

Criteria Report

Equity Credit for Hybrids &
Other Capital Securities

Analysts

Damir Bettini, London
+44 207 862 4095
damir.bettini@fitchratings.com

Keith Buckley, Chicago
+1 312 368 3211
keith.buckley@fitchratings.com

Martha Butler, Chicago
+1 312 368 3191
martha.butler@fitchratings.com

Karsten Frankfurth, London
+44 207 664 0085
karsten.frankfurth@fitchratings.com

Sharon Haas, New York
+1 212 908 0362
sharon.haas@fitchratings.com

Ellen Lapson, New York,
+1 212 908 0504
ellen.lapson@fitchratings.com

Ian Linnell, London
+44 207 417 4344
ian.linnell@fitchratings.com

Gerry Rawcliffe, London
+44 20 7862 4019
gerry.rawcliffe@fitchratings.com

■ Introduction

This report outlines Fitch Ratings' global, streamlined and consistent approach to allocating equity credit for hybrids and other capital securities across all corporate and financial sectors.

Equity credit analysis has always been a key consideration for Fitch in risk-adjusting capital and financial leverage ratios as part of its fundamental credit analysis of an issuer. The methodology detailed in this report has been implemented based on feedback that market participants would favour a consistent approach across the corporate, banking and insurance sectors worldwide, and that a streamlined debt-equity continuum would aid transparency and predictability. An enhanced methodology that meets the needs of all key capital markets players is thus timely.

The criteria has been finalised following a six-week consultation period, during which Fitch sought feedback from all interested parties and market participants. As a result of this, a number of amendments have been implemented compared with the original proposals published on 22 June 2006, in the agency's "Exposure Draft – Equity Credit for Hybrids & Other Capital Securities". These are detailed in a separate paper called "Equity Credit Exposure Draft: Market Feedback and Fitch's Responses" published on 27 September 2006. Both papers are available on Fitch's website, www.fitchratings.com.

Section 1 of this report outlines the overall approach and ratings implications of the new methodology. Section 2 covers the detailed analytical considerations.

■ Executive Summary

Hybrids and other capital securities refer to a wide range of capital markets instruments with precise definitions varying by sector and country. For clarity, Fitch will use these terms interchangeably and the agency's definition will encompass all instruments that are neither common stock nor ordinary debt, such as preferred and preference shares, trust preferred securities, deferrable payment debt and various convertible securities.

Fitch previously published separate, but related, equity credit criteria covering the corporate and banking sectors (the insurance sector drew parts from both approaches). Although certain differences will always be appropriate due to regulatory influences and varying market practices that differ by sector (causing the issuers of capital securities to behave differently under stress scenarios), Fitch believes that banking and corporate methodologies should be harmonised. To that end, this paper focuses on several core principles and key analytical considerations in determining equity credit that truly apply across all sectors, while also highlighting appropriate circumstances when differences still exist among sectors. The methodology detailed in this report supersedes all previous criteria published by Fitch on matters of equity credit in both the corporate and banking sectors.

Key highlights of the agency's enhanced methodology include:

- Alignment of debt-to-equity considerations for all financial and corporate sectors globally;
- Application of a streamlined and user-friendly debt-to-equity continuum consisting of five classes, denoted from Class A to Class E. Class A will represent 100% debt, Class B 25% equity and 75% debt, Class C equity and debt components of 50% each, Class D 75% equity and 25% debt, and Class E 100% equity. In order to unify across all sectors, the new scale is slightly more granular than that previously used by Fitch's banks group and considerably less granular than that used by Fitch's corporate and insurance groups;
- Movement to a flat 30% tolerance limit on the amount of equity capital derived from hybrids and other capital securities as a percent of eligible capital, regardless of the issuer's credit rating level;
- Amendments to the effective maturity regime for non-convertible hybrids, with maximum (Class E) equity credit achievable for instruments with 20 years or greater remaining to effective maturity. The maximum equity class achievable for instruments with maturities between the tenth and twentieth years is Class D, Class C for those with effective maturities between the eighth and ninth years, Class B for those with effective maturities between the sixth and seventh years, and the elimination of equity credit (Class A) for maturities of less than five years;
- More detailed guidance on evaluating the quality of mechanisms to avoid or defer periodic coupon payments, with a focus on constraints or triggers that could limit or increase the ability of the issuer to enact a deferral, e.g. look-backs, mandatory triggers, alternative coupon settlement mechanisms, etc.;
- Elimination in general of equity credit for optional convertibles, unless other characteristics of the pre-converted instrument merit equity credit consideration. Mandatory convertibles will continue to receive equity credit determined principally by the convertible feature, but also influenced by the nature of the pre-converted instrument. Equity credit will reduce as the conversion period lengthens or for any debt-like features of the pre-converted

instrument, e.g. seniority, no effective deferral, onerous covenants, etc.; and

- Retrospective application of the new criteria to existing hybrids. The equity credit for outstanding instruments will be reassessed pursuant to the new standards which may result in revisions to the equity credit accorded.

Market participants will still have the opportunity to present new products while in the final stages of development to Fitch's Hybrid products committee, which will provide a formal indication of the assignment of equity credit to the proposed security. This process can include an interactive dialogue and feedback process, and allow Fitch to better serve investors by having more timely equity credit assessments of rated issuers' capital structures.

Included in this report is an appendix that provides examples of the equity credit class assigned to a number of generic hybrid instruments. In addition, after new hybrid products become publicly available, Fitch will publish periodic research with respect to its equity credit assignments on these new products via a hybrids bulletin, or some other timely research tool. Fitch research on hybrids and other capital securities will be accessible in a new location on its website at www.fitchratings.com/hybrids

■ Section 1 – Overall Approach and Rating Implications

What is Equity Credit?

Equity credit is an analytical concept that expresses the extent to which Fitch views a security as containing debt-like or equity-like qualities in a risk-adjusted evaluation of an issuer's capital structure and financial leverage. Such risk-adjusted evaluations of capital are used in support of the Issuer Default Rating ("IDR") that Fitch assigns to the issuer itself. The IDR is a measure of the likelihood that an issuer may fail and default on its obligations. Capital securities and hybrids are evaluated as to their likely effect on the viability of the issuer and on the issuer's senior obligations under the condition of financial stress, potential insolvency and bankruptcy, regardless of the probability that financial distress will occur. In other words, the actual equity credit assigned to an instrument is independent of its issuer's credit rating.

Equity credit is derived first from the financial flexibility the hybrid security should afford an issuer under periods of financial distress. For example, such flexibility may be available through the ability to avoid or defer making an interest payment without

experiencing a default or the absence of a stated maturity.

Equity credit is also derived from the loss-absorbing features of the hybrid security, either before or after a bankruptcy or debt restructuring, and the degree to which the hybrid can support recoveries of senior unsecured creditors or their equivalents. Fitch believes that the existence of loss-absorbing securities in an issuer's capital structure can reduce its default risk, by enhancing financial flexibility. Having a larger cushion in the form of very junior ranking capital securities that absorb loss, even if only in bankruptcy, may enable a financially troubled entity to retain the confidence of trade creditors and senior lenders and thereby avoid insolvency and default.

Guiding Principles

In order for a security to qualify for equity consideration, typically it must demonstrate the following core features:

- Loss absorption in relation to senior creditors through subordination along with the ability to avoid ongoing cash payments without triggering a default, OR
- mandatory conversion to an equity instrument.

Regardless of any other advantageous features a capital security may possess, if it does not include the above core features, it will be viewed by Fitch as pure debt and assigned no equity credit. For example, a straight 100-year bond would not qualify for equity credit, nor would a straight, deeply-subordinated note that does not allow for deferral of interest payments.

That said, for securities that possess the above-mentioned core features, the proportion of equity credit assigned by the agency is influenced by various product features, such as:

- permanence/maturity, including the influence of call features;
- quality of deferral mechanisms, including the length of deferral periods, their cumulative or non-cumulative nature, or the existence of any constraints or triggers that could limit or increase the ability of the issuer to enact a deferral;
- the subordination/ranking of the security, and the resultant degree of loss absorption provided before or after bankruptcy to unsecured senior debt securities (or their equivalents); and

- investor protection mechanisms, such as covenants and cross-default protections (i.e. securities with significant investor protection are more debt-like).

These features can accentuate, detract or even eliminate entirely the equity credit otherwise implied by the core features, and are thus referred to by Fitch as its key analytical considerations in the final determination of a security's position on the debt-to-equity continuum. However, as noted above, they do not provide equity credit in and of themselves. The application of these features is based on a weak link analysis, whereby the amount of equity credit assigned is generally constrained by the weakest component of the hybrid's features.

