

Special Report

Hybrid Securities
An Empirical View

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Related Research

- Equity Capital for Hybrids & Other Capital Securities, Criteria Report, Sept. 27, 2006.
- 2006 Trust Preferred CDO Performance Summary, Special Report, Dec. 19, 2006.

■ Overview

Hybrid securities are capital instruments that demonstrate rapid and ongoing evolutionary adaptation. In the beginning (i.e., before 1992), most hybrid securities were traditional preferred or preference shares rather than simple one-celled creatures. A second generation of hybrids emerged in 1993 and multiplied over the next nine years. These included structured instruments called trust preferred securities, or capital securities, and so-called “mandatorily convertible” hybrid units. Continuing capital market evolution is producing a third generation of hybrids, described on pages 5–6.

Faced with complex hybrid products, investors are best served if credit rating agencies base their credit policies on empirical experience. Fitch Ratings studied the actual experience of the first and second generations of hybrid securities in order to formulate and test its “first principles” about these securities. Fitch’s over-riding principle is that hybrid securities should deliver on their equity-like quality during periods that an issuer faces financial distress. Equity-like status is derived from the ability to provide cash flow flexibility and absorb loss in extreme situations, goals that some hybrids achieve through having a long tenor, no periodic payment obligation and junior ranking. Alternatively, a convertible instrument may meet those goals and provide real loss-absorption capacity by virtue of a near-term conversion to an equity security.

In recent years, a minority of the issuers of hybrid securities experienced financial stress, but in those cases, some second-generation hybrids were subjected to a test of their basic character. In 2005, Fitch carried out two studies of hybrid securities that focused on the hybrid securities of firms that experienced financial declines or distress during the most recent business downturn. The first study surveyed a broad array of securities of several different types issued by corporations and nonbank financial institutions. The second study focused on a small number of troubled banks. In addition, Fitch provides ongoing surveillance of large portfolios of hybrid securities of small and regional banks, whose hybrids are incorporated into structured finance securitizations (trust preferred security collateralized debt obligations [CDOs]). The observations from these three sources contributed to the September 2006 revisions Fitch made to its policies for allocating debt and equity components to hybrid securities (see Fitch’s criteria report, “Equity Capital for Hybrids & Other Capital Securities,” dated Sept. 27, 2006, accessible at www.fitchratings.com/hybrids).

■ Empirical Evidence

In 2004 and 2005, Fitch reviewed a cohort of U.S. issuers that had outstanding hybrid securities in the economic downturn of 2000–2003

Hybrid Securities in Fitch Ratings' General Hybrid Study

Category	Types of Securities Included	Number of Issues
1. Nonconvertible (Straight) Preferred Securities	Perpetual preferred stock and preferred with mandatory redemption date.	35
2. Deferrable and Trust Preferred Securities (Deferrable Securities)	Trust preferred securities, capital securities, quarterly and monthly income preferred securities (QUIPS and MIPS), and quarterly and monthly deferrable interest debentures (QUIDS and MIDS).	65
3. Synthetic Mandatory Convertible Units	Automatically convertible equity securities (ACES), dividend-enhanced convertible securities (DECS), preferred equity redemption cumulative stocks (PERCS), preferred redeemable increased dividend equity securities (PRIDES) and similar synthetics.	13
4. Optionally Convertible Bonds and Preferred Shares	Debt and preferred stock convertible at holder's option and contingently convertible securities	90
5. Other "Exotics"	Equity-linked loans, remarketable term income deferrable equity securities (HIGH TIDES).	6

Source: Fitch Ratings.

to see how the issuers and the hybrid securities behaved in a stress scenario. Fitch analyzed which structures or features of the securities resulted in the most equity-like or debt-like performance. The short history of issuance of second-generation securities and the concentration of their issuance in the United States, primarily by highly rated banks or insurers that did not face financial stress, limited the number of cases in the study and largely ruled out non-U.S. cases. Also, the population of financially troubled hybrid issuers did not all issue securities with identical structures, so Fitch's sample included five subsets, each too small a sample to provide statistically predictive results. Nonetheless, Fitch found that the results of the review were instructive.

From its ratings universe, Fitch identified for review 209 securities of 89 U.S. corporate issuers outstanding during 2000–2003. (A list of the issuers appears in the appendix on page 7.) A sharp downturn in 2001–2002 provided a material number of distressed issuers of hybrids, defined for the study as issuers with subinvestment-grade ratings at any time during the period 2000–2003. The securities reviewed, approximately \$48 billion in total, came from several sectors, including industrials, utilities, telecommunications, finance, and insurance. This was not the total population of outstanding hybrid securities. The great majority of investment-grade hybrid issuers remained within investment grade and never experienced a sufficient stress to be included in Fitch's study.

For the most part, the issuers and issues in the study experienced downgrades during the study period, and most could be considered "fallen angels." Approximately 90% of the securities were issued by companies with investment-grade senior debt ratings

at the time of the hybrid's issuance. For this review, Fitch included all hybrids of issuers rated 'BB+' or lower at any time during the study period. Fitch considered limiting the sample to companies whose issuer default ratings were 'B+' or lower, a level that would have constituted a more serious stress, but that would have further reduced the size of the sample. Not all of the 209 securities had the same structures, and Fitch sorted the 209 securities into the five categories shown in the Hybrid Securities in Fitch Ratings' General Hybrid Study table.

Some broad observations about the categories of securities included in the study are summarized below, and more detailed analyses of the observations appear in Appendix 1 on pages 7–12.

Categories 1 and 2

Relatively straightforward conventional hybrid securities (e.g., straight preferred and preference stock, trust preferred and deferrable interest junior subordinated debt) absorbed loss and gave relief from ongoing payments for their issuers equal or nearly equal to common stock in cases of imminent insolvency.

There was no material distinction in the behavior of Category 1 (straight preferred and preference stock) versus Category 2 (trust preferred securities, or junior subordinated notes with optional coupon deferral). Issuers of these instruments did not halt dividends or interest payments on these securities early in the issuer's financial slide. Omissions or deferrals of dividends or interest payments tended to happen in a late stage of distress. In bankruptcy, the recoveries of preferred shareholders and holders of deeply subordinated trust preferred issues were comparable.

Both typically suffered very deep losses relative to senior holders.

There was not a sufficient sample of financially distressed issuers of noncumulative securities to draw any conclusions about cumulative versus noncumulative issuers or instruments. There was little or no difference between the performance of straight perpetual preferred and straight preferred with a mandatory redemption date with at least 10 years remaining life among the 35 issues in the back test study. Both performed in an equity-like manner during periods of financial stress.

Also, within Category 2, there was no discernable difference in behavior or recoveries in the cases of preferred stock issued by a special-purpose entity (SPE) or trust versus direct issues of deferrable deeply subordinated notes without a trust or SPE structure.

Seven issuers suspended dividends during the study. Of these, four companies subsequently filed for bankruptcy protection while the other three ultimately resumed payments when their financial conditions stabilized. The extremely rapid collapse that characterized the 2000–2003 collapse in the telecom, Internet services and energy trading sectors resulted in a few of the issuers in the study filing hasty bankruptcy petitions without ever suspending dividends. Fitch is uncertain if this phenomenon will recur in any future business cycle.

