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Evaluation on Equity Content of Hybrid Securities

As presented below, Japan Credit Rating Agency, Ltd. (JCR) has summarized its basic perspective and criteria for the evaluation on equity content of hybrid securities that include preferred stocks.

JCR has also compiled its point of view on rating hybrid securities. For details, please refer to the press release 06-D-416 released together with this issue.

1. Points to consider in evaluation on equity content of hybrid securities

Hybrid securities include subordinated bonds, senior securities, preferred securities, and preferred stocks. While they differ from common stocks in certain features, such as having a maturity date in some cases and a step-up provision for interest and dividend payments, they do possess some of the same features of common stocks in terms of their liquidity and their order of claim in the event of bankruptcy. For example, these features are enabled by a deferral provision that allows interest, dividends, and, in some cases, the principal to be carried over without default (non-performance of obligations and non-payment in breach of contract) when certain conditions are met and a subordination provision that subordinates the claim in the case of the bankruptcy of the issuer.

From the perspective of a creditor, common stocks play a role in increasing the certainty of the performance of obligations, primarily through two functions: (A) provide financial flexibility and stability by curbing any cashing out under stressful conditions and reduce the possibility of an issuer default; and (B) increase the possibility of debt recovery (credit from the perspective of a creditor) by acting as a buffer to absorb losses under stressful conditions. Of these two functions, the ability to curb any cashing out under stressful conditions derives largely from these characteristics: (i) no obligation to redeem the principal and no maturity date; and (ii), no obligation to pay interest and dividend. The function of serving as a buffer aimed at absorbing losses under stressful conditions originates from this characteristic: (iii) the order of claim in case of a bankruptcy is the most subordinate.

In evaluation on equity content of hybrid securities, therefore, JCR analyzes how much of functions (A) and (B) above that are favorable for creditors are incorporated in the hybrid securities. To this end, JCR basically takes the approach of examining the extent to which the hybrid securities concerned possess the aforementioned characteristics (i) through (iii) and measuring their similarity to common stocks, by taking into account the contractual provisions presented in the table below.

	Characteristics of Common Stocks	Expected Benefits	Related Contract Provisions, etc.
i	No obligation to redeem the principal and no maturity	• No repayment pressure or refinancing risk, adding to financial stability and flexibility	• Redemption period • Call provision • Step-up provision for interest rates and dividend payments • Replacement language • Common stock conversion provision • Provisions for capital reduction
ii	No obligation to pay interest and dividends and no accumulation of deferred interest and dividends	• Can curb cashing out under stressful conditions, adding to financial stability and flexibility • Deferral does not lead to default or cross default	• Deferral provision for interest and dividends (mandatory/optional) • Cumulative/non-cumulative • Mandatory payment provision • Conditions for default
iii	Order of claim in case of bankruptcy is the most subordinate	• Increased rate of recoverability in case of bankruptcy	• Residual property distribution provision • Special conditions for subordination

The following assesses the similarity between hybrid securities and common stocks in each of the characteristics (i) through (iii) as stated above and presents major points and our point of view that lead to our evaluation on equity content of hybrid securities.

2. Evaluation on equity content based on attributes and product design of securities

(1) No obligation to redeem the principal and no maturity

Ordinary debt carries an obligation to repay the principal in installments or lump sum within a certain period of time. The inability to repay the obligation (default) would cause issuer bankruptcy such as through a cross default provision of other obligations. Common stocks do not carry the obligation of redemption and maturing date, enabling increased financial flexibility and stability. This reduces the possibility of default associated with debt redemptions or deterioration in financial conditions and financing capability.

A. Term

In order to incorporate the benefits associated with the life of a common stock in securities, the permanency of a common stock is undoubtedly the most desirable feature. However, it is not uncommon for hybrid securities to have a maturity date in view of taxation. Provisions for maturity work negatively in evaluation on equity content of securities. That said if the term attached to hybrid securities is extremely long, it becomes increasingly likely to detect their similarity to common stocks rather than ordinary debt.

B. Call provision and step-up of interest rates and dividend payments

Even when hybrid securities are perpetual or very long term, many include a call (voluntary redemption of the issuer before maturity) provision. Securities with call provisions offer the issuer the benefit of increasing the option to refinance under better conditions. For investors, they are attractive because of the potential recoverability of the principal at a relatively early stage while receiving returns that correspond to high risk.

If the issuer is likely to actually exercise the call provision, the expiration of the securities concerned would be deemed substantially the same as the exercise period for a call option. Hybrid securities are not considered to be very similar to common stocks in the context of maturity dates when the issuer is deemed likely to exercise the call feature to curb the cost of financing. This situation could arise when hybrid securities are issued with a step-up provision (the increase is generally about 100 basis points) that automatically increases the interest rate and dividends after the stated exercise period for the call or when the level of initial cost of financing is extremely high.