In addition to the features of the security itself, Fitch's view of equity credit is further influenced by environmental factors, the most important of which is the influence that a regulatory regime may have on the flexibility a hybrid feature provides an issuer, compared with its basic contractual provisions. For example, regulators may deny an issuer permission to redeem a security at the call date.

Thus the degree of equity credit assigned to a hybrid may vary between industries. The regulatory effect is most notable for banks (and bank holding companies), securities firms/brokers, finance companies and to a lesser extent, insurers, but does not generally apply to corporates. Even within the banking or insurance industry, such regulatory influences can vary, at times significantly, from country to country.

Equity-to-Debt Continuum

Fitch's categorisations of the equity-like characteristics of individual instruments are summarised in Table 1, below.

Table 1: Debt-to-Equity Continuum

Equity Classes (%)	Equity	Debt
Class E – Superior Equity Content	100	0
Class D – High Equity Content	75	25
Class C – Moderate Equity Content	50	50
Class B – Low Equity Content	25	75
Class A – Debt; No Equity Content	0	100

Source: Fitch

If a capital security is categorised in Class D, for example, the principal value of the security is allocated in Fitch's equity-credit-adjusted financial leverage and capital ratios, transferring 75% to adjusted equity and 25% to adjusted debt. For interest coverage ratios, however, these percentage allocations are not applied. Instead, coverage ratios

are calculated first with all scheduled payments, and secondly with only non-avoidable payments.

This new scale is slightly more granular than that formerly used by Fitch for banks, but is considerably less granular than that previously applied by Fitch's non-bank groups, which allowed for equity credit at any percentage between 0% and 100%. In the agency's view, this greater focus provided by the new scale will afford a greater degree of clarity and consistency, and will also allow equity credit to be more significantly influenced by the most important attributes of a hybrid security.

Limits on Hybrids in Capital Structures

Fitch will place a consistent limit across all industries on the amount of equity credit derived from hybrids that Fitch will include in an issuer's adjusted capital structure. That limit is 30% of eligible capital. This is applied both at the consolidated group and unconsolidated entity levels, depending on the relevant rating analysis undertaken. The proportion of any hybrids that exceed that limit will be treated as debt (refer to section below for sample calculations). Fitch's precise definition of eligible capital can vary across sectors, but typically the focus is on core shareholders' equity, subject to various analytical adjustments (for example, in certain sectors the deduction of goodwill), plus the amount of eligible hybrid equity. An example of the calculation of the cap is provided in the sidebar on page 4.

There are several reasons for a cap on hybrids and capital securities as a source of total adjusted capital. Firstly, most hybrid securities have debt-like qualities when the issuer is financially sound and when the issuer's financial condition is weakening, but not yet in distress. Specifically, there is some onus on management to continue making scheduled periodic payments on hybrids despite the existence of deferral features, in order to avoid triggering a potential liquidity crisis and/or to maintain the company's access to financial markets before and after any potential restructuring. Secondly, hybrids usually have either a contractual or an effective maturity compared to common stock, which has no right to demand or expect redemption. Thirdly, many hybrids are structured to take advantage of tax regulations, and the issuer may suffer some economic consequences from changes in the tax regime. A balance sheet structure reliant on a large percentage of these securities would reduce the issuer's flexibility under the circumstances referred to above, even though the securities provide flexibility when used in limited amounts.

For corporate issuers in sectors in which corporate liquidity far outweighs technical measures of capital as an analytical concern, the hard limit on hybrids

Example of Calculation of the Hybrid Tolerance Limit for an Issuer

Assuming Issuer A has common equity and retained earnings of 1,000. For the purposes of this example, this will be referred to as the issuer's core equity. To calculate the maximum eligible hybrid equity credit, the core equity is grossed up for the maximum amount of equity derived from hybrids (i.e. 30%) by dividing the core equity by (1-30%). In this example, $1,000/70\%=1,429$. The 1,429 represents the maximum total eligible capital for core equity of 1,000. Since the maximum total adjusted eligible capital is 1,429 on a core equity base of 1,000, then the maximum amount of allowable hybrid equity credit supported by this amount of core equity is $1,429 - 1,000 = 429$. The amount 429 reflects the maximum aggregate 'equity component' from all hybrids that Fitch will include as equity in its equity-credit adjusted ratios; it is not a limit on the nominal amount of hybrid securities.

and capital securities as a percentage of eligible capital need not be strictly applied. For example, when an issuer's book equity is extremely low or negative due to prior write-downs, it would not be reasonable to limit the benefits of hybrid equity through excessive attention to the formula. In these circumstances, the rating committee may determine that more capital can be accepted from this source, depending on individual circumstances; for example, analysts have used normalised value in place of book value of equity, or considered the benefits of the planned use of the capital infusion. Further guidance on this topic will be provided by Fitch in due course.

Whatever the limit, Fitch is generally indifferent to the composition of the hybrids included within it, although rating committees may review the qualitative composition of the hybrids and capital securities, particularly for low-rated companies.

Assessing Hybrids and Other Capital Securities

Fitch applies a number of basic steps (see below) in determining the equity credit of hybrid securities. These steps are intended as a basic guide and readers should refer to the more detailed explanations in Section 2 of this report.

The steps follow a weak link analysis with the most debt-like feature acting as a cap to the overall equity credit a particular security can attain. Thus, as the evaluation progresses, the equity credit is either reduced in subsequent steps of the evaluation or else maintained.

Table 2: Assessing Hybrids and Other Capital Securities

Step 1	Determine source of Equity Credit: A security must either demonstrate the ability to absorb loss pre- or post-bankruptcy, or convert to common equity in the foreseeable future (as defined by Fitch to mean no more than five years). If the equity character of the instrument is primarily driven by a combination of junior ranking and an effective coupon deferral mechanism, then Track A should be followed to determine the overall equity credit. If the equity character is primarily driven by convertibility features, then Track B should be followed.	
	Track 'A': Non-Convertible Hybrid	Track 'B': Convertible
Step 2	Loss Absorption: A security must demonstrate loss absorption through a preferred, junior subordinated or subordinated ranking to be considered for equity credit. The most junior securities, such as preferred shares, can be considered for Class E, and the next highest ranking, such as subordinated debt, can be considered for Class D. Senior securities do not qualify for any equity credit and are designated Class A.	Nature of Convertible Feature: The convertible feature itself is the dominant driver in determining equity credit for convertibles. Optional convertibles will receive no equity credit, unless merited by the underlying characteristics of the pre-converted security, in which case the non-convertible hybrid column should be utilised. Mandatory convertibles that have a conversion period of three years or less will be eligible for equity credit as high as Class E. Equity credit decreases as the conversion period lengthens.
Step 3	Ability to Avoid Ongoing Cash Payments: The level of implied equity credit from a deferral feature can range anywhere from Class E to Class A. Core features that determine where a security falls include its cumulative versus non-cumulative nature, the length of the deferral period, any constraints on deferrals such as look-backs, the optional or mandatory nature of a deferral and the impact of any alternative coupon settlement mechanisms. Deferral features with Class E characteristics are those with non-cumulative deferrals devoid of any constraints. The class is systematically reduced as the deferral feature becomes cumulative and various constraints are added.	Loss Absorption of the Pre-Converted Note: For mandatory convertibles, the equity credit is decreased if the ranking of the pre-converted note is senior (mandatory convertibles are the only hybrid afforded equity credit at a senior ranking).
Step 4	Permanence/Maturity: Equity credit is also influenced by the permanence or effective maturity of a security. Those securities that are perpetual or with effective maturities over 20 years have a Class E permanence characteristic, while those with effective maturities of less than five years are viewed as debt-like, or Class A. These classifications are heavily influenced by the nature of any call provisions, including the influence of interest step-ups and replacement language.	Ability to avoid ongoing cash payments: The ranking is decreased if the pre-converted note has no effective deferral mechanism (unless already reduced for seniority).
Step 5	Covenants and Other Features: Equity credit above Class A will only be assigned to securities without covenants or events of default, other than a very limited set listed on page 16. Additional qualifications that can reduce (but not raise) the equity credit include substantial step-ups.	Covenants and Other Features: The presence of debt-like covenants and events of defaults may reduce the equity class (unless already reduced for seniority and/or lack of ability to defer ongoing cash payments).
Final Step	Conclusion: In each case, the next successive step can be neutral to, or reduce the equity credit implied by, the prior step, but will never increase it, i.e. a weak link approach. Thus, for a security to be assigned Class E equity credit, it must be Class E in Steps 2 to 5. If it is Class E in three of these four steps, and Class C in one of the four steps, its equity credit will be Class C.	Conclusion: Equity class assigned in Step 2 can be reduced by any debt-like results from Steps 3 to 5.