Category 3

Mandatorily convertible units (when the investor's contractual obligation to purchase common shares was secured by collateral) fulfilled their expected exercise as scheduled and at the contractual price, despite severe declines in the equity value of the common shares. However, in the United States, the contractual commitment to exercise was extinguished if the issuer filed in bankruptcy prior to the exercise date, although in other jurisdictions, this is not necessarily the case.

Category 4

Senior notes convertible to common shares at the option of the investors (optionally convertible debt), to which Fitch did not accord any capital equivalence, unless the conversion was imminent and in the money, confirmed Fitch's view that they were entirely debt-like. If the optionally convertible security was a preferred or preference stock, it

provided similar support as any security in Category 1. If optionally convertible securities ranked equally with senior debt, they did not absorb loss in the issuer's bankruptcy and were predominantly debt-like.

Category 5

Six irregular exotic instruments were included in the study. These securities had either an explicit or implicit option for the investor to put the instrument back to the issuer when the issuer's stock price declined. That feature turned the security into a source of liquidity risk for the issuer. Several of these securities had a conversion ratio based entirely on the market price of the common stock at the time of the exercise. Concern about the unlimited dilution of the common equity and change of voting control of the company motivated the issuers to sell valuable assets or issue secured debt in order to redeem the hybrid securities in the years before the issuer's bankruptcy.

■ Experience in the Regulated Banking Sector

Fitch observed a wider spectrum of types of hybrid instruments in the corporate sector than the more limited array seen in the banking sector. Among the banks, the prevalent securities take the form of straight preferred or preference shares or deeply subordinated deferrable coupon hybrids, similar to Categories 1 and 2 in the general hybrid study. This reflects the fact that only a few structures have been approved by bank regulators to be treated as regulatory capital.

A few banks with outstanding preferred or hybrid securities became distressed over the period 1999–2005, and Fitch reviewed those distressed entities in 2005 to see how hybrids behaved in practice and what equity support, if any, they provided. There were so few cases of distress that Fitch utilized a case-by-case approach. Fitch determined that hybrids provided ongoing support and helped prevent insolvency in the following examples:

- Bay View Capital Corp., United States.
- Riggs National Corporation, United States.
- Resona Holdings, Inc., Japan.
- UFJ Holdings, Inc., Japan.

Cases Fitch reviewed in which hybrids did not prevent a general default but improved the recoveries of more senior obligations were:

- Ashikaga Financial Group Inc. and The Ashikaga Bank, Ltd., Japan
- Hamilton Bancorp Inc., United States.

Finally, two cases in which issuers chose not to omit payments on hybrids despite financial distress were Advanta Corp. and Providian Financial Corp. Another source of evidence about the performance of preferred and trust preferred securities as well as comparable hybrids issued by banking institutions comes from Derivative Fitch's ongoing surveillance of CDOs backed by such instruments. On Dec. 19, 2006, Derivative Fitch published a report entitled, "2006 Trust Preferred CDO Performance Summary," which detailed the performance of trust preferred securities funded through CDOs since 2000. A brief summary of the finding of that report is in the following section.

Since 2000, Fitch has conducted credit assessments and ongoing surveillance of more than 1,500 unrated community banks that have issued trust preferred securities through a CDO. These small and unrated financial institutions are deemed by Fitch to be more likely to defer or experience a general default than larger banks with greater access to the capital markets that are direct issuers of hybrids. Nonetheless, default and deferral history among these CDO portfolio securities to date has been minimal. Of the approximately 1,500 bank/thrift entities that participated as issuers in these CDOs, only 10 entities deferred interest payments on their trust preferred obligations as of December 2006. Of the 10 deferring banks/thrifts, eight repaid all cumulative dividend payments and became current. On average, for the eight bank/thrift institutions that deferred and resumed paying current dividends, the average deferral period was approximately 12–18 months. In some cases, these entities were purchased by larger institutions and thus resumed payments. Of the two institutions that were still deferring as of December 2006, one had been deferring for approximately 32 months and the other had been deferring for just more than 12 months.

While not germane to banking, CDOs have also financed the purchase of trust preferred securities and surplus notes issued by small and typically unrated insurance companies. As of December 2006, only three unique insurance companies had either deferred or defaulted on payment out of the 226 entities participating in that sector. The insurance sector has been the main source of deferral activity over the past year. One highly exposed entity deferred in

December 2005. Of the two remaining insurance credit events, one involves a surplus note and is regarded as defaulted and the other has very low prospects for any meaningful recovery.

In aggregate, the banking cases Fitch studied have led to the following observations. Banks find hybrid capital to be highly attractive to the extent that it qualifies as a form of regulatory capital. To the extent that regulators accord securities the status of regulatory capital, they will also expect banks to suspend payments in the event of emerging financial deterioration. The relatively small number of deferrals in the banking sector, while in part reflecting the very benign market conditions in recent years, also highlights that this course of action is not implemented without careful consideration. The regulatory response shows that bank supervisors typically consider preferred, preference and hybrid capital as a form of regulatory capital that is intended to absorb losses for the ongoing operations of a troubled entity or in the extreme case, support depositors in a bankruptcy or liquidation.

■ Findings that Influence Fitch's Criteria

Many observations from the studies previously cited influenced Fitch's current criteria for allocating equity equivalence to hybrid securities. The observations also shed some light on how investors in hybrid securities may expect these securities to perform when an issuer's financial condition gradually weakens or experiences extreme distress.

Duration of Distress

Issuers in financial distress either succeeded in restructuring and resolved their problems in three years or less or entered bankruptcy. There were no examples in Fitch's study of a company continuing in business for three years after the start of a dividend deferral or omission without improving or entering a more general default or bankruptcy. Therefore, a five-year deferral period (a market standard for these securities) offers an issuer enough time to implement a turnaround strategy if the enterprise is viable. Fitch is not inclined to accord greater equity credit to a security merely because it offers the possibility of a seven or 10-year deferral versus five.

Permanence/Maturity

The study demonstrated that once an issuer was in a distressed condition, securities with 10 or more years remaining until maturity and without the right of

acceleration provided the issuer ample liquidity relief. The benefits of ultra-long maturity were not evident at the margin. For this reason, Fitch's current criteria provide maximum equity credit to securities with 20 or more years remaining until maturity (i.e., double 10 years) and as much as 75% equity credit for hybrids with more than 10 years to effective maturity.

Replacement

Most Category 2 trust preferred and deferrable interest securities in Fitch's study were issued at relatively high interest rates (e.g., 8.0%–9.5%). Issuers with greater capital market access tended to redeem Category 2 securities and replace them with less costly instruments during a period of extremely low interest rates and credit spreads. In some cases, a company materially reduced its cost of capital through such replacements. When redemptions occurred, Fitch treated the redemption or refinancing as an occasion to review the company's capital adequacy and revised the corporate ratings if necessary. This is consistent with the dynamic capital structures of corporations and financial institutions. Many companies repurchase common shares, and Fitch's treatment of redemptions or replacement of hybrid securities parallels its approach to common share buybacks.