If no step-up provision is attached and the initial cost of financing is low, the probability of exercising the call feature would vary depending on the issuer's financial condition and investment policy and the level of investor expectations for the call to be exercised. In this case, there are fewer similarities between hybrid securities and common stocks in the context of maturity dates compared with when hybrid securities do not have a call provision. However, it is not possible to make one broad assessment in this case, making it increasingly necessary for us to study each situation.

C. Replacement language

The so-called replacement language expresses the intention to issue securities that are equal or greater than the equity content of the hybrid securities before a call is exercised, the proceeds from the issuance are applied to redeem the hybrid securities concerned. Even for securities with a high probability of the call option being exercised, if the replacement language exists, and this replacement is deemed likely, the period before maturity can be regarded as considerably long, and there is an increased likelihood of detecting similarities between hybrid securities and common stocks.

Replacement language is contractual in other countries and in some cases provides creditors of senior debt the right to force the issuer to fulfill its obligations. In many cases, however, it is not contractual but only serve as an expression of intention in documents such as a prospectus. A prospectus does not provide the creditors with the right to force the issuer to follow the expressed intention. Yet, if an issuer's shares are listed on a stock exchange or its bonds are public traded, making it important for the issuer to gain the trust it of the capital markets, the expression of intention included in a prospectus is also likely to have great significance. For the issuer, replacement language is a feature that could help ease the negative aspect stemming from a call provision.

D. Common stock conversion provision

The maturity date for hybrid securities is removed when they are converted to common stocks. Thus, if conversion is highly likely, they are considered to have greater similarity with common stocks.

Important factors in determining the possibility of conversion to common stocks include whether the conversion is optional or mandatory; the level of the conversion price in comparison to the stock price; and the period left until conversion. Compared with an optional conversion provision, if a mandatory conversion of hybrid securities is to take place regardless of the willingness of investors, the likelihood of conversion becomes higher if the period left until the mandatory conversion is short, that is, within three years. A conversion could be expected to a certain extent if conversion to common stocks is optional, such as in the case of convertible bonds, or if the conversion price is considerably lower than the stock price. But in general, the possibility of conversion is not likely to be high due to stock price fluctuations and the impact of investors' intention on the conversion.

E. Subject of capital reduction

When a company with poor business performance acquires new external capital, in order to make dividend payments possible, accumulated losses from the past are often eliminated with the procured funds. In such a case, debt forgiveness or a debt-equity swap (DES) and capital reduction of common stocks or preferred stocks are utilized. The former corresponds to default (non-payment in breach of contract) of the securities concerned, and the latter does not. Securities without the legal obligation of redemption, therefore, are not only useful in curbing incidents of cashing out, but are also able to absorb and eliminate the losses accumulated from the past without resulting in default and contribute to financial reorganization. Thus, they are considered to contribute to financial flexibility more than securities with mandatory redemption.

Yet in many cases in Japan, the benefit of being the subject of capital reduction is seen only after an issuer's financial condition deteriorated considerably. And instances of capital reduction are often accompanied by debt forgiveness or DES (debt-equity swap). In other words, capital reduction in many cases has increased the possibility of partially recovering debt, but we cannot consider it to have reduced the possibility of issuer default. The characteristics that determine the possibility of capital reduction is basically secondary in evaluation on equity content of hybrid securities in the context of whether financial flexibility can reduce the possibility of default.

(2) No obligation to pay interest and dividends

In the case of common stocks, the Companies Act regulates the sources of funds used for the distribution of surplus, including dividends. If the source for distribution runs dry, a company is forced to stop its dividend payments or reduced the amount of dividend payments. And an issuer can willingly suspend or reduce its dividend payments even if the source of fund distribution remains intact. Non-payment of dividends does not represent non-payment in breach of contract. Common stocks consequently have a function of: (i) avoiding financial default in the sense that cashing out can be voluntarily controlled even during a period when there is not much stress involved and (ii) avoiding legal default because non-payment does not constitute default.

A. Mandatory or option deferral

Many hybrid securities include an interest and dividend deferral provision that allows deferred interest and dividend payments (including non-payment) when there is conflict with the certain conditions specified in the deferral provision (reasons for deferral) would not correspond to default. The function of avoiding legal default is held commonly by securities.