Source: Fitch

Application of the Debt-to-Equity Continuum in Fitch's Ratings Analysis
Fitch makes pro forma adjustments to an issuer's financial leverage and capital ratios based on application of its debt-to-equity continuum. For interest coverage ratios, adjustments are based on deferrable and non-deferrable coupon payments, rather than pro-rata adjustments based on equity

credit allocations. These adjusted ratios are used by Fitch in its fundamental analysis of an issuer, and thus they form a key basis for the agency's ratings opinions and debt and hybrid tolerances for a given issuer.

In adjusting financial leverage and capital ratios, Fitch uses adjusted equity and debt figures based on

the relevant equity and debt attributions for each hybrid security in an issuer's capital structure. These adjustments are made within the context of Fitch's 30% tolerance cap for banks and insurers. For corporates, alternate benchmarks for exceptional circumstances using notional or normalised equity will be published in due course. In cases of mandatory convertible hybrids, in addition to making pro-forma adjustments to current period leverage ratios, Fitch will also make projections beyond the conversion date, to gain a sense of the relief ultimately available to leverage ratios when conversion occurs.

Interest and fixed charge coverage ratios, a key factor in credit ratio analysis in the corporate and insurance sectors, are less meaningful in the banking sector. In the corporate sector, Fitch uses two interest or fixed charge coverage ratios. The first measures the ratio of operating EBITDA (or EBITDAR) relative to fully loaded interest expense, assuming all interest and preferred dividends are paid as scheduled. The same ratio is performed assuming that no deferrable or avoidable periodic payments are made on hybrids and preferred.

Also, using as the numerator the cash flow from operations or funds from operations, a pair of ratios is calculated; one includes as the denominator the full amount of scheduled interest and preferred dividends, and the second includes only non-avoidable interest and preferred dividends (if any). These ratio pairs give analysts a sense of the potential relief afforded the coverage ratio if management opted to defer, or if a mandatory trigger was activated, and are considered as a component in financial flexibility. When used in the context of projections, the deferred scenario ratios have the most relevance and weight in cases of distressed issuers for which a deferral may become necessary over the projection period.

Equity Credit Implications of Issuing Entity's Status within a Group

From an equity credit classification perspective, Fitch is generally indifferent to whether the issuer of a hybrid is an operating or a holding company. The equity credit classification is primarily a function of the characteristics of the note, rather than the nature of the issuer.

Although the risk to the investor will vary depending on whether the issuer is an operating or holding company, these variable risk levels are captured in the rating of the hybrid instrument which may differ depending on the type of issuer. This is particularly true for insurance companies, where differing regulatory regimes can materially enhance the

Table 3: Sample Ratio Adjustments

Background Information	
Debt	300
Core Equity	500
EBITDAR	200
Funds from Operations (FFO)	150
Pre-tax Net Income	140
Issuance of Class C Hybrid Securities	200
Implied Equity Allocation (%)	50
Implied Debt Allocation (%)	50
Adjusted Leverage Numbers	
Debt	300
Debt Attributed to Hybrid	100
Total Adjusted Debt	400
Core Equity	500
Equity Attributed to Hybrid	100
Total Adjusted Equity	600
Total Capital (Debt + Equity)	1,000
Adjusted Leverage Measures	
Adjusted Debt/Capital (%)	40
Adjusted Debt/EBITDAR (x)	2.0
Adjusted Debt/FFO (FFO Leverage)	2.7
Adjusted Coverage Measures:	
Interest on Debt (Assume 5% Non-Deferrable Coupon)	15
Interest on Hybrid (Assume 10% Deferrable Coupon)	20
Total Interest	35
Coverage (x)	
EBITDAR/Total Interest (fixed charge cover)	5.7
EBITDAR/Non-Deferrable Interest	13.3
FFO/Total Interest	4.3
FFO/Non Deferrable Interest	10.0
Pre-tax Income/Total Interest	4.0
Pre-tax income/Non-Deferrable Interest	9.3
EBITDAR – Earnings before interest, taxes, depreciation and amortization and rental or lease expenditures. FFO – Funds from Operations	
Source: Fitch	

default risk of debt issued out of a holding company relative to an operating company.

When an operating subsidiary of a parent holding company is the hybrid issuer, the equity class determination relates to the evaluation of the capital and leverage of the issuer (the subsidiary) and to group analysis that uses a consolidated approach. However, in the context of unconsolidated parent holding company analysis, Fitch makes no equity adjustments at the parent level to add an equity component relating to the subsidiary's hybrid issues. Also, in cash flow analyses of the holding company, analysts may consider the possibility that upstream dividends or distributions from the subsidiary to the parent could be stopped by any dividend blocker in the subsidiary's hybrid securities.

Rating/Notching Hybrid Securities

Fitch's ratings of hybrid securities follows the notching methodologies announced by Fitch during 2005 and early 2006, depending on the sector, with the roll out of the agency's IDR and Recovery Rating ("RR") methodology. As part of this methodology, Fitch assigns an IDR to all debt issuers that reflects the probability that the issuer will fail and default on all of its obligations. Individual security issues, including hybrid issues, are then notched relative to the IDR based on their expected post-default recovery characteristics. Fitch's RR scale and related notching against the IDR are shown in Table 4 below.

Table 4: Notching Relative to IDR

Recovery Rating	Recovery Range (%)	Investment Grade	Non-Investment Grade
RR1	91-100	+2	+3
RR2	71-90	+1	+2
RR3	51-70	+1	+1
RR4	31-50	0	0
RR5	11-30	-1	-1
RR6	0-10	-1 or -2	-2 or -3

Source: Fitch

Since most if not all hybrids are designed to be loss-absorbing, most would be considered RR6 on Fitch's recovery scale, and thus be rated 1-2 notches below the IDR at investment grade, and 2-3 notches below the IDR at non-investment grade.

Fitch does not employ a hard and fast rule in the RR6 category as to when a security is rated at -1 versus -2 at investment grade, or -2 versus -3 at non-investment grade. However, the following most commonly applies:

- At IDRs of 'A-' and above, RR6 securities are typically notched by one (unless an actual deferral has taken place in which case a further notch would typically be applied);
- At IDRs of 'BBB' notching by one or two is determined following specific analysis of the issuer, for example RR6 securities will often be notched by one if no RR5 securities (typically subordinated debt) exist, or are expected to exist, in the capital structure, and by two if RR5 securities exist, or are expected to be issued; and
- Similarly, at non-investment grade, RR6 securities will be notched by two if there are no RR5 securities and by three if there are RR5 securities.

It should be noted that notching of hybrids is based primarily on their recovery characteristics, and that

the risk of a permitted coupon omission or deferral is generally not the dominant analytical factor considered in the rating of the hybrid. Hence the simple existence of a deferral mechanism does not result in extra notching. However, if a coupon omission or deferral has actually occurred or is deemed to be imminent, Fitch will typically widen the notching to the level indicated for RR6 if the security has not already been rated at that level. In addition, notching will also be widened, although still within the bands indicated above, when the probability of deferral is significantly increased due to easily activated mandatory deferral features that would be expected to trigger a deferral far ahead of an issuer experiencing financial stress. An example of such a feature can be seen in Spanish bank preference stock, which is activated if the issuer has insufficient current net income to cover the payment, irrespective of the issuer's capital strength.

The exercise of a deferral option in accordance with its terms is not viewed by Fitch as a default.

For additional methodology papers on IDR's, RR's and notching please refer to the following (all are available at www.fitchratings.com):

- for all sectors, see "*Recovery Ratings: Exposing the Components of Credit Risk*", dated 26 July 2005;
- for banks, see "*Support Ratings and the Rating of Bank Hybrid Capital and Preferred Stock*", dated 27 July 2005; and
- for insurers see "*Insurance Industry: Global Notching Methodology*", 28 February 2006

■ Section 2 – Detailed Analytical Considerations

The following section covers the detailed analytical considerations underpinning the overall approach and proposed methodology.

Loss Absorption

The first core feature that needs to be present for a non-convertible security to be considered for equity credit is loss absorption, either pre- or post-bankruptcy. In this section, Fitch discusses why loss absorption represents one of its alternative core features, the agency's views on both pre- and post-bankruptcy loss absorption, and how loss absorption can influence equity credit.

Why Loss Absorption is Important and Forms of Loss Absorption

The most common form of loss absorption is post-bankruptcy loss absorption, and is provided by the junior ranking (or subordination) of a hybrid, and its

limited ability to secure recoveries in a bankruptcy. Thus, such securities support higher recoveries for unsecured senior debt (or its equivalent) in a post-bankruptcy environment. That said, they can also help support higher financial flexibility pre-bankruptcy, by retaining the confidence of trade creditors and senior creditors whose obligations would be supported by a greater balance of junior securities.