Senior Ranking

Issues with a senior claim against the company in the event of a bankruptcy reduced the recoveries of other senior creditors. Therefore, a deferrable interest security with a senior ranking upon default is accorded no equity credit (a "weak-link" approach). Regarding Category 3 mandatorily convertible units, in a few cases in which an issuer filed in bankruptcy before the exercise date, the hybrid instrument absorbed loss in line with the class of the underlying note, not in accordance with the equity conversion. For instruments of this category, if the note portion of the unit has senior ranking or senior debt features, Fitch reduces the transaction's equity allocation by 50%.

Covenants and Events of Default

Hybrids with financial covenants, cross-default and cross-acceleration similar to senior debt resulted in liquidity demands upon the issuer and added to financial stress. For Fitch, this supports a weak-link approach in which a security is treated as purely debt with no equity content if it includes covenants or

events of default in excess of the few permissible events of default listed in Fitch's criteria.

■ A New Generation of Hybrid Instruments

Hybrid capital securities issuance entered a third generation, and some instruments Fitch reviewed in the general hybrid study are out of style. Issuance is now focused on securities built on the framework of Category 2 instruments, with the addition of some untested features.

Mandatory Omission or Deferral

Many new hybrid instruments incorporate a mandatory omission or deferral of interest payments in the event that the issuer fails to maintain specified financial targets. This provision responds to the perception, borne out in Fitch's study, that issuers of Category 1 or 2 securities did not exercise their optional suspension of coupon payments until a general default was imminent. Hybrid securities of regulated banks have long included regulatory triggers for suspension of payments if the entity's regulatory capital fails to meet requirements. New mandatory suspension triggers for nonregulated entities attempt to replicate the function of a financial regulator. There is no evidence yet on which to base any conclusions about the performance of instruments with this feature. Fitch observes that the triggers are often set at a relatively weak level, and in some cases, there would be a measurement delay of up to two years before a payment suspension, so this feature may be less onerous for investors and contribute less to the equity content of the security than it appears.

Alternate Settlement or Payment

In many cases, mandatory payment suspension is combined with an alternative payment mechanism that permits or obliges the issuer to try to market equity securities and use the proceeds to pay a coupon that would otherwise be omitted because of the suspension trigger. An alternative settlement arrangement could involve giving common or preferred shares in lieu of the omitted cash payments. There are many permutations of alternate settlement and little or no empirical experience for investors to rely upon.

Scheduled Maturity and Effective Maturity

Most of the new securities embody very long-stated maturities (60 or even 80 years), but a shorter "scheduled" maturity (30 years has been typical),

along with a call at the option of the issuer, allows the issuer to refinance and replace the issue in five or 10 years. Determining the expected duration can be challenging for investors. Structures designed for regulated institutions reflect the particular preference of the regulator with regard to maturity so that the issuer can optimize the regulatory capital treatment. This often means that the issuer must receive regulatory approval before calling or redeeming a security that qualifies for regulatory capital. The issuer may need regulatory approval to redeem a security even at its final maturity date.

Because issuers are keen to preserve the tax advantage of the debt-like characteristics in some jurisdictions, such as in the United States, bifurcated structures are used to keep a first-leg scheduled maturity well-inside the perceived length tolerance of

the U.S. tax authorities, which is then paired with a replacement capital covenant and/or an option to extend the security for up to another half century. The trend has recently been for scheduled maturities and final maturities to be longer and longer dated. However, in Fitch's study, there is no evidence that a 60-year or 80-year instrument (with a five-year noncall period coupled with a replacement capital covenant) is more equity-like than an instrument with 15 years to its effective maturity. The key is for the effective maturity to extend well-beyond the length of the next financial stress. For maximum equity consideration, Fitch looks for securities to have at least 20 years remaining term to effective maturity to provide sufficient permanence for Class E (100% equity credit) and at least 10 years remaining life to qualify for Class D (75% equity credit) or for repayment to be subject to regulatory approval from a strong regulator.

■ Appendix 1: The General Hybrid Study

The objective of the review was to determine whether Fitch’s 2001 guidelines for evaluating the equity and debt-equity components of hybrid securities accurately predicted how these securities would affect the credit of more senior debt issues of a corporation during a period of financial and economic stress. To do so, Fitch selected as its study period calendar-years 2000–2003. Fitch focused on hybrid securities of issuers whose senior debt was rated noninvestment grade during all or some of the study period. To that end, the study tracked more than 200 U.S. securities with a face value of approximately \$48 billion. The study was limited to U.S. hybrid securities, because the U.S. market had led in the issuance of the more complex products. The securities included in the study were outstanding at any time between Jan. 1, 2000, and Dec. 31, 2003. Among the industry sectors represented in the study were industrials, retailers, utilities, telecommunications, and financial institutions that were not subject to stringent regulatory supervision.

For the most part, the issuers and the issues in the study experienced downgrades during the study period, and most can be considered “fallen angels.” Approximately 90% were securities issued by companies with investment-grade senior debt ratings at the time of the hybrid’s issuance, and only 10% were securities issued by companies with speculative-grade senior debt ratings at the time of issuance. Not all of the companies included in the study suffered equal degrees of financial distress. Limiting the sample to companies whose senior debt ratings were ‘B+’ or lower would have constituted a more serious stress but would also have further reduced the size of the sample. On balance, Fitch decided to include all hybrids of issuers rated subinvestment grade at any time during the study period, rather than only those in the lower speculative-grade rating levels.

It would have been unrealistic to expect hybrid capital instruments, normally issued in small amounts relative to the total capital structure of a firm, to have miraculous properties to eliminate the risk of corporate default. For the purpose of the study, Fitch’s determination of the equity-like or debt-like nature of a security was based on the points listed in the “Identifying Debt-Like and Equity-Like Performance” sidebar.

To facilitate comparison and analysis, Fitch analysts assigned the securities to the following categories:

- Straight (nonconvertible) preferred stock.
- Deferrable subordinated hybrids.
- Synthetic mandatory convertible units.
- Optionally convertible securities.
- Other “exotics.”

Given the proliferation of features in some hybrids, some securities qualified for inclusion in more than

Identifying Debt-Like and Equity-Like Performance

In reviewing the back-test, Fitch deemed a security to behave like debt if any of the following occurred:

- The issuer, during its distress, redeemed the securities prior to maturity or exchanged higher ranking senior or secured debt for the instruments, while higher ranked debt remained outstanding.
- The securities experienced covenant defaults, accelerated their maturity or caused acceleration of other loans or credit facilities.
- The securities were deemed to be a senior claim upon the issuer’s estate in a bankruptcy proceeding and diluted the recoveries of senior classes of debt.