In the case of hybrid securities, however, investors often expect the continuous and stable payment of interest and dividends. The issuer is likely to strive to continue the payment of interest and dividends unless under serious stress, fearing that deferral of interest and dividends of securities purchased by investors who expect periodical and stable income would be detrimental to the trust of the investors, which may work negatively in financing later on. Attachment of a deferral provision does not mean that financial flexibly (default avoidance function) is always recognized. Especially when securities only have attached a voluntary deferral provision, under which deferral would depend on the will of the issuer even if a conflict with the reasons for deferral occurs, the issuer may continue the payment of interest and dividends even after reaching the stage that the sources of distribution of common stocks run dry and dividends for common stocks are suspended. While similarity to common stocks is recognized in the sense that there is discretion to defer interest and dividends when under stress, the level of similarity is not considered high. The assessment would be even lower if deferral would invite a situation not preferred by the issuer such as attachment of voting rights to preferred stocks.

Meanwhile, a compulsory deferral provision, under which a conflict with the reasons for deferral would force deferral, would not cause the concerns in the case of voluntary deferral provisions only, and similarity to common stocks is considered high in terms of interest and dividends.

B. Conditions for deferral

A positive assessment of deferral provisions requires the assumption that the reasons for deferral have been established appropriately, and that triggers have been set to curb incidents of cashing out at a considerably earlier stage than default of the issuer's debt, or more specifically, at the least, before the stage during which fund distribution related to common stocks runs dry.

C. Cumulative or non-cumulative

The cumulative provision states that deferred interest and dividend payments are accumulated and paid when reasons for deferral are no longer valid. Particularly when an issuer voluntarily defers and accumulates its interest and dividend payments over time, there is less incentive for the issuer to defer obligatory payments in the future. This lowers our evaluation on equity content.

D. Mandatory payment provision

A mandatory payment provision makes interest and dividend payments compulsory as a result of an event from the past. A common example is in which dividend payments of hybrid securities (e.g., September and March every year) must be made one year (e.g., fiscal year ending March 2008) if dividends of common stocks were paid in the previous fiscal year (e.g., fiscal year ending March 2007) even if this action conflicts with the reasons stated in a deferral provision. For example, if an interim dividend payment of common stocks is to include year-end dividends as advance payment and if interim dividend payments of common stocks are made in July 2006, the dividend payments of hybrid securities for the year ending March 2008 would include the amount for March 2008. In other words, in this example, suspending dividend payments of hybrid securities for the year ending March 2008 would require advance suspension of interim dividends 20 months prior in July 2006. As in this example, if a deferral of interest and dividend payments including mandatory deferrals took place over a year ago as a result of a mandatory deferral provision, there is little similarity between hybrid securities and common stocks in terms of interest and dividend payments.

(3) Order of claim in case of bankruptcy is the most subordinate

The order of claim of common stocks in case of a bankruptcy is the most subordinate and has the function of increasing the "recoverability of debt" in bankruptcy (subordination). For this reason, in assessing the order of claim for hybrid securities when the issuer declares bankruptcy, it is important to compare its ranking with that of the entire list of the issuer's liabilities. In other words, in contrast to preferred stocks, the level of ranking is not a major issue, but if a debt that is more subordinate exists or is likely to exist, hybrid securities is not very similar to common stocks in the context of subordination.

In fact, assessing the level of subordination is secondary in the context of evaluation on equity content of hybrid securities. The following two characteristics are more important: (i) no obligation to redeem the principal and no maturity date: and (ii) no obligation to pay interest and dividends. Evaluation on equity content is aimed at contributing to the analysis of the degree of certainty attached to the performance of the issuer's debt obligation. The degree of certainty here is considered largely dependent on whether the issuer is able to continue its business without going bankrupt and continuously receive necessary cash flow. In analyzing solvency, it is not appropriate to emphasize the assessment of post-bankruptcy recoverability as the core of the analysis. Likewise, it is not appropriate to focus on analyzing items related to recoverability when evaluating equity content of hybrid securities, unless the credit standing of the issuer is very low.

(4) Other

In evaluation on equity content of hybrid securities, in principle, we do not incorporate accounting categories for hybrid securities, that is, whether they belong to the liability or the capital and net asset section of a balance sheet. Because liabilities normally carry the obligation to pay principal and interest -- unless there is a condition that conflicts with reasons for deferral -- risk of a default exists and there is less financial flexibility than in the case of financing methods that below to the capital and net asset sections of a balance sheet. Unlike liabilities, redemption by issuance for common stocks and preferred stocks require the issuer to show the same amount of funds in its source for fund distribution. The possibility of purchase, therefore, is expected to be lower than that of the call feature being exercised when securities are categorized as liabilities. In the case of liabilities, the expectation among investors to receive interest and dividend payments may be stronger than that for securities categorized as capital, making it perhaps more likely that the issuer would avoid any deferral compared with when the securities are considered capital. However, we will assess these factors individually in the context of each of the items above when examining the similarity between hybrid securities and capital.

(5) Categorized attributes of securities

In terms of the attributes of hybrid securities (product design), we have consider three major points. We combined the assessment of these major points is in evaluating the attributes of hybrid securities and categorized their equity content into four levels as shown below.