In some rare cases, a hybrid security's ranking changes if the issuer defaults or if its financial condition becomes stressed. For example, a hybrid issued as senior debt may convert to preferred stock or common stock in the event of bankruptcy or a wind-up. In a few cases, the reverse can apply, i.e. a security issued as junior subordinated or subordinated debt becomes a senior claim in the event of a downgrade. In any event, Fitch's equity credit adjustments are typically based on the post-bankruptcy loss absorption implied by the post-default ranking of the security. Fitch believes the initial ranking of a security prior to default is cosmetic. (N.B. Fitch would also rate the security based on this post-default ranking.)

Hybrid securities may include a feature that mandates the reduction in the principal value of a hybrid security as the value of assets is impaired. This forces the hybrid security to absorb loss while the corporation remains a going concern, without undergoing a bankruptcy or restructuring. The write-down reduces hybrid obligations outstanding on the balance sheet and offsets the decline in ordinary share capital caused by recognising losses, thereby avoiding a technical bankruptcy. Fitch refers to this as pre-bankruptcy loss absorption.

Depending on the conditions that allow for a write-down, such a feature can enhance the equity content of a security, particularly when the security possesses a deferral feature that is constrained in some manner. In such cases the pre-bankruptcy loss absorption is viewed by Fitch as a supra-deferral and can benefit the equity credit classification by moving an instrument from Class B to C or C to D. However, in itself, this feature will not result in an instrument being moved out of Class A or into Class E. Constraints on deferral mechanisms are explained further in the section on deferral features" on page 11.

Equity Credit for Loss Absorption

Table 5 summarises the maximum equity credit cap typically available from loss-absorbing features. Note that other than for mandatory convertible securities, hybrids will be categorised as Class A if they do not provide for loss absorption. In most corporate and insurance sectors and geographic

regions, a ranking at a level subordinated to unsecured senior debt is the minimum required to avoid Class A status. For these sectors, junior subordinated status will be grouped with other subordinated creditors and capped at Class D. In banking, a ranking lower than subordinated debt will usually result in Class E treatment since it is Fitch's view that these instruments are typically fully loss-absorbing and will generally be written off in a debt restructuring plan. This is primarily done to help facilitate any rescue by supporting continued funding from the capital and money markets, and can effectively place junior subordinated bank debt on a par with preference shares. Where the agency believes this is not the case, such instruments will be treated consistently with other corporate sectors, i.e. Class D will be applied.

Table 5: Subordination

Equity Class Caps (%)	Level of Subordination
Class E – 100	Preferred and preference shares, such as junior subordinated debt for banks (and bank holding companies)
Class D – 75	Subordinated and subordinated-like debt, such as junior subordinated debt for corporates and less regulated insurance companies
Class C – 50	n.a.
Class B – 25	n.a.
Class A – 0	Senior debt

To the extent that insurance companies are regulated in the same way as banks - more specifically that junior subordinated debt will fully absorb loss in any potential debt restructuring or bankruptcy due to regulatory action - any junior subordinated debt issued would result in a Class E classification. n.a. - not applicable.
Source: Fitch

Convertibility

Another way that a capital security may fulfil the core requirement of loss absorption is by convertibility into common equity. In this section, Fitch outlines why conversion to equity is one of its alternative core features, and gives the agency's views on different types of conversion features and how such features can influence the security's position on the debt to equity continuum.

Why is Conversion Important?

Conversion to equity, common or preferred, can provide for equity credit simply because the security will (or may) become equity itself, which is highly advantageous to an issuer's capital structure in support of the IDR. In general, convertible securities come in one of two forms: mandatory convertible or optional convertible. As discussed below, because of uncertainties surrounding the ultimate conversion of a security with optional conversion features, particularly under conditions of financial stress, only securities with mandatory conversion features fulfil

Fitch's core requirement for equity credit consideration.

Forms of Convertibles

Mandatory conversion features can support equity credit since they are effectively a forward commitment on the part of the investor to purchase equity securities. Furthermore, most such securities require a conversion to shares (or the exercise of the investor's commitment to purchase shares) in a relatively short time period, such as three to five years from issuance. In addition, some include a dividend deferral option when structured as a junior subordinated or preferred instrument prior to conversion.

For such securities, key differentiating factors are: the nature of the security to be received in exchange; the conversion ratio; and the time taken to exchange. Fitch's equity credit is also influenced by the debt-like or equity-like character of the pre-conversion instrument. If the conversion ratio is defined within a reasonably narrow band at the time of issuance, equity credit will be very high for a short-dated mandatory convertible hybrid. However, if the conversion ratio is effectively set by the market price of equity at the time of conversion, the effect will be to eliminate equity credit, for the reasons explained below.

In the latter case, Fitch's concern is that if the issuer is under financial stress, which is the scenario considered when assigning equity credit, it is highly likely that the common stock share price will be low, and dilution will be great. Fitch has observed that under such circumstances even distressed issuers will take actions to avoid conversion, including selling core assets or issuing senior debt to refinance the hybrid. Fitch thus believes the economic incentives are sufficiently strong as to negate the potential benefit of the conversion feature.

Another form of mandatory convertible is a junior debt instrument that converts automatically to preferred or common equity upon bankruptcy, insolvency or restructuring. Such securities are treated by Fitch in accordance with their post-bankruptcy ranking, as noted on page 8. As noted above, optional conversion features are typically afforded no equity credit. Many securities with optional conversion features call for cash settlement rather than stock settlement, which does not support equity credit in any amount. Even if the instrument mandates stock settlement, in a scenario of financial stress the exchange option is highly likely to be out of the money and investors will not exercise.

Equity Credit for Convertibles

Equity credit available to mandatory convertible securities is summarised in Table 6. The degree of equity credit is influenced by four core attributes: the equity content of the post-conversion security (most commonly common stock, but occasionally perpetual preferred shares); the period to conversion; the ability to avoid periodic payments prior to conversion; and the ranking of the pre-conversion security. Mandatory convertible securities that rank equal to senior debt do not include a deferral or zero coupon feature, or contain debt-like covenants and events of default, will have their equity credit classifications lowered by two full classes.

If a conversion or exercise date is more than five years in the future, no equity credit will be accorded, as the potential capital injection is too uncertain. Once conversion is within five years, any potential equity credit is derived in accordance with Table 6.

Table 6: Mandatory Convertibles

Equity Classes (%)	Time to Conversion; Pre-Conversion Instrument
Class E - 100	Three years or less to conversion; preferred or junior subordinated note
Class D - 75	Between three and five years to conversion; junior subordinated note
Class C - 50	Three years or less to conversion; senior or non-deferrable/non-loss absorbing note
Class B - 25	Between three and five years to conversion; senior or non-deferrable/non-loss absorbing note
Class A - 0	Over five years; senior or non-deferrable/non-loss absorbing note

Any conversion factor is rendered immaterial if it is over five years, hence equity credit if merited would be derived from the underlying characteristics of the pre-converted instrument.
Source: Fitch

Companies rated in the single-'B' range and below (i.e. highly speculative grade issuers), that have issued significant amounts of convertibles, will be viewed with greater caution than higher-rated companies as they may not be solvent for long enough to reach the date for conversion or exercise. Rating committees will apply qualitative judgements in such specific circumstances that would typically limit the equity credit to that available based on other features (such as junior ranking and deferral features).

Many capital security issues that mimic the features of mandatory convertibles are structured for tax purposes as synthetic units comprised of a debt security plus a forward contract to purchase shares at a future date and purchase price. Such synthetic units are treated in the same way as mandatory convertible securities, provided that the investors' forward

purchase contracts are at all times secured by collateral of at least equal value.

Ongoing Cash Payments/Flexibility

The second core feature that must be present in all non-convertible hybrids and capital securities to allow them to be considered for equity credit is the ability of the issuer to avoid making cash payments in periods of financial stress. Coupon deferral mechanisms and alternative coupon settlement mechanisms are structured to achieve this objective, but there is a wide variety in the types and quality of coupon avoidance or deferral features present among hybrid and capital securities.

For example, capital securities that have no obligation to make interest or dividend payments have the greatest flexibility regarding ongoing cash payments. That said, many capital securities have the debt-like feature of fixed interest or dividend payment rates or a fixed formula for floating interest or dividend payments. More debt-like still are those that have a feature that calls for increasing coupon rates over time (coupon step-ups), or those where coupon payments change from being tax-deductible to non-tax deductible (potentially creating a significant increase in the after-tax cost of servicing).

In this section, Fitch will use the shortened term 'deferral' to refer to the avoidance or deferral of periodic payments. The principles that guide Fitch in judging the quality of the varied forms of deferral features and the degree of equity credit linked to certain deferral mechanisms are discussed below.