Conversely, equity-like performance characteristics include the following:

- Dividends or interest payments were actually suspended without precipitating a default while the company experienced cash flow stress.
- The securities were not early redeemed or prepaid in cash or exchanged for more senior debt instruments.
- The securities had a mandatory provision for conversion to equity or required the holders to purchase equity securities, and the equity conversion or purchase occurred on or before the required date.
- In bankruptcy proceedings, the securities had a materially lower recovery than the senior debt of the issuer, equivalent to or only slightly higher than the recovery for common shareholders (i.e., the securities absorbed the loss).

one category. However, Fitch generally assigned such securities to the category that resulted in the highest amount of equity attribution based on the 2001 guidelines. Please refer to the Hybrid Securities in Fitch Ratings' General Hybrid Study table on page 2 for descriptions of the categories and the number of issues in the review by category.

Securities in Categories 4 (optionally convertible) and 5 (other) were not eligible for allocation of any equity credit included in the review to determine whether these securities provided equity-like flexibility or loss absorption in a period of corporate stress.

The study did not produce statistically significant results due to the relatively small size of the each group within the five categories of securities and the variations of the terms and conditions of securities within each category. Nonetheless, the study resulted in analytical insights regarding each of the major categories, which are provided below.

Category 1: Nonconvertible Preferred Stock
The study included 35 securities of this type, predominantly issued by utilities, telecommunications companies, banks and finance companies, 22 of which were perpetual while 13 had a required redemption date. Although Fitch's 2001 criteria deemed the perpetual preferred securities to be more equity-like than preferred stock with a mandatory redemption date, there was little or no difference in the performance of these two types of preferred securities in the review. The straight preferred securities outstanding were typically older than any of the other hybrids in the study, and the outstanding amounts of straight preferred securities were quite small relative to the total debt and capital of the issuers. This was because the U.S. tax law before and during the study period made preferred stock dividends tax-inefficient for most corporations. The securities of this category fulfilled the expectations for equity-like instruments and showed none of the debt-like characteristics listed in the "Identifying Debt-like and Equity-like Performance" sidebar on page 7.

Only one of the redeemable preferred securities had its scheduled redemption during the study period, while the others had longer remaining terms, and none of the issues in the sample was redeemed early or exchanged for more senior securities during the period of the study. Few of the issuers availed themselves of the right to eliminate or defer preferred stock dividend payments. It is possible that the continuing payments of preferred dividends were related to the relatively small principal

value of outstanding securities so that the dividend amounts were insignificant or the timing of dividend requirements did not coincide with the companies' cash flow stress. Seven distressed companies suspended dividends, with one, Global Crossing Holdings Ltd. (Global Crossing), suspending cash dividends and switching to pay-in-kind dividends prior to filing for bankruptcy. Four of the companies that suspended dividends subsequently filed for bankruptcy protection, and the other three avoided bankruptcy and subsequently resumed payments when their financial condition stabilized. Some companies filed hasty bankruptcy petitions without previously suspending dividends, probably due to the speed of their collapse and the infrequent timing of preferred dividends.

In the seven bankruptcy proceedings involving straight preferred securities, the securities were classified as low-ranking claims in the waterfall of distributions. Two bankruptcies (Pacific Gas & Electric and AMERCO) were unusual cases of "strategic bankruptcy" in which the value of the enterprise exceeded all of the senior and junior debt claims and preferred securities recovered 100% of principal. In other bankruptcies with very low recovery for senior creditors, such as WorldCom, Inc. (WorldCom), Global Crossing and Enron Corp. (Enron), preferred claims received no value, similar to common equity.

Conclusions

Preferred stock continues to warrant a very high equity allocation, and preferred stock, with a required redemption date or remaining life of at least 10 years, is for all practical purposes as equity-like as perpetual preferred.

Category 2: Deferrable Hybrid Securities

The securities in this category include trust originated preferred securities (TOPrS), capital securities, and quarterly and monthly income preferred securities (QUIPS and MIPS, respectively) as well as subordinated deferrable interest notes sold directly to investors without a trust as issuer. These instruments were structured so the issuers could deduct interest payments from taxable income, and they used a deferral mechanism to imitate the ability to defer dividends on cumulative preferred stock.

There were 65 securities issued by 40 companies in the review of this category. Nearly 90% of the securities were Fitch-standard instruments, deemed to be consistent with the most conventional features of these

securities, including nonconvertible, a long, initial maturity ranging from 20–49 years, explicit subordination to all senior and other subordinated debt of the issuer, and permitted deferrals of interest and dividends for up to five years without triggering a default on the security (subject to suspension of common dividends). Typically, the securities permitted a call by the issuer. Approximately 10% of the issues incorporated other features, such as optional or mandatory conversion into common shares.

The results of the back-test show that the deferrable hybrids derive most of their equity-like characteristics from deep subordination, loss absorption and weak covenants, and less from the opportunity to defer interest or dividends.

The market-standard deferrable hybrids did not default or cross-default with other instruments or accelerate or cross-accelerate in any circumstance except for bankruptcy events, which was consistent with the original intent.

In the event of an issuer's bankruptcy, the deferrable hybrids absorbed loss and performed in the same manner as straight preferred stock. Three of the issuers filed for bankruptcy. In the bankruptcies of Enron and WorldCom, recoveries were so low for all claims that the deferrable securities had no recovery value, which was the same as preferred and common stocks. In the unusual case of Pacific Gas & Electric, there were full recoveries for all classes of claims, including deferrable securities.

Issuers did not take advantage of the dividend deferral option to the extent Fitch expected. However, in this regard, the issuers of deferrable interest hybrids behaved in the same manner as did issuers of straight preferred stock.

Of the 65 securities, none experienced a scheduled maturity during the period of the back-test since all had been issued for lengthy terms in the 1990s or early 2000s. However, during the period under study, 14 were redeemed early by the issuers, with one security exchanged for senior debt (United States Steel Corporation) and the 13 others apparently redeemed for cash (in the case of Vesta Insurance Group, Inc., the issue was exchanged for common stock). It was not possible to determine the source of that cash in all instances, but it was generally from proceeds of asset sales, cash from operations or issuance of some other debt instrument. However, the weakest and most troubled companies in the back-test

did not prepay or early redeem any of these securities. It is clear that many issuers were not in the severe financial distress desired to remove these relatively costly securities from their capital structure when they had the opportunity.

Conclusions

The standard forms of deferrable hybrids displayed equity-like characteristics when the issuer was in deep financial stress and the security had 5–10 remaining years prior to its stated maturity. However, those issuers with more financial flexibility and capital market access were inclined to redeem the securities and replace them with less costly debt instruments during a period of extremely low interest rates and relatively narrow credit spreads. In Fitch's view, the voluntary replacement of the securities by their issuers with less costly capital sources when the issuers had the flexibility to do so did not constitute a flaw in the equity-like nature of the instruments.

Category 3: Synthetic Mandatorily Convertible Units

The Fitch-standard units combine two components, a debt instrument (notes) of the issuer and a forward stock purchase commitment between the investor and the issuer (contract). The investor commits in the contract to purchase stock of the issuer (or in a few cases, stock of another company) at the exercise date (typically 3–4 years from the issuance date) at a price committed in advance and pledges the notes as security for the stock purchase commitment.

The sample group was relatively small, with sufficient information to analyze 13 securities issued by 12 companies. While this is not a meaningfully statistical sample, the results were useful, especially when combined with insights gained from analyzing more than 40 other securities of this type issued by issuers that remained in the investment-grade category and did not qualify for inclusion in the study.

