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Equity Credit for Hybrid Securities

This criteria procedure offers A.M. Best's perspective on hybrid securities and the amount of equity benefit that may be forthcoming to an organization's capital structure in the rating process. It describes how hybrid securities are evaluated for equity credit when financial leverage is calculated on a consolidated holding company basis.

Hybrid securities, typically in the form of a preferred stock, trust-preferred securities, convertible securities or subordinated debt, share some basic characteristics associated with common equity. Hybrids can include a variety of features that, over time, allow them to exhibit changing proportions of debt and equity characteristics.

Equity Credit Treatment

Conventional balance sheet treatment of certain types of securities by the accounting profession often does not represent a true picture of the risk or financial leverage employed by an organization. For instance, an issuer may have a large portion of reported equity in the form of traditional preferred stock, which has a relatively short time to maturity. Conversely, an issuer may report a relatively large debt issue on its balance sheet that can and will be converted to common equity over a short period of time. The former is potentially exposed to a major credit event, while the latter ultimately will result in improved financial flexibility.

Accordingly, A.M. Best analyzes the features and characteristics of all securities within an issuer's capital structure and may adjust reported balance sheet financial leverage by giving, or possibly removing, equity credit for certain instruments.

While financial leverage remains a critical consideration during the rating process, A.M. Best believes that the effect of hybrid securities on debt-service ability is also a key determinant of debt capacity. In addition to the positive impact these securities may have on operating cash flow through interest-deferral features, cash coverage also can be tempered or strengthened materially by a company's consistency and sustainability of earnings and alternate sources of cash, including cash at the parent holding company level and unrestricted dividends from subsidiaries.

Rating Guidelines

When assessing a specific entity's capital structure, A.M. Best reviews the company's history in managing its overall capital base, its funding needs and the sources and types of financing used to satisfy its capital requirements. Integral to the overall rating process is having an in-depth understanding of management's historical and current strategies toward maintaining appropriate levels of capitalization and the composition of its capital base prospectively. This understanding is of particular importance when attempting to quantify equity credit for hybrid securities, and assessing the permanency and form of current and future capital. For example, a company may be highly focused on maintaining or improving general measures of operating performance such as earnings per share or return on common equity. In such cases, the

Equity Characteristics

- Permanency of capital – is the note available to pay losses when needed?
- Ability to defer interest or dividend payment – are payments deferrable when a company is in distress?
- Subordination in an issuer's capital structure, i.e., loss protection provided to policyholders and other creditors.

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company may be unwilling to tolerate the dilution caused by the conversion of a security into common shares, and it may in fact issue new debt securities to fund a share repurchase.

In general, A.M. Best grants equity credit for hybrid securities that exhibit the characteristics of common equity up to 20% of a firm's total capital. The amount of credit given to hybrid securities is based on A.M. Best's belief that the insurance industry, as well as the broader financial services sector, is very sensitive to changes in the market's perception of an issuer's financial health. This sensitivity may expose issuers to sudden changes in the cost of capital or a diminished ability to access the capital markets. As such, A.M. Best takes a conservative view toward the amount of equity credit an individual security may receive, as well as the aggregate credit an issuer may receive. Additionally, A.M. Best calculates coverage ratios including hybrid obligations.

As a general guideline, holding companies with financial leverage ratios less than 35% (adjusted for equity credit) on a consolidated basis are considered to have an acceptable level of debt and hybrids for "a-" or higher issuer credit ratings (ICRs); the range of 35% to less than 45% is considered acceptable for issuer credit ratings in the "bbb" category; and leverage ratios greater than 45% are associated with ICRs of "bb" and below (see **Exhibit 1**).

Equity Credit Guidelines

In ranking equity-credit-afforded securities along an equity-debt continuum, A.M. Best places senior debt with a short time to maturity and a cash put option at one end and common stock at the other end. All other securities fall in between, based on loss-absorption characteristics and their cash-flow flexibility. Given that equity credit is linked to loss absorption (structural subordination) and relative permanency in the capital structure, equity credit can be assigned to a security relative to its time to maturity and notching (see **Exhibit 2A**).

In most cases, notching is determined by the structural subordination as described in the security's indenture (see **Exhibit 2B**).