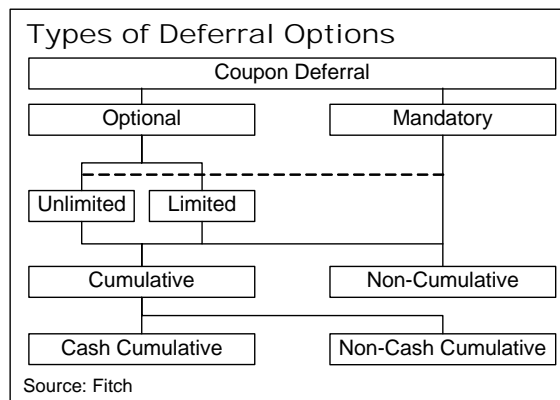
Why is Deferral Important?

While some issuers pay large common stock dividends, even during times of financial deterioration, common equity poses no contractual obligation on the part of the issuer to pay a dividend. Furthermore, common stock dividends can be cut or suspended at any time. While management teams and boards of directors vary in their willingness to cut or suspend common stock dividends (due to the negative perceptions following such an action), the lack of any contractual dividend requirement affords tremendous flexibility.

From the perspective of the issuer's IDR, the ability to avoid paying interest or dividends on a hybrid security in a manner similar to avoiding common dividends is a core aspect of financial flexibility under stress, and thus a prerequisite in according any equity consideration. While Fitch recognises that management teams may be loath to defer hybrid payments, just as they are often loath to cut common dividends, the focus in assessing equity or debt content is a balanced consideration of management intent and the flexibility provided by the option to

avoid a potential payment default by utilising the deferral features themselves.

Deferral Features



Optional Deferral Features

Optional deferral features vary greatly among hybrids. Fitch views those that allow for an unconditional deferral that can be made at any time, at management's complete discretion, on a non-cumulative basis, for an unlimited time period, as the most equity-like. To the extent that management's ability to defer payments is more constrained, the security becomes less equity-like and more debt-like. For example, a cumulative deferral option is more debt-like than a non-cumulative option, and would typically be limited to no higher than Class D.

Limitation of the deferral period can also reduce the equity-like characteristic. Fitch views favourably deferral periods of five years or more, whereas deferral periods of fewer than three years would eliminate equity credit (i.e. Class A). Features that occur five years after a stress event or the activation of a deferral mechanism, although potentially beneficial, are not viewed as being sufficiently material to impact the equity credit classification. This is because Fitch would expect a company during a five-year stress event to either recover (or be rescued) or to fail. Hence deferral features that enhance the equity characteristics of a hybrid to endure more than five years of stress appear to be of limited incremental value.

When assessing the probability of a deferral mechanism being activated, Fitch believes that in a severely distressed scenario, it is likely that management will defer on all hybrids simultaneously rather than selectively. However, judgement on this is intuitive rather than statistical.

Some hybrids incorporate a coupon step-up, typically coinciding with an option date at which the issuer can call the security. Fitch views substantial coupon step-ups as more-debt-like than equity-like.

When a step-up is in excess of Fitch's threshold level, and is combined with a cumulative deferral mechanism, it can reduce the issuer's flexibility, and therefore will typically result in the reduction of the initial equity classification by one class. Fitch's threshold level will be defined from time to time based on the market convention of the country/region where the note is issued (please refer to breakout box on page 16 for more detailed guidance).

Look-Back Provisions

If financial stress occurs and a deferral could bolster corporate liquidity, the optional deferral feature only has value if management has full rein to defer when liquidity relief is needed, without contractual restrictions. Any such restrictions, such as so-called look-back provisions that require the prior cessation of common stock dividends or other hybrid interest or dividend payments, can materially reduce or even eliminate the equity credit that the deferral feature would otherwise afford, depending on the magnitude. Such provisions often require prospective planning on management's part to enact a deferral, and in periods of rapid deterioration, time for such prospective planning may not be available. While a look-back only places restrictions on the first deferral period, Fitch's view is that when a company is under severe stress, executing that first deferral may be crucial. However, effective mandatory deferral triggers, such as regulation in certain jurisdictions, can override the effects of a look-back provision.

In contrast, no reduction in equity credit results from the inclusion of a dividend stopper. After an issuer omits or defers a distribution to hybrid or preferred holders, the issuer is typically barred from paying distributions or dividends on common shares or more junior classes of capital securities until it resumes or comes current on the hybrid payments. In this case, no prospective planning by management is required to enact the deferral.

Mandatory Deferral Features

Some hybrids also include a mandatory deferral provision linked to a financial ratio or other metric, such as an income measure. For regulated financial institutions, the trigger may be a regulatory order or breaching a regulatory capital ratio. A mandatory deferral feature can either add to Fitch's assessment of a hybrid's equity class or be neutral depending upon several conditions. It cannot lower a security's equity credit. The key benefit of a well-designed mandatory deferral feature is that it will require an issuer to defer and preserve liquidity as financial stress is growing, and is not linked to the uncertainties surrounding management willingness

to defer, as exists in the case of an optional deferral feature. An effective mandatory trigger may also compensate for constraints on a hybrid depending on the exact nature of the constraint. For example, an effective mandatory deferral may be able to neutralise the negative impact of an optional deferral constrained by the look-back feature.

For a mandatory deferral feature to add to Fitch's assessment of a hybrid's equity class, the defined deferral trigger should correlate strongly with a condition of financial stress. In other words, the ratios and their trigger levels need to be defined in a way to provide significant comfort that if the company is undergoing financial stress, it will be reflected in the noted ratios and indeed trigger the deferral so that cash is retained within the company well before potential insolvency. This will be most easily achieved in regulated industries such as banking or insurance, by linking the triggers to regulatory capital ratios. It may be more difficult to achieve in unregulated industries, where it is harder to pinpoint ratios that have such a close correlation with financial stress. Preferably, the defined trigger ratios for non-financial corporates will be based on cash flow measures of leverage and interest coverage, rather than measures of earnings or profitability.

When there is a weak correlation between deferral triggers and potential financial stress circumstances, the mandatory deferral may take effect unnecessarily, or fail to take effect when the company is materially weakening. In these cases it will not result in allotting a higher equity class than an unconditional optional deferral mechanism.

Furthermore, the measurement and reporting of the mandatory deferral triggers must be timely. For example, if the trigger is defined based only on annual financial statement reporting, the lapse of time between the timing of periodic payments and the reporting of the ratio to trigger a deferral may be significant. The greater the possible delays, the lower the contribution of a mandatory deferral feature to the assessment of equity content. The highest equity credit from a timeliness perspective is likely to be in the banking industry in cases when regulatory capital ratios are reported on a regular basis. However, even with less frequent reporting, if the timing of an annual or semi-annual measurement is well-correlated with the timing of annual or semi-annual payments on the hybrid timeliness can be acceptable; with a lag of less than six months timeliness can still be strong, and a with lag of six to 12 months can be deemed moderate. Further guidance on these issues is provided in the footnotes of Table 8. In addition, follow-up papers will define in more detail Fitch's views on strong and weak deferral features.

For hybrids that have a mandatory deferral feature (rather than an optional one), the equity credit classification will be driven by an analysis of the effectiveness of the mandatory trigger, and whether the issue is cumulative or non-cumulative. If the mandatory trigger is deemed by Fitch to be:

- Exceptionally strong: the equity credit classification will be capped at E for non-cumulative instruments and D for cumulative ones;
- Strong: the classification would be capped at D and C for non-cumulative and cumulative instruments, respectively; and
- Moderate: the classification would be capped at C and B for non-cumulative and cumulative instruments, respectively.

In the event that a mandatory deferral is combined with an optional deferral, the equity credit classification will be derived from whichever Fitch deems to be the most effective component of the deferral mechanism.

Deferral with Alternative Settlement

Alternative coupon settlement mechanisms (ACSMs) either permit or require the issuer to settle omitted coupon payments in cash via the market issuance of securities (such as common or preferred shares, warrants, or junior hybrid securities, referred to here as equity-like securities), or by giving the hybrid holder equity-like securities directly in settlement of the coupon amount, similar to payment-in-kind (“PIK”) settlements. In early examples, the alternative settlement method was included when there was a mandatory trigger that could halt coupon payments. More recently it has appeared as a means of resolving optional deferrals as well.

ACSM’s come in a number of different forms and are structured to satisfy a variety of market participants. They may permit an issuer to settle amounts instead of deferring, or to avoid the stigma of having omitted a coupon amount. Tax authorities in certain jurisdictions require cumulative dividends in order to classify a hybrid as debt and its normal cash payments as tax deductible expenses. Hence an instrument that is cash non-cumulative, requires cumulative stock settlement (i.e. Innovative Tier1 instruments in the UK) can, depending on the jurisdiction, maximise the benefit from a tax perspective (the cumulative stock settlement feature) and from a regulatory capital perspective (the cash non-cumulative feature).