Of the instruments in the sample group, 10 were deemed to have standard features, despite the different trade names used by various investment banks. The major variable among the standard issues was the senior or junior ranking of the notes that formed the note component of the units. Four of the synthetic units incorporated a senior note, while six used a subordinated or junior subordinated note. The equity purchase contracts of nine of the 10 synthetic units in the sample had a specified exercise price or

limited band of exercise prices, which is consistent with Fitch's policy.

In five of the 10 units, the exercise date occurred either during the study period or in the following year, and the exercise (i.e., the purchase of common stock) in four of the five cases occurred on the date and at the price dictated in the contract. Because the review focused on a sample of companies whose credit ratings dropped after the issuance of the units, the price at which the shares were issued pursuant to the contract was, in three out of four cases, significantly above the market price of the issuer's common at the exercise date. Thus, the exercise of the contract was highly beneficial to the issuers and disadvantageous to the investors, but the collateral securing the investors' commitments (the pledge of the notes or substitute Treasury securities) eliminated any possibility of withdrawal from the investors' contractual commitment. The single case in which the stock purchase contract was not fulfilled involved Enron. In that case, the issuer's bankruptcy petition before the exercise date terminated the equity purchase contract.

In two additional cases, Solectron Corporation (Selectron) and TECO Energy, Inc. (TECO), the issuers made an early settlement offer during 2004 in order to cause the equity purchase to take place earlier than the contracted exercise date. Solectron offered a cash incentive to holders to cause them to purchase the equity ahead of the contract settlement date. TECO offered a smaller cash incentive and a slight improvement in the equity conversion ratio to induce holders to accept the offer. Fitch did not view this as an early redemption or prepayment, since the outcome in these two cases was an increase in equity capital at an earlier date than contracted and still at a very favorable price per share, despite the small cash inducement.

The loss absorption of these securities, prior to the common stock exercise date, depends on whether the underlying note was senior or junior subordinated. If an issuer files a bankruptcy petition before the exercise date of the units, the contracts terminate and the investors have no obligation to settle on the equity purchase. The notes, however, remain outstanding and participate as debt of the bankrupt debtor for recovery along with other senior, subordinated or junior subordinated notes of the issuer, depending on the specific terms of the note. In the case of one Enron synthetic unit security in the sample, the unit incorporated a senior note, which

recovered in bankruptcy at the same level as other senior instruments of Enron. Thus, this instrument did not absorb loss. Instead, it diluted the recoveries of other senior creditors. However, if the Enron synthetic units had incorporated a junior subordinated note, they would have fully absorbed loss and have had no principal recovery.

Three additional transactions included units that did not conform to the Fitch standard, and their performance contrasts sharply with the performance of the more standard products described earlier. All three were marketed under the trade name of RHINOS. These securities were structured to appear like mandatorily convertible synthetic units, but they lacked some essential features. The units consisted of a note of the issuer along with an underwriting agreement between the issuer and the investment bank to underwrite an equity security of a type and at a price to be determined in the future. The forward underwriting contracts were not publicly disclosed but were subject to many contingencies. Unlike the synthetic units, these securities did not have any investors committed to purchase the equity, the price of the equity was not fixed in advance and no collateral was pledged by investors to secure an equity purchase commitment. All three securities were redeemed by the issuers for cash during the period of the study, even though the three issuers suffered from cash flow stress and none of the securities of this type resulted in any equity issuance.

Conclusions

The Fitch-standard synthetic units resulted in a reliable forward issuance of securities at a predetermined price and date, provided that no event of bankruptcy occurred before the exercise date. The forward issuance of equity at a precommitted price is a favorable feature of these securities that may be meaningful for issuers in the investment-grade category as well as for the companies in the study group. However, if the issuer becomes bankrupt prior to the exercise date, units that incorporate a junior subordinated note absorb loss, while units incorporating a senior note do not. As a result of the findings, Fitch's policy limits equity attribution to units with a subordinated note, since units with a senior note do not fulfill the objective of loss absorption in the event of the issuer's bankruptcy prior to the exercise date.

The debt-like performance of the nonstandard securities forms a contrast to the higher reliability of equity issuance of the mandatorily convertible

synthetic units that fulfill Fitch's requirement that the equity settlement price be fixed (or within a limited band fixed at the outset) and the investors' exercise be secured by collateral.

Category 4: Optionally Convertible Securities

The back-test identified 90 securities of this type, which were issued by 42 companies. Although the issuer universe was broad-based, industrial, telecom and technology companies accounted for the bulk of the issuance. These securities varied based on their seniority in liquidation, with 44 issues as senior, 28 as subordinated and 18 as preferred stock. Other key variations include the conversion strike price and the opportunity for holders to put the securities back to the company under various circumstances.

Fitch analysts believe the issuers of optionally convertible senior debt securities had used the convertibility feature as a tool to increase the marketability of the securities and lower the interest rate on the debt, rather than as a means to issue equity.

If the holders lack the right to put the convertibles back to the issuer, distressed issuers did not early redeem or prepay these convertible securities when the trading price of the common stock declined substantially below the exercise price. However, when investors had the option to put the securities back to the issuer, some issuers exchanged or redeemed convertible securities in advance of a put by investors. These examples included Hilton Hotels Corp., Lucent Technologies, Inc. and Tyco International Ltd. Such a put option made the instrument more debt-like, rather than equity-like.

In the event of the issuer's bankruptcy, the loss absorption of these issues varied depending on whether the instrument was a senior or subordinated note or a preferred stock. In the case of junior subordinated or preferred convertible securities, Fitch observed that these instruments were classified in bankruptcy proceedings as very junior claims and absorbed loss, but convertible senior notes did not.

Conclusions

Optionally convertible senior notes are debt-like, not equity-like. Convertible preferred stock or junior subordinated notes may be equity-like, provided that holders do not have the option to put the securities

back to the issuer and do not have the right to demand a cash payment in lieu of common shares.

Category 5: Other

The other category included six securities of exotic types that were never allocated any equity component under Fitch's guidelines.

Three instruments in the back-test were notes issued by subsidiaries of The AES Corporation (AES) under the name of "equity-linked loans." The credit enhancement for these notes was the pledge to give the noteholders common shares of the parent company stock if certain adverse credit events occurred. The parent company committed to register and issue an unlimited number of shares of stock, depending on the prevailing market price of the stock as security for the debt if certain credit downgrade events occurred. The parent company, AES, redeemed or exchanged the majority of the securities of this type for cash or senior secured debt in order to avoid the dilution that would have been created by the issuance of an unlimited number of shares when downgrade events occurred and the price of AES' common stock declined significantly. Not only was this instrument not equity-like, but it also accelerated the repayment of the supposedly nonrecourse debt of a subsidiary ahead of senior debt of the parent.

