under an RCC, the more our view that a company's intention to maintain a hybrid capital instrument or replace it with instruments, including common stock, of at least similar equity classification is reinforced. We would generally have a neutral view on calls or carve-outs relating to loss of deductibility of distributions for: corporate income-tax purposes; a change of accounting standards resulting in a change of the equity classification of the instrument; or a change in rating agency methodology leading, upon the adoption thereof, to a weaker equity-content classification. Provisions that seek to capture a wider range of circumstances would, in our view, weaken the permanence expectation. See "Criteria Clarification On Hybrid Capital Step-Ups, Call Options, And Replacement Provisions," published on Oct. 22, 2012, for more details about the role of RCCs for "intermediate" equity content hybrids.
9. Such a qualitative assessment of management intentions regarding the issue's permanence is undertaken over the life of the instrument and could therefore lead to a reassessment of the equity content after the security has been issued.

B. Hybrid capital instrument characteristics consistent with "high" equity content

10. The only instruments that are eligible for "high" equity content are mandatory convertible securities that meet the conditions specified in paragraphs 41-44 of the "Hybrid Capital Handbook" or government-owned hybrids that meet the conditions for "high" equity content specified in paragraphs 45-57 of the "Hybrid Capital Handbook."

C. Clarification on hybrid capital instrument characteristics consistent with "intermediate" equity content

11. We recognize that the incentive to redeem may also extend to an "intermediate" equity content hybrid capital instrument at the point when it loses its partial equity treatment. However, the incentive is less when the equity content and its effect on calculated metrics is only half that of a "high" equity content security. Even an instrument with an expected maturity date is eligible for "intermediate" equity content as long as the residual time to maturity exceeds the minimum standards regardless of any intervening loss of equity credit if the instrument's other features, together with management intent, are consistent with the "intermediate" category (see paragraphs 134-138 of the "Hybrid Capital Handbook" for details of the residual maturity standards by rating category).

D. Clarification on refinancing hybrid capital instruments within five years of issuance date

12. We generally do not change our view of the equity content of existing and future hybrid instruments where there is an open market repurchase, exchange, tender, or buyback offer (or similar repurchase mechanism) of an existing hybrid at any time after issuance if the repurchase is funded by a replacement hybrid issued on or before the repurchase date that meets the following conditions:
 - It is at least as equity-like as the original hybrid instrument in terms of equity content. For example, if the original instrument had "intermediate" equity content, then the replacement is

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also eligible for "intermediate" equity content, is eligible for "high" equity content, or is common equity. Given that an "intermediate" equity content instrument is only included in our cash flow and leverage measures at 50% of its principal for a corporate issuer, then, for example, a \$1 billion "intermediate" hybrid can be replaced by a \$500 million "high" equity content hybrid or common equity or by a \$1 billion "intermediate" equity content hybrid.

- The replacement does not in our view materially weaken the creditworthiness of the issuer including that it will not cause a lowering of the issuer's long-term credit rating or cause a negative revision to the outlook on the issuer's long-term credit rating.
- Our view of management intent, in particular our view of the issuer's long-term commitment to retain hybrid capital as a layer of capital to absorb losses or conserve cash in a time of credit stress, remains supportive.

REVISIONS AND UPDATES

This article was originally published on Jan. 16, 2018.

Changes introduced after original publication:

- On March 7, 2019, we republished this criteria article to make nonmaterial changes. We updated the contact information, deleted outdated text that was related to the initial publication of the article, and updated references to related criteria.

RELATED CRITERIA AND RESEARCH

Superseded Criteria

- Methodology And Assumptions: Assigning Equity Content To Corporate Entity And North American Insurance Holding Company Hybrid Capital Instruments, April 1, 2013

Partly Superseded Criteria

- Criteria Clarification On Hybrid Capital Step-Ups, Call Options, and Replacement Provisions, Oct. 22, 2012
- Hybrid Capital Handbook: September 2008 Edition, Sept. 15, 2008

Related Criteria

- Request For Comment: Hybrid Capital: Methodology And Assumptions, Nov. 26, 2018
- Reflecting Subordination Risk In Corporate Issue Ratings, Sept. 21, 2017
- Issue Credit Rating Methodology For Nonbank Financial Institutions And Nonbank Financial Services Companies, Dec. 9, 2014
- The Treatment Of Non-Common Equity Financing In Nonfinancial Corporate Entities, April 29, 2014

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- Criteria Clarification On Hybrid Capital Step-Ups, Call Options, And Replacement Provisions, Oct. 22, 2012
- Hybrid Capital Handbook: September 2008 Edition, Sept. 15, 2008
- 2008 Corporate Criteria: Rating Each Issue, April 15, 2008

Related Research

- RFC Process Summary: Hybrid Capital Instruments Issued By Corporate Entities And Other Issuers Not Subject To Prudential Regulation, Jan. 16, 2018
- Guidance: Assigning Equity Content To Hybrid Capital Instruments Issued By Corporate Entities And Other Issuers Not Subject To Prudential Regulation, Jan. 16, 2018

This report does not constitute a rating action.

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