From Fitch’s perspective, the differing ACSM structures may have positive, neutral or negative

effects on a security’s equity classification depending upon the details of the settlement mechanism and the type of deferral that it modifies. A brief summary follows:

1. Non-Cash ACSMs

Issuer settles deferred or omitted dividends with common stock. If the underlying optional or mandatory deferral mechanism is cumulative, the effect of non-cash stock settlement is to replicate a non-cumulative deferral, qualifying for a higher equity class (absent a restraint on the class by another factor). If the underlying deferral was non-cumulative, then the stock settlement is neutral (no change in equity class). Although from an equity credit classification perspective this feature appears attractive, it is rarely seen, because it is relatively unattractive to investors and in the US would result in the issue being categorised as equity from a tax perspective. When the non-cash settlement is accomplished with junior securities, similar to PIK settlement, this would be viewed by Fitch as a cumulative feature as the accumulated PIK amount will ultimately have to be paid in cash. Also, if the hybrid gives management discretion to settle in any of a variety of securities including common, preferred, like hybrids, options, etc., it is Fitch’s view that the issuer is more likely to opt for settling with hybrid securities rather than common, and this will be treated as a cumulative deferral.

2. Cash ACSMs via Market Issuance

Most ACSMs include a pledge by the issuer to attempt the market issuance of new junior or equity securities (once or repeatedly) and to use the proceeds of any issuance of junior securities or equity to settle the omitted coupon on the hybrid issue. Although some may argue that such a settlement mechanism is cash neutral, in that payments are only paid with new funds raised externally, Fitch views this as a burden on the issuer’s financial flexibility at a time of financial stress. Such a provision provides debt-like protections for hybrid holders and lowers the security’s equity quality.

When a cash settlement mechanism is merely an option available to the issuer, it is generally neutral to equity credit.

When the issuer must pursue cash settlement in connection with a nominally non-cumulative mandatory or optional deferral, prior to resuming coupon payments and common stock dividends, this feature may effectively turn the hybrid’s deferral from non-cumulative to cumulative and thereby reduce the maximum equity class. If the same ACSM were associated with a cumulative deferral, it

would have a neutral effect on the equity class. If the issuer is unable to successfully market equity-like securities to settle the coupon, a likely scenario in a stress event, the consequences can vary. In some instances the issuer must continue to use its reasonable efforts to sell equity-like securities until successful, or the unpaid coupons accumulate and must be satisfied with cash whenever the company subsequently sells equity-like securities or pays a common dividend. In both these cases Fitch will view the feature as equivalent to a cumulative deferral. However, in some cases, if the ACSM is unsuccessful, the unpaid coupons are eliminated (as if non-cumulative). Fitch will view such a feature as equivalent to a non-cumulative deferral.

3. Dilution effects of ACSM

In the event that an ACSM mechanism could result in a material dilution of ownership, Fitch would view the ACSM mechanism as eliminating equity credit. If employing the ACSM is entirely at management's discretion, then Fitch would view it as neutral to equity credit. Where the issuer could be forced into a dilutive transaction (issuance of an unlimited amount of common shares to satisfy unpaid coupons), Fitch is concerned that management may undertake measures to avoid equity dilution and such actions could exacerbate the financial stress on the issuer. The dilutive effects of the ACSM are not considered excessive by Fitch if they are limited to 2% of the maximum percentage of outstanding shares that can be issued pursuant to ACSM for any hybrid security in any one year, and no more than 10% of outstanding shares in aggregate in any year for all hybrids. For PIK features, Fitch does not impose any limits on the value of securities that can be utilised to satisfy the ACSM. Such a feature is viewed as being equivalent to a cumulative deferral, which is not capped.

4. Covenants

Some hybrids have covenants prohibiting the issuance of debt in order to buy back shares that

have been issued in order to satisfy an ACSM requirement. Fitch is indifferent to such covenants from an equity credit classification perspective. Issuers adding leverage in order to pursue share buy-back programmes is a key part of the wider rating analysis.

Fitch's treatment of ACSM mechanisms is summarised in Table 7.

Equity Credit and Deferral Features

Table 8 summarises the upper limit that various deferral features would place on Fitch's classification of hybrid security. Note that the final equity credit afforded any hybrid or capital security results from the combined impact of all applicable core features of the hybrid, together with adjustments for any analytical considerations linked to additional product features.

■ Permanence/Maturity

While permanence of hybrid capital, in and of itself, does not provide for equity credit because it is not a core feature, permanence and maturity influence the level of equity credit a hybrid can receive. To put permanence in perspective, it is important to remember that common equity is perpetual and has no maturity, and thus it poses no refinancing risk to the issuer in a time of financial stress. Furthermore, while common equity can be repurchased, thus potentially reducing its theoretical permanence, all such repurchases are strictly voluntary.

Some hybrids are perpetual like common stock and these securities can enhance a security's equity content based simply on the absence of a stated maturity or redemption. The lack of any refinancing risks is a noteworthy condition in Fitch's view.

That said, many hybrid securities have a stated maturity or redemption date. Fitch believes that when effective maturities are greater than 20 years, the hybrid affords virtually the same financial

Table 7: ACSM Impact on Equity Credit Classification

	Nominally Cumulative	Nominally Non-Cumulative
Non-cash settlement	Settlement with common shares changes treatment to non-cumulative. Otherwise, no change.	No change
Cash settlement via optional market issuance	No change	No change
Cash settlement via required "reasonable efforts" market issuance	No change	If company is obliged to repeatedly attempt to access the market after an unsuccessful attempt, or is obliged to use the proceeds of any future equity-like issue to settle prior unpaid ACSM, or cannot resume common dividends without settling prior unpaid ACSM, Fitch will interpret the arrangement as cumulative deferral.

Source: Fitch

Table 8: Deferral Features and Equity Credit

Equity Classes (%)	Optional Deferral		Mandatory Deferral	
	Non-Cumulative	Cumulative	Non-Cumulative	Cumulative
100	Unconstrained		Exceptionally Strong	
	With minor constraint AND pre-bankruptcy loss absorption			
75	With minor constraint	Five years or more unconstrained	Strong	Exceptionally Strong
	With major constraint AND pre-bankruptcy loss absorption	Five years or more with minor constraint AND pre-bankruptcy loss absorption		
50	With major constraint	Five years or more with minor constraint	Moderate	Strong
		Three to five years unconstrained		
		Five years or more with major constraint AND pre-bankruptcy loss absorption		
25		Five years or more with major constraint		Moderate
		Three to five years with minor constraint		
0		Less than three years	Weak	Weak
		Three to five years with major constraint		

Constraints/Look-backs: A typical constraint would be a look-back feature of no more than 12 months. Longer look-back periods would be treated as Class A. Looks-backs for 0 to 6 months are viewed as minor constraints. Looks-backs for 6 to 12 months are viewed as major constraints. In some cases, look-backs that require a prior cessation of payments on pari passu securities (i.e. other hybrids), rather than just ordinary share capital can effectively eliminate the issuer's ability to defer. In such cases, the look-back will result in application of Class A. Looks backs that require pari passu cessations that are structured to avoid such an occurrence will be treated as otherwise discussed.

Non-cumulative: The table above assumes that non-cumulative deferral option is available for no fewer than five years (or four annual coupons). In the rare case of limitations on the number of available non-cumulative deferrals to fewer than five years, equity class would be reduced consistent with that shown in the column 'Cumulative Deferral'

Coupon Step-ups with Cumulative Deferral: Step-up in excess of Fitch's threshold will reduce the equity class by one level from those shown above

Mandatory Deferrals: An exceptionally strong feature would typically refer to financial ratios that trap cash well before severe distress, and for which there is very frequent (weekly, monthly) reporting of the trigger and/or frequent regulatory supervision of the trigger, such as is most common for strongly regulated banks. Strong features would refer to levels of ratios and/or less than 6 months between the timing of ratio measurement and the timing of coupon payments on the security. Moderate features would refer to levels of ratios and/or 6 to 12 months between the timing of ratio measurement and the timing of coupon payments on the security. Weak features refer to those which only take effect when severe distress has already occurred or is imminent, and/or for which reporting of the trigger is poorly correlated with the timing of capital security payments (testing dates that are at a distance of 12 months or more to the payment date). Another example of a "Weak" feature could be multiple conditional events linked to infrequent reporting periods.

Impact of constraints on Mandatory Deferrals: Look-backs and other constraints would have the same impact on mandatory column classifications as it does for the optional column classifications at the level of exceptionally strong and strong mandatories, i.e. a reduction in the equity class by one for a minor constraint and two for a major constraint. Likewise pre-bankruptcy loss absorption features would be treated in the same way. At the moderate level, each will be reviewed on a case-by case basis. These elements have been omitted from the table for simplicity of presentation.