Three issues of an exotic instrument called HIGH TIDES were issued by a subsidiary of Calpine Corp. (Calpine). The securities incorporated various features and options that would enable them to be classified in more than one of the standard hybrid categories. They were deeply subordinated notes that were optionally convertible in one price range, while conversion was mandatory under other circumstances, and they obtained additional credit enhancement via an unusual put mechanism. Although these securities appeared to have long initial tenors, investors had the right to put the securities to the issuer in the fifth year for remarketing, and investors who exercised the put would receive the proceeds of remarketing. If the note remarketing failed to produce the par amount of the notes, the issuer was required to issue as many common shares at the prevailing market price as necessary to equal the principal amount of the notes.

Had Calpine not redeemed the HIGH TIDES early, holders could put the securities to the company at the put date for conversion into common shares, and the holders of the three issues might have owned, by Fitch's calculation, an estimated 60%–70% of the common equity. Avoiding the put with its potential equity dilution and possible change of control

motivated management to monetize core assets and issue new senior secured debt in order to tender for or prepay these securities. Not only was this instrument not equity-like, but it also accelerated the repayment of the supposedly deeply subordinated notes ahead of senior debt of the company and materially weakened the position of senior unsecured debt holders, prior to Calpine's eventual bankruptcy filing in 2005.

Conclusions

Fitch never accorded any equity credit to these issues. However, not only were these securities not equity-like but they also resulted in transactions that effectively subordinated senior unsecured creditors. The experience of the Calpine HIGH TIDES underscores how difficult it can be to analyze and predict the behavior of exotic structured securities with multiple imbedded options. Also, the existence of securities that give the holder the right to be repaid in an unlimited number of shares of common stock heightens risk for senior creditors in the event of falling equity prices. It appears that companies will go to great lengths to avoid massive dilution of equity shareholders' ownership interest when the stock price plunges.

Hybrid Issuers in Review

Advanced Micro Devices, Inc.
Advanta Corp. (included in Appendix 2)
The AES Corporation
Allegheny Energy, Inc.
Allied Waste Industries, Inc.
Allmerica Financial Corporation
America West Airlines, Inc.
American Airlines, Inc.
AMERCO
AmeriSourceBergen Corp.
Aquila Inc.
Arrow Electronics, Inc.
ArvinMeritor Inc.
Avnet, Inc.
BankUnited Financial Corporation
Bay View Capital Corp. (included in Appendix 2)
Bergen Brunswig Corporation
Beverly Enterprises, Inc.
Calpine Corp.
Chesapeake Energy Corp.
Cincinnati Bell, Inc./Broadwing Corp.
CMS Energy Corp.
Coastal Bancorp, Inc.
Community Health Systems, Inc.
Consumers Energy Co.
Continental Airlines, Inc.
Corning Inc.

Crown Castle International Corp.
Cummins Inc.
Delta Air Lines, Inc.
Dillard's, Inc.
Dynergy Inc.
Edison International
Enron Capital Resources, L.P.
Enron Corp.
Fairfax Financial Holdings Limited
The FINOVA Group, Inc.
Fremont General Corporation
GenCorp Inc.
Global Crossing Limited
Greater Bay Bancorp, Inc.
Hamilton Bancorp Inc.
Hilton Hotels Corp.
Illinois Power Co.
Independent Bank Corp.
Indianapolis Power & Light Co.
Intermedia Communications Inc.
Interpool Inc.
Interpublic Group of Companies, Inc.
IndyMac Bancorp, Inc.
KB Home
Lucent Technologies, Inc.
Mirant Corp.
Nextel Communications, Inc.
Northwest Airlines Corporation
NorthWestern Corporation
Navistar International Corporation
Owens-Illinois Inc.
Pacific Gas & Electric
PacifiCare Health Systems, Inc.
J.C. Penney Company, Inc.
PerkinElmer, Inc.
Portland General Electric Company
Provident Bankshares Corp.
Provident Financial Group, Inc.
Providian Financial Corp. (included in Appendix 2)
Riggs National Corp.
Sanmina-SCI Corp.
Selectron Corporation
Southern California Edison Co.
Sovereign Bancorp, Inc.
Starwood Hotels & Resorts Worldwide Inc.
Sterling Bancshares, Inc.
Taylor Capital Group, Inc.
Tech Data Corporation
TECO Energy, Inc.
Tenet Healthcare Corp.
TIG Holdings, Inc.
TNP Enterprises, Inc.
Toys 'R' Us, Inc.
Tyco International Ltd.

United States Steel Corporation
Vesta Insurance Group, Inc.
Westar Energy
WilTel Communications Group, Inc.

The Williams Companies, Inc.
WorldCom, Inc.
Xcel Energy Inc.
Xerox Corporation

- Appendix 2: Bank Hybrids in Practice: Stress Case Studies, 1999–2005

Cases Where Hybrids Provided Ongoing Support

Bay View Capital Corp. United States

Bay View Capital Corp. (BVC) was the bank holding company for Bay View Bank, N.A., a \$4 billion bank based in San Francisco and initially focused on the San Francisco market. The company raised nearly \$100 million of trust preferred securities through a wholly owned subsidiary of the holding company in 1998. The proceeds from the issuance fully qualified as Tier 1 capital at the holding company and were used to fund growth. BVC's use of trust preferred was fairly typical relative to the size and use of proceeds employed by its peers.

The company's financial troubles can be traced to the mid-1990s when it embarked on a program of acquiring high loan-to-value residential mortgages. Its demise was hastened by the acquisition of Franchise Mortgage Acceptance Company in 1999, a lender focused on providing loans to various franchisees in industries, such as the fast food sector. The addition of these higher risk activities added a notable level of volatility to BVC's financial performance. The financial troubles resulted in rating downgrades and a heightened level of regulatory attention. In mid-2000, BVC's management announced that it had entered into various agreements with its regulators. These included deferring on the outstanding trust preferred obligations.

In response to its emerging and sizeable losses in its loan portfolio of mortgage and franchise loans, the company initiated an aggressive self-liquidation program. Through a series of transactions in 2002 and 2003, the company sold the foundation of its bank, including the majority of its loan portfolio as well as its entire deposit base and branch network. Following an agreement with its creditors in 2002 that allowed the company to retire its trust preferred obligation at par (the original terms allowed for a call in 2003 at a slight premium), BVC repaid deferred dividends on its trust preferred obligation and began retiring the principal balance. By year-end 2003, the outstandings had been paid down to \$22 million, and the remainder was fully paid in 2004.

The deferral of the trust preferred retained cash within the organization at a time when its financial future was highly uncertain. In working with, and at times under, the direction of bank regulators, BVC pursued a course of corrective action that allowed all creditors to be paid in full. While the proceeds of the asset liquidation were the most significant factor in allowing creditors to come out whole, the period of deferral on the trust preferred provided additional flexibility as the company plotted a difficult course. In October 2005, BVC announced its intention to merge with Great Lakes Bancorp, Inc., a Buffalo, N.Y., based banking company. The merger was consummated in 2006.

Riggs National Corp. United States

Riggs National Corp. (Riggs) was the holding company for Riggs Bank, N.A., a \$6 billion bank headquartered in Washington, D.C. The company's ratings long reflected its relatively weak level of profitability, high reliance on trust preferred in its capital structure and the corporate governance issues stemming from a single family being the largest shareholder and having key roles in management. The ratings recognized the high level of regulatory capital and the holding company's possession of material levels of liquid assets, which served to provide resources to support the company's high levels of debt and trust preferred.