Equity Content	Criteria for Analysis	Applicable Examples
Equivalent to debt	0	• Fixed-term subordinated bonds that prohibit deferral of interest and dividend payments
Low	25	• Subordinated bonds, senior securities and preferred stocks; permanent or super-long term; call option possible; interest rate and dividend payments step-up; interest and dividend deferral possible (optional deferral clause only)
Middle	50	• Subordinated bonds, senior securities, and preferred stocks; permanent or super-long term; call option possible; interest rate and dividend payments step-up; replacement language available; interest and dividend deferral possible
High	75	• Senior securities and preferred stocks; permanent or super-long term, prohibits a call option; allows dividend deferral (mandatory deferral and non-cumulative) • Preferred stocks (non-cumulative) with a mandatory conversion clause within three years
Common Stocks	100	

3. General assessment taking into account individual situations of the issuer

Thus far, we have presented our point of view based only on the attributes of hybrid securities (product design). A call feature and deferral of interest and dividend payments are largely affected by individual situations of the issuer. Therefore, first, based only on the attributes of hybrid securities (product design), we will revise our assessment of their similarity with common stocks by incorporating each issuer's individual situation. We, then, ultimately evaluate the equity content of the hybrid securities in question.

In terms of individual situation, an issuer's policy on financial management is important. For example, if exercising a call feature by the issuer's management is considered to have an adverse effect on factors including financing, stock price and rating, the probability of the call being exercised is likely to be relatively low. But it is difficult to conclude that there will be a low probability of a call feature to be exercised solely based on the issuer's financial management policy. Thus, we would carefully examine the issuer's financial conditions by analyzing whether the issuer's financial management policy is based on a rational foundation.

In studying financial conditions, it is necessary to see the position hybrid securities take in the financial affairs of the issuer. If hybrid securities comprise a large part of financing, the issuer may tend to increasingly avoid deferral, fearing that deferral of interest and dividend payments would be detrimental to gaining trust from investors, which in turn may cause problems with financing down the line.

When assessing hybrid securities with a conversion provision into common stocks, the issuer may exercise the call feature in an attempt to avoid dilution of shares that results from conversion as well as changes to the shareholder composition. Therefore, we must also study the degree of tolerance the issuer has for conversing hybrid securities into common stocks. Ultimately, in order to give a high evaluation for the equity content of hybrid securities at the time of maturity --- even if the time left until mandatory conversion is short, i.e., within three years -- it is necessary to confirm that there are no concerns such as major stock dilution and changes in the shareholder composition. We also must detect that the issuer has tolerance for conversion and is operating its financial affairs on the assumption of a conversion.

The personality of the holders of securities and their purpose for holding are also important in the analysis of the financial management policy of the issuer. General institutional investors who have purchased bonds through public issuance could expect periodic and stable income from interest and dividends of hybrid securities, leaving little room for issuers to deter payments. Meanwhile, there is increased likelihood of a deferral of interest and dividend payments or withholding of a call option-related redemption close to the exercise date when holding hybrid securities are not for resale, such as when held by the parent company of the issuer or a company that intends to establish a strategic alliance with the issuer.

While our point of view described thus far will be used as a basis of our evaluation on equity content of hybrid securities in all industries, we might see slight differences in the evaluation on equity content among different industries. More specifically, in assessing financial institutions, we would consider the likely impact on the issuer's financial management from the intentions of regulatory and supervisory authorities. In the case of a bank, for example, attaching a call feature to hybrid securities normally requires approval by the authorities. Consequently, under stressful financial conditions, there is little possibility in the future for an issuer to exercise a call feature without having an alternative source of funds. Bank-issued hybrid securities are widely held in the market and a large portion of a bank's funding source stems from hybrid securities, compared with that seen in other industries. Deferral of interest and dividend payments could result in a deterioration of the financing environment of individual banks and lead to instability of the financial system. The authorities, therefore, have shown great interest in interest and dividend payments, and as such, their intentions are likely to affect the issuer's policy of interest and dividend payments. Under such circumstances, the evaluation on equity content of hybrid securities issued by financial institutions may vary from that of other business corporations, even if the product design is similar. (For the evaluation on hybrid capital of life insurance companies, refer to press release 06-D-417 issued together with this article)

As described thus far, it is necessary to consider a wide range of individual conditions of the issue in evaluating the equity content of hybrid securities. While the evaluation on equity content of hybrid securities is founded on the analysis of the securities' attributes (product design) the issuer is bound to, it is important to note that when the hybrid securities' attributes include functions that reflect the will of the issuer, such as a call feature, assessment of hybrid securities is substantially affected by the individual situation of the issuer.

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