Source: Fitch

flexibility as a true perpetual security as any refinancing risk is so far into the future. For maturities greater than 10 years, the hybrid's tenor is still very equity-like. Hybrids become more debt-like as maturities move under 10 years, and pending hybrid maturities actually add materially to refinancing risks when they fall below five years.

These views are summarised in Table 9, which shows the maximum equity credit that can be achieved depending on the effective maturity of the hybrid.

Equity Credit for Permanence

Table 9: Equity Credit and Permanence

Maximum Equity Class (%)	Effective Maturity
Class E – 100	Perpetual/20 years plus
Class D – 75	10 th to 20 th years
Class C – 50	8 th to 9 th years
Class B – 2	7 th to 8 th years
Class A – 0%	Less than 5 years

10 year call therefore would be Class D for one year as it would be in its tenth year for 365 days, i.e. from 9 years and 365 days to 9 years and one day.
Source: Fitch

Defining Effective Maturity

A common feature in many hybrids with very long nominal maturities, or no stated maturity, is an issuer call option. As an option, the call provision places no contractual obligation on the part of the issuer to call and refinance the hybrid security. Thus, in a period of severe financial stress it allows the issuer to avoid refinancing risk and benefit from the longer maturity of the security. In this sense, a call provision can be viewed as similar to the voluntary decision to repurchase common equity.

However, features related to the call option (such as rate step-ups) may place economic or reputational pressures on an issuer to call and refinance the hybrid, even if the issuer is experiencing some deterioration in its financial position. In many cases, if the hybrid is not called, a higher interest rate may apply in the future (a so-called step up provision). Furthermore, in many cases, hybrids are priced upon issuance, assuming a call will occur. Thus in order to satisfy hybrid investors, issuers often feel obligated to initiate the call if they can, even if the refinancing leads to a weaker capital structure or reduces future financial flexibility.

Fitch believes a call option is most benign when there is no interest step-up (material or otherwise) or there is a statement of management intent (more positively still a binding covenant), allowing a call only if a similar hybrid can be issued to replace the existing hybrid. Fitch is likely to view the date of the step-up option as the effective maturity of the instrument, reducing the equity credit that would otherwise be available to the hybrid based on its stated tenor. Fitch would also view as an effective maturity a change in the interest rate from fixed to floating, provided a step-up was priced into the change, as is typical in a number of hybrids.

The views noted above on “effective maturities” (summarised in Table 10) can vary across sectors and individual issuers based on Fitch’s understanding of regulatory practice, past management practices and concerns with respect to management intent. An example is industries where

Table 10: Effective Maturity Guidelines

Feature	Effective Maturity
No call	Perpetual/stated maturity
Call only	Perpetual/stated maturity
Call with step-up only	Call date
Call with step up consistent with a threshold amount plus replacement language acceptable to Fitch*	Perpetual/stated maturity
Call with step up but replacement provisions do not satisfy Fitch concerns regarding management intent*	Call date

* Acceptable replacement provision may come in any form (i.e. regulatory requirement, contractually enforceable, management intent), providing that Fitch’s rating committee does not have specific concerns with regard to management’s intent on capitalisation or the issuer’s market access.
Source: Fitch

regulatory approval is required for an instrument to be called, and that approval would only be granted if it is replaced with a comparable equity-like instrument, (i.e. most bank Tier 1 instruments). For such sectors, an equivalent refinancing would be the starting assumption and Fitch would then look to the contractual maturity of the hybrid instrument.

In contrast, if the company in question is a company that in the past failed to live up to a replacement language provision, or Fitch was otherwise concerned that management would live up to their intended replacement language, the agency would typically treat the effective maturities of such securities as the call date.

Fitch is indifferent to the precise wording of any potential replacement provisions since they are viewed purely as statements of intent, whether they are structured to be legally binding or not. An implied call based on a change in rating agency classification, would not be regarded by Fitch as an effective maturity date. A rating agency change in classification may make it less appealing for a company to retain the hybrid instrument, thus it appears reasonable to allow management the flexibility to call the security at that point.

Organic replacement features, such as those which may permit redemption only if sufficient earnings are retained in advance, will be reviewed on a case-by case-basis. In general, hybrid instruments with this kind of feature will not be granted an exemption from the effective maturity regime, but the build-up of any underlying reserve or provision would be credited to equity provided it is genuinely loss-absorbing in insolvency.

Change of Control and Put Rights

In some cases, the issuer has the right to make an exceptional call in the event of a change of control, i.e. if the issuer is taken over by different owners. Typically, if the issuer does not make such a call, the interest rate steps up substantially. The rationale for this structural element is to protect hybrid investors from being disadvantaged in the capital structure of an issuer, in a takeover situation.

Fitch views the occurrence of a takeover as event risk. This would also be true for an exceptional call at the issuer's option, and hence this feature would not cause Fitch to shorten its view of the effective maturity of the hybrid instrument.

In contrast, if a change of control gives investors the right to put a security or entails an obligation by the issuer to redeem a security in the event of a takeover, then its inclusion makes the security more debt-like and less equity-like by reducing permanence and loss absorption under these circumstances. That said, Fitch acknowledges that this is only one potential scenario for a company in distress. As a result Fitch's overall approach is to reduce the equity credit classification by one Class for instruments containing this feature.

■ Absence of Creditor/Investor Protections – Covenants

Common stock has no covenants, no defined events of default, and no protections afforded common stockholders that would allow shareholders to trigger an involuntary bankruptcy or winding up of the issuer under any circumstances. Some hybrids and capital securities however, contain covenants or defined events of default within their documentation that are designed to protect the interests of hybrid investors, and in some cases could allow hybrid investors to cause the bankruptcy of the issuer, if the issuer fails to perform with respects the hybrids' stated terms and conditions.

Since many common types of hybrids are junior subordinated debt instruments, their debt indentures or note agreements typically contain some limited covenants and defined events of default, the breach of which can give the holders legal remedies against the issuer. These include the right to take the issuer to court and demand payment; and the right to put the issuer into bankruptcy if not satisfied.

Hybrid securities can attain equity credit only if they have no more than a select few, fairly benign events of default or covenants. Permissible events of default are the following:

Additional Step-Up Considerations

A particularly onerous step-up in conjunction with a cumulative deferral mechanism can in Fitch's view reduce an issuer's flexibility. Such a combination of features will therefore typically result in the reduction of the initial equity classification by one class. For example, a security that otherwise merited Class D equity credit would be reduced to Class C if the step-up was deemed by Fitch to be particularly onerous. Threshold levels will not apply to non-cumulative instruments. Fitch's threshold level will be defined from time to time based on market conventions of where the note is issued, which may or may not coincide with the domicile of the group. Taking into consideration that the current norms in Europe and the US are 100 bps and 200 bps for investment grade and speculative grade issuers, and in Australia for all issuers 200 to 250 basis points, Fitch will attempt to set a threshold that does not encourage onerous increases in charges. An increase of 50% of the initial credit spread can also be considered a threshold level for jurisdictions where this is defined by the appropriate regulators.

- Events of bankruptcy and liquidation.
- Failure to redeem the securities after invalidation of basic structure. An example of invalidation could be if a security is structured as a preferred note issued by a special-purpose entity which gains its credit support from a subordinated guarantee from its parent company. The invalidation of the underlying subordinated guarantee would render invalid the security's basic structure.
- Failure to pay amounts due after application of all permitted deferrals.

At the other extreme, senior debt and ordinary subordinated debt may contain a range of positive and negative covenants. Examples include covenants to provide financial statements by a certain date, to maintain properties in good order, and to maintain insurance. Financial covenants could also exist regarding maintenance of certain financial measures or financial ratios. Typical events of default that Fitch would view as problematic for equity credit include failure to comply with covenants (after their cure period), or cross acceleration or cross default to other obligations of the issuer. Such covenants and events of default make an instrument entirely debt-like (Class A), no matter what other features the security may contain (with the exception of mandatory convertible securities).

Finally, it should be noted that traditional preferred shares typically do not have any covenants, although

certain events can lead to increased rights for the preferred holders. Failure to pay dividends to the preferred holders may prohibit payment of dividends or other types of distributions to common shareholders. Failure to redeem the stock at its scheduled redemption date or failure to pay dividends for a long period (e.g. five years), may give the preferred holders the right to elect a certain number of directors to the board. While none of these create a trigger for bankruptcy or liquidation,

they do create some behavioural pressure on common shareholders and the corporate board of directors to make scheduled payments on the preferred. Fitch views these provisions in the context of a reasonable protection for preferred shareholders preserving their status relative to common shareholders, and thus their existence does not result in any covenant-related caps placed on the equity credit available to traditional preferred stock.