In general, as notching widens, the amount of equity credit increases for a given time to maturity. The table below assumes non-convertible securities with interest/dividend payments that are cumulative and may be deferred for 3-7 years. Equity credit for a security may diverge from the guidelines based on other features of the security. For example, interest payments that are deferrable and non-cumulative could result in a modest increase in equity credit from the guideline. Due to its equity attributes, preferred stock (and securities with features similar to preferred stock) receives the higher end of the equity credit range relative to similarly rated securities (e.g., junior subordinated debt). Convertible securities can receive varying degrees of equity credit depending on the terms and structure of the particular

Exhibit 1
Typical Holding Company Financial Leverage & Interest Coverage Guidelines

ICR Category	Debt/Capital*	Interest Coverage**
aaa	<15%	>10x
aa	<25	>7x
a	<35	>5x
bbb	<45	>3x
bb	<65	>2x
b	>65%	<2x

* Long-term + Short-term Debt (adjusted for hybrid securities)/[(Total Shareholder's Equity +Minority Interest and Other + Preferred Stock (Non Equity) + Long-term Debt + Short-Term Debt) net of AOCI]
** (Pretax Operating Income + Interest Expense) / (Interest Expense + Preferred Dividends)
A.M. Best's economic view of capital in any given organization can differ significantly from reported capitalization.

Exhibit 2A
Equity Credit Guidelines: Notching Versus Maturity

Remaining Years to Maturity	Notches 0	1	2
5	0%	0%	10%-20%
10	0	10	20-35
20	0	20	30-50
30	0	30	40-70
40	0	40	50-80
Perpetual	0	50	60-90

Exhibit 2B
Notching

Security Type	Notches From Non-Operating Holding Company
Senior Debt	0
Subordinated Debt	-1
Junior Subordinated Debt, Trust Preferred, Capital Trust Securities, Preferred Securities/Stock	-2

instrument. If a security has an issuer call option that can be exercised in the next five years, and A.M. Best has reason to believe that the security will be called and not replaced with an issue possessing the same or similar equity content, then the issuer call date will be considered the effective maturity date. This determination is made after an analysis of several factors including the stated intentions of management, the existence and cost of incentives to call (step up features, etc.), interest rate and market conditions, market expectations regarding the call feature, and the track record of management with respect to exercising the option to call.

The placement of securities shown in **Exhibit 2A** reflects A.M. Best's typical perspective, though rating committees have flexibility to adjust equity credit attribution based on individual circumstances.

Classes of Hybrid Securities

The determination of equity credit for any given security is based on that instrument's specific features when compared/contrasted with the characteristics of equity: no maturity, no ongoing payments and deep subordination.

Below is a brief overview of the major classes of hybrid securities from the context of features that typically warrant equity credit.

Traditional Preferred Stock

Generally viewed as the original form of a hybrid security, preferred stock pays a stated dividend yield, much like the interest rate paid on bonds, but is unlike common stock in that it typically does not confer voting rights. Holders of preferred stock also have certain preferences or priorities over holders of common stock as to dividends and/or distribution of assets in the event of bankruptcy or liquidation.

Preferred stock is issued directly by a holding company or operating company and can include equity-like features such as:

- Perpetual maturity, with no put options that present refinancing or repayment risk;
- Ability to defer ongoing payments; and
- Deep subordination, senior only to common stock.

While some forms of preferred stock may receive nearly full equity credit, such as a perpetual noncumulative issue, other forms may not receive any equity credit. For example, issues with a short time to maturity expose the issuer to refinancing or repayment risk. The issuer also may elect to replace these deeply subordinated obligations with securities having a more senior claim in the overall capital structure. Also, there is a risk that the organization may not be able to issue new securities to repay maturing issues.

Convertible Securities

Convertible securities typically can be converted into shares of a company's common stock. For this reason, the issuance of convertible securities typically is seen as management's readiness to issue equity in the future. In general, these instruments can be grouped into two broad categories: mandatory conversion and optional conversion.

In a traditional, mandatorily convertible security, the conversion formula is fixed; that is, the instrument automatically converts upon maturity into common stock based on a fixed price. Such instruments are equity-like since there is no obligation to return cash to investors at maturity. Furthermore, equity benefit increases progressively as maturity approaches, particularly if it is clear that the equity will remain a permanent part of the issuer's capital base. In such cases, these securities may receive close to 100% equity credit within two years of conversion. Securities with a floating exchange rate are viewed as more debt-like.