In mid-2003, the bank's regulators uncovered problems in the bank's compliance with regulations and laws pertaining to the reporting of large cash transactions and the prevention of money laundering. These areas of compliance for Riggs were of particular concern given the bank's active and sizeable business with embassies of various countries. The regulatory problems became more detailed and increasingly indicative of deeper problems throughout 2003 and 2004. The bank's already weak profitability immediately came under pressure from increased compliance costs relating to attempted corrective actions, restructuring costs relating to the bank's exit from higher risk business activities, regulatory fines and the uncertain dollar dimension of emerging lawsuits.

In mid-2004, the company's fortunes took a positive turn, as The PNC Financial Services Group, Inc. (PNC), a much larger and financially stable banking company, announced that it had reached an agreement to acquire Riggs. The bank's compliance

and legal troubles continued to build in the second half of 2004 to the point where PNC's willingness to continue with its plan to acquire Riggs was called into question. The growing problems and the uncertain status of the acquisition moved regulators to put Riggs' trust preferred obligations into deferral at year-end 2004. Riggs was subsequently acquired by PNC.

The Riggs situation shows how material financial consequences can emerge from seemingly benign compliance issues. The deferral on the trust preferred obligations demonstrates how regulators can use this attribute to preserve capital in a troubled institution with uncertain future prospects. If the acquisition is not consummated, Riggs will have additional financial resources available to it that would have otherwise been paid to trust preferred holders. This serves to provide a firmer foundation for more senior creditors and potentially better recovery prospects should the situation not chart a course toward stability.

Resona Holdings, Inc.
Japan

Resona Bank, Limited (Resona Bank) was created in March 2003 from the merger of Daiwa Bank and Asahi Bank. Both banks had existing preferred instruments in their capital structures from previous issues, including public funds injected in 1999. However, just one year after the merger, as a result of enforced write-downs of its deferred tax assets by external auditors, stricter classification of problem borrowers and huge losses from its extensive equity portfolio, Resona Bank found itself undercapitalized and was compelled to apply for an injection of public funds. As a result, the bank was effectively nationalized in July 2003, when JPY1.960 trillion (approximately US\$18 billion) of public funds were injected in the form of common and preferred stock. The Deposit Insurance Corporation of Japan soon swapped its shares for a similar stake in Resona Bank's holding company. However, Resona Holdings, Inc. (Resona Holdings) was forced to defer dividend payments on its preferred stock in 2003 and 2004.

While the existence of preferreds in Resona Bank's capital structure has given it some operating flexibility, it should be noted that they were insufficient in their own right to enable the bank to trade through its operating difficulties. Without the injection of public funds, it is highly likely that the

bank would have defaulted. That being the case, even in this scenario, the existence of preferreds would have still benefited unsecured creditors, though in such a situation, it is highly unlikely that the government would have stood aside and forced unsecured creditors, including uninsured depositors, to absorb losses. It should be noted that Resona Holdings resumed paying preferred dividends in 2005. Resona Holdings repaid the perpetual subordinated loans of JPY200 billion, which it borrowed from The Resolution and Collection Corporation in September 2005. It also repaid JPY570 billion (issued value was JPY532.7 billion) of government-owned preferred stock through a repurchase and cancellation in January 2007. Subsequently, in April 2007, Resona Holdings secured JPY350 billion in new preferred stocks for the purpose of repaying part of its outstanding balance of JPY1,998.8 billion (issued value) of government-owned preferred shares. These are the latest of a string of efforts by Resona Holdings to achieve its goal to repay public funds while maintaining total and Tier 1 capital ratios of 9% and 5%, respectively.

UFJ Holdings, Inc.
Japan

UFJ Holdings, Inc. (UFJ Holdings) was created in April 2001 as the owner of Sanwa Bank, Tokai Bank (both of which merged a year later to form UFJ Bank Ltd. [UFJ Bank]) and Toyo Trust and Banking (later to become UFJ Trust). However, lingering asset quality problems, concentrated loan portfolios and large exposures to equities continued to cause the group difficulties. This culminated in an inspection of the bank in 2004 with the regulator accusing it not only of classifying some of its large exposures inappropriately but encouraging employees to conceal this fact by deliberately falsifying documents. Apart from the criminal prosecutions launched against some senior employees, UFJ Bank was forced to reclassify and strengthen reserving against some of its largest borrowers. This forced UFJ Holdings to report another large net loss in 2004, which left it close to breaching the minimum 4%/8% Basel capital ratios. With the expectation that the ongoing asset quality clean-up would produce further losses in financial-year 2005, UFJ Holdings was faced with an immediate need to raise additional capital.

While UFJ could have applied to the government for an additional injection of public funds, it chose to

find a market-based solution and agreed to merge with Mitsubishi Tokyo Financial Group. Nevertheless, with another net loss reported in financial-year 2005, all of which was reported in the first half of the year, UFJ Holdings had insufficient distributable reserves to pay the dividends on its common stock, preferred stock and overseas special-purpose vehicle-issued preferred securities. Interestingly, UFJ Bank also chose voluntarily to exercise the option to miss the June 2005 dividends on one of the ex-Tokai Bank's overseas preferred security issues, even though it had paid dividends on this issue in December 2004 after its very poor first half. Unlike UFJ Holdings' other preferred stock and preferred securities, missing dividends on that particular issue (issued out of a Bermuda-registered operating company with the proceeds on-lent to the bank as a perpetual subordinated loan) was not compulsorily linked to the availability of distributable reserves. Consequently, the fact that UFJ Holdings chose to exercise its right to defer the (noncumulative) dividend payments in June 2005 surprised many investors.

U.S. Community Banks

Since 2000, Fitch conducted credit assessments and ongoing surveillance of approximately 1,500 unrated community banks that have raised trust preferred through a CDO structure. Of the bank/thrift entities that have participated as issuers in these CDOs, only 10 entities had deferred interest payments on their trust preferred obligations as of December 2006. Of the 10 deferring banks/thrifts, eight repaid all cumulative dividend payments and became current. On average, for the eight bank/thrift institutions that deferred and then resumed paying current dividends, the average deferral period was approximately 12–18 months. In some cases, these entities were purchased by larger institutions and thus resumed payments. Of the two institutions that were still deferring as of December 2006, one had been deferring for approximately 32 months and the other had been deferring for just more than 12 months.

These situations highlight the regulatory approach toward trust preferred obligations of U.S. banking organizations. U.S. banking regulators actively promote the exercise of deferral features of the security in response to emerging financial deterioration. The ability of a majority of the deferring banks to return to current payment status demonstrates that the deferral was implemented at an early enough stage to serve as an element of an effective plan to restore a sound financial profile. The

relatively small number of deferrals highlights that this course of action is not implemented without careful consideration. The regulatory response shows that the bank supervisors consider trust preferred as a form of regulatory capital that is well-suited and designed to absorb losses for the ongoing operations of a troubled entity.