Table 11: Summary of Hybrid Features and Impact on Equity Classes

Class	Equity Credit Loss Absorption, (%) Seniority	Coupon Deferral or Avoidance	Permanence/ Remaining Time to Effective Maturity	Investor Protections/ Covenants	Mandatory Convertibility
Class E	100 Preference shares; junior subordinated (for banks)	Non-cumulative without constraints	Perpetual or at least 20 years		Within three years, subordinated or more junior ranking
Class D	75 Junior subordinated and subordinated (non-bank); subordinated of banks	Non-cumulative with minor constraints or cumulative five years or more and unconstrained	10th to 20th years		Exercise in more than three but within five years, subordinated or more junior
Class C	50	Non-cumulative with major constraints or cumulative three to five years and unconstrained	8th and 9th years		Exercise within three years, senior note, or non-deferrable subordinated note
Class B	25	Cumulative five years or more with major constraints	7th and 8th years		Exercise three to five years, senior note, or non-deferrable subordinated note
Class A	0 Senior debt	Cumulative or non-cumulative, less than three years; Cumulative three-five years with constraints	Less than five years	Any covenants or events of default other than a limited set listed on page 16	Over five years to exercise
Comment		Excessive Step-up in coupon rate reduces equity classification by one class. May also be affected by terms of an alternative settlement mechanism (ACSM)			Instruments with more than five years to exercise may derive equity content from deferral and loss absorption features.

Source: Fitch

Table 12: Special Features Affecting Equity Class

Alternate Settlement (ACSM)	Effect on Equity Class	Features related to Call	Effect on Maturity	Pre-Conversion Features
Cumulative, with non-cash settlement with shares (not cash or PIK)	Same as non-cumulative	No call	Perpetual/stated maturity	If the convertible hybrid ranks senior prior to conversion, has no coupon deferral flexibility, or has debt-like covenants and events of default, its equity classification will be reduced by two classes.
Non-cumulative, with required settlement in cash via market issuance of shares or PIK	Same as cumulative	Call only	Perpetual/stated maturity	
Step-Up in Coupon	Effect on Equity Class	Call with step-up only	Call date	
In excess of Fitch's guideline, i.e. market convention	Reduces equity classification by one class.	Call with step up, but replacement language acceptable to Fitch	Perpetual/stated maturity	
Additional Factors	Effect on Equity Class			
Mandatory deferral	If exceptionally strong then offset impact of constraint. If strong then offset by one class only			
Pre-bankruptcy loss absorption	Offset constraint by one Class but cannot raise to Class E or out of Class A	Call with step up, and replacement provisions not satisfactory	Call date	

Source: Fitch

■ Appendix 1

The following is a summary of the equity credit Fitch would assign to several common classes of hybrid securities. These should be viewed as representative only, as equity credit for specific similar products could differ based on unique features within those specific products.

In the following illustrations (Table 13), Preferred/ Preference examples one, two and three are all evaluated based on Track A as explained in Assessing Hybrids and Other Capital Securities on page five. Similarly, the deferrable/trust preferred instruments four and five (Table 14) derive their equity credit based on a Track A evaluation. In the case of the convertible securities in Table 15 on the next page, examples one and two derive their equity credit by means of Track B, whereas examples three and four do not derive any equity credit from their convertibility, but example four does warrant modest equity credit from Track A (i.e. the pre-conversion deferral features and junior subordination, but limited by seven years remaining to maturity).

Table 13: Preferred/Preference Shares/Innovative Tier 1

	1. Preferred Stock (Corporate)	2. Preferred Stock (Bank)	3. Innovative Tier 1 (Insurance Europe)
Description of Security	Initial 40-year maturity, 30 years remain	Perpetual	Perpetual
	Preferred Stock	Preferred stock	Preferred stock
	Dividends cumulative	Dividends non-cumulative	Dividends non-cumulative or cumulative stock settled
		Dividend stop if regulatory capital violation	Call after 10 years with maximum step-up of 100 basis points
	No covenants or events of default	No covenants or events of default	Early redemption typically only after regulatory approval
Conversion	None	None	None
Ongoing Cash Payments	Class D	Class E	Class E
Loss Absorption	No cap	No cap	No cap
Permanence/Maturity	No cap	No cap	No cap*
Covenants	No cap	N cap	No cap
Overall Class	Class D – 75% equity	Class E - 100% equity	Class E - 100% equity

* Provided issuing entity is subject to effective regulatory oversight
Source: Fitch

Table 14: Deferrable/Trust Preferred

	4. Trust Preferred Security	5. Deferrable Subordinated Debt (Corporate)
Description of Security	30-year initial, 22 remaining	Perpetual
	Junior Subordinated	Subordinated
	Cumulative five-year deferral option	Optional unlimited non-cumulative deferral, but constrained by look-back
	No call; OR Optional call, no step-up	Call after 10 years with maximum step-up of 100 basis points
	No replacement provisions (but none required)	Replacement language
	Acceptable (weak) investor protections	Acceptable (weak) investor protections
Conversion	None	None
Ongoing Cash Payments	Class D	Class C
Loss Absorption	No cap	Cap at Class D
Permanence/Maturity	No cap	Cap at Class D*
Covenants	No cap	No cap
Overall Class	Class D – 75% equity	Class C - 50% equity

* Unless acceptable replacement provisions in which case cap due to maturity is removed
Source: Fitch

■ Appendix 1 (Continued)

Table 15: Convertible Securities

	1. Mandatorily Convertible	2. Mandatorily Convertible	3. Optionally Convertible	4. Optionally Convertible
Description of Security	Mandatory convertible Three-year exchange; five-year junior subordinated note	Mandatory convertible Three-year exchange; five-year senior note	Optionally convertible Seven-year maturity; senior note	Optionally convertible Seven-year maturity; junior subordinated note
	Cumulative deferral five years	No deferral of interest	No deferral of interest	Optionally deferrable five years
	Acceptable (weak) investor protections	Acceptable (weak) investor protections	Normal debt investor protections	Acceptable (weak) investor protections
Conversion Features	Class E (Dominant Feature)	Class E	Class A	Class A
Ongoing Cash Payments	Class D	Class A	Class A	Class D
Loss Absorption	No cap	Cap at Class A	Cap at Class A	Cap at Class D
Permanence/Maturity	No cap	No cap	Cap at Class B	Cap at Class B
Covenants	No cap	No cap	Cap at Class A	No cap
Overall Class	Class E - 100% equity	Class C - 50% equity*	Class A - 0% Equity	Class B - 25% Equity**

* Reduced 2 equity classes due to senior rank and non-deferrable pre-conversion security. **Based solely on the features of the pre-conversion security.

Source: Fitch

Copyright © 2006 by Fitch, Inc., Fitch Ratings Ltd. and its subsidiaries. One State Street Plaza, NY, NY 10004.

Telephone: 1-800-753-4824, (212) 908-0500. Fax: (212) 480-4435. Reproduction or retransmission in whole or in part is prohibited except by permission. All rights reserved. All of the information contained herein is based on information obtained from issuers, other obligors, underwriters, and other sources which Fitch believes to be reliable. Fitch does not audit or verify the truth or accuracy of any such information. As a result, the information in this report is provided "as is" without any representation or warranty of any kind. A Fitch rating is an opinion as to the creditworthiness of a security. The rating does not address the risk of loss due to risks other than credit risk, unless such risk is specifically mentioned. Fitch is not engaged in the offer or sale of any security. A report providing a Fitch rating is neither a prospectus nor a substitute for the information assembled, verified and presented to investors by the issuer and its agents in connection with the sale of the securities. Ratings may be changed, suspended, or withdrawn at anytime for any reason in the sole discretion of Fitch. Fitch does not provide investment advice of any sort. Ratings are not a recommendation to buy, sell, or hold any security. Ratings do not comment on the adequacy of market price, the suitability of any security for a particular investor, or the tax-exempt nature or taxability of payments made in respect to any security. Fitch receives fees from issuers, insurers, guarantors, other obligors, and underwriters for rating securities. Such fees generally vary from US\$1,000 to US\$750,000 (or the applicable currency equivalent) per issue. In certain cases, Fitch will rate all or a number of issues issued by a particular issuer, or insured or guaranteed by a particular insurer or guarantor, for a single annual fee. Such fees are expected to vary from US\$10,000 to US\$1,500,000 (or the applicable currency equivalent). The assignment, publication, or dissemination of a rating by Fitch shall not constitute a consent by Fitch to use its name as an expert in connection with any registration statement filed under the United States securities laws, the Financial Services and Markets Act of 2000 of Great Britain, or the securities laws of any particular jurisdiction. Due to the relative efficiency of electronic publishing and distribution, Fitch research may be available to electronic subscribers up to three days earlier than to print subscribers.