Cases Where Hybrids Ultimately Provided Equity Support

The Ashikaga Bank, Ltd. and Ashikaga Financial Group Japan

Persistent asset quality problems in the 1990s resulted in The Ashikaga Bank, Ltd. (Ashikaga Bank) having to be supported by the government in 1999 via an injection of preferred stock and again thereafter by capital injections by local businesses and municipalities. Over this period, Ashikaga Bank deferred dividends on its preferred stock several times. In early 2003, Ashikaga Bank established a holding company, Ashikaga Financial Group (Ashikaga FG), and became a 100%-owned subsidiary of it. At that time, all common and preferred stock in the bank was converted into equivalent securities issued at the holding company level.

However, soon thereafter, following a regulatory inspection in autumn 2003, Ashikaga Bank was forced to recognize huge losses in its loan portfolio. At the same time, the amount of deferred tax assets the bank was carrying on its balance sheet was deemed to be unrealistic and was written off. As a result, in November 2003, the government declared that the bank was worthless (in fact, it had negative net worth) and nationalized it, confiscating and cancelling all common and preferred equity. As all equity instruments in Ashikaga Bank were owned by Ashikaga FG and were in fact the holding company's main asset (an asset that was suddenly rendered worthless by the bank's nationalization), Ashikaga FG had no choice but to file for liquidation. The recovery rate experienced by nonpublic fund preferred stock holders is JPY52.65 on a par value of JPY500, which is equivalent to 10.53%. This is slightly better than the level Fitch normally assumes for preferred stock holders in general, though it is worth remembering that the recovery experience of these stock holders has been boosted by the Resolution and Collection Corporation deliberately

sacrificing its own interests for local political reasons. By contrast, the total recovery rate achieved on the public fund preferred stock is 5.11%. However, the overall (weighted-average) recovery rate of 6.68% is considered to provide a truer reflection of recoveries at Ashikaga FG, and this figure is very much in line with the recovery rating of 'RR6' that Fitch normally assumes for preferred stock obligations. The definition of 'RR6' is that expected recoveries, in the event of default, will be in the range 0%–10%.

In this case, given the scale of Ashikaga Bank's problems, it is arguable that the dividend deferrals that occurred in the run-up to the bank's collapse and nationalization had no effect other than to delay the inevitable. And while it can be argued that senior unsecured creditors were supported and remained "whole" despite the bank's difficulties, this primarily reflected government intervention, not the equity cushion provided by the preferred capital securities.

Perhaps the most interesting aspect of the treatment of preferred stock investors is that they have actually recovered more as a result of their securities being issued by a legally bankrupt holding company rather than a fully supported bank that survives as a going concern. This is perhaps counterintuitive, but in this case, it is clear that by owning preferred stock issued by Ashikaga FG, investors have recovered more than if they had held preferred stock issued directly by Ashikaga Bank, as all Tier 1 capital investments in the latter were written down to zero when it was nationalized. (For full details of the Ashikaga FG failure, and subsequent recoveries achieved by preferred stock holders, see "The Ashikaga Saga — A Case Study of Japan's First Bank Holding Company Liquidation," published on July 4, 2005, and available at www.fitchratings.com).

Hamilton Bancorp United States

Hamilton Bancorp (Hamilton) was a \$2 billion bank holding company based in Miami. The bank was actively involved in international trade finance, which was the source of its ultimate demise. At the end of 1998, Hamilton raised \$11 million of trust preferred, which was far short of the initial planned offering that was expected to raise more than \$30 million.

The company found itself in regular disputes with its primary regulator, pertaining the accounting and risk profile of its trade finance book of business in South America. The regulatory actions and disagreements escalated in late 2000 and intensified throughout 2001. The bank reached an agreement with regulators that it needed to carry a higher than normal level of capital given its risk profile. The bank's performance became increasingly volatile in 2001. The disputes with regulators resulted in delays in the filing of financial statements and periodic restatements.

In mid-2001, the Federal Reserve Bank of Atlanta required the company to receive prior regulatory approval for the payment of dividends, including the payment of trust preferred dividends. The bank's initial request under this requirement was approved, but subsequent requests starting with the June 30, 2001 payment were rejected.

Following a tumultuous period in 2001, the bank was seized by regulators in January 2002. In subsequent reports, the bank's problems continued to be centered in its trade finance unit. The scope of the problems widened beyond South America to include various transactions in eastern Europe, some of which the regulators classified as fraudulent.

The relatively small size of the trust preferred obligation and the short time of deferral prior to the failure of the bank prevented the equity-like feature of the obligation from serving as a financial buffer to allow the company to survive.

Cases Where Hybrid Features Were Not Activated

Banking companies in the United States were frequent issuers of trust preferred securities beginning in 1996, when the Federal Reserve first approved the scope of how these instruments could qualify as a form of Tier 1 regulatory capital. Although revisions to regulatory capital rules limited the amount of trust preferred that can qualify as the highest form of regulatory capital, the combination of regulatory capital treatment for an instrument that is tax deductible for the issuer made these an attractive element for most banks to add to their capital structure.

The premise behind these instruments qualifying for Tier 1 regulatory capital treatment is that the five-year deferral feature can be used to trap cash and provide financial flexibility to issuers that have run

into financial difficulty. As previously highlighted, this feature has been used effectively in a number of cases. The implementation of the deferral feature of a trust preferred instrument is not the only or the first used element of a corrective action plan for a bank in troubled financial condition.

The following cases represent issuers rated by Fitch that ran into significant financial difficulty and chose not to defer on their trust preferred obligations. While deferral was a potential alternative, the situations were managed without having to defer on the trust preferred securities.

Advanta Corp.
United States

Advanta Corp. (Advanta) is the parent of a U.S. credit card bank. Throughout the first half of this decade, its performance has been poor mainly due to a series of charges relating to lawsuits, write-downs on its venture capital portfolio and the exit of noncore businesses. As a result, over the period 2000–2002, it recorded significant losses. However, at no time did it defer on its preferred securities. The parent company was not subject to typical banking regulatory supervision. Also, the company sold a major subsidiary for cash, which bolstered liquidity, and thus no deferral was warranted.

Advanta's performance subsequently improved, reflecting a more focused strategy on small-business credit cards.

Providian Financial Corp.
United States

Over the 2001–2003 period, Providian Financial Corp.'s (Providian, a U.S. credit card bank) profits collapsed due to an aggressive expansion into subprime lending. Although the company did not actually make a loss or defer on its preferred securities, its primary banking subsidiary was made subject to a written agreement with the Office of Comptroller of the Currency surrounding dividend payments and appropriate capital levels at the bank. Like Advanta, Providian's performance improved, primarily reflecting management efforts to restructure the group. Furthermore, the amount of trust preferred securities outstanding was small, and deferring the modest coupon payments would not have conserved a material amount of cash. Subsequently, Providian was acquired by Washington Mutual, Inc. While difficult to determine all aspects and influences of a regulatory response to a problem situation, Fitch believes Providian's lack of focus and size in deposit gathering and its unique business niche greatly influenced the approach regulators took in handling this situation.

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