Other variations of mandatorily convertible securities include those that convert to a:

- Fixed number of common shares when issued, which protects the issuer from potential earnings per share dilution; and
- Number of shares that equals the principal amount owed to the investor, which may expose the issuer to significant earnings per share dilution should its stock price become depressed at the time of maturity.

In general, a convertible security issue allows the issuer to benefit by offering lower dividend or interest rates, which enhances the issuer's fixed-charge coverage ratio.

Typically, optionally convertible securities can convert to a fixed number of common shares at the option of the investor. When reviewing such issues for potential equity credit treatment, A.M. Best looks for provisions to include an issuer's call feature, exercisable after a given time period, to require investors to convert. Without the call feature, it is unlikely that investors would forego the benefit of continuing to receive dividend payments on "in the money" securities.

Key features of optionally convertible securities typically include:

- Maturity—Its automatic conversion to common shares from issue makes it closely resemble common equity's no-maturity characteristic, but while these securities typically do not have a repayment issue, they represent a subordinated claim in the event of default or cross default.
- Dividend or ongoing cash payments can be deferred.
- Such securities are subordinated within the capital structure.

Trust Preferred Securities

Trust preferred securities, which include issues such as MIPS (Monthly Income Preferred Stock), QUIPS (Quarterly Income Preferred Stock) and TOPRS (Trust Originated Preferred Redeemable Stock), have the characteristics of both debt and equity instruments. These hybrid securities allow the issuer to make tax-deductible interest payments, which reduce the issuer's cost of capital while also providing equity-like benefits similar to traditional preferred stock.

Trust preferred securities generally are issued by a special-purpose trust created by the parent company. The trust lends proceeds to the parent, typically through a subordinated loan that is junior to all other debt of the parent. The terms of the preferred securities match the terms of the underlying subordinated loan.

Payment obligations of the trust typically are guaranteed through several agreements and by the terms of the debt securities that the trust holds. The agreements normally include a guarantee and an expense undertaking from the parent company; the trust indenture for the debt securities the trust holds; and the trust declaration of the trust itself.

Typical key features of trust preferreds include:

- Long maturity, between 20 and 40 years, with an issuer call option after five years. As such, it is an obligation that must be repaid from cash flow or refinanced.
- Dividends are deferrable, subject to suspension of common dividend, for up to five years without triggering a default. Deferred amounts accumulate, accrue interest and must be

paid before resuming common dividends or at the end of the limited deferral period.

- Subordination to all debt obligations of the parent and on parity with other directly issued trust preferreds. Due to the loan structure underlying the issued security, it has a more senior claim in liquidation to preferred stockholders.
- Default triggers where, as a debt claim, it is an obligation that could become due immediately in the event of a default, cross default, bankruptcy filing or other form of reorganization. Also, the existence of a call option would raise the possibility that the instrument could be replaced in the future with a new issue, with no guarantee that the refinancing will be neutral with respect to senior creditors in the issuer's capital structure.

Subordinated Debt

Subordinated debt supplements capital without diluting existing shareholders' control and allows the issuer to make tax-deductable interest payments, which reduces its cost of capital. In addition to these traditional debt features, these instruments often have equity-like characteristics such as a long or perpetual maturity and deferrable coupon payments.

Typical key features of these instruments include:

- Long term, typically having a stated maturity of over 20 years (often perpetual), with an issuer call option after 5 or 10 years;
- Subordination to policyholders and senior debt holders;
- Coupons can be deferred and are non-cumulative.

Appendix

Case Study – $500 Million Issuance of Hybrid Securities

($ Millions)

Capital Structure

	Prior Issue	Post Issue
Debt (Senior Unsecured)	$600	$600
Hybrid Issuance		$500
Shareholders' Equity	$1,800	$1,800
Capital	$2,400	$2,900
Debt + Hybrid to Equity	33.3%	61.1%
Debt + Hybrid to Capital	25.0%	37.9%

Hybrid Securities

	Issue Amt	Equity Credit	Description
Hybrid I	$500	75%	Mandatorily convertible securities, five years to conversion, with a fixed conversion formula; that is, the instrument automatically converts upon maturity into common stock based on a fixed price.
Hybrid II	$500	50%	Trust preferred securities, 40 years remaining to maturity, a call option after five years. Dividends are deferrable for up to five years without triggering a default. Deferred amounts accumulate and accrue interest.
Hybrid III	$500	25%	Optionally convertible securities with a fixed exchange rate and an issuer's call feature, exercisable after five years.

Adjusted Leverage Measures

	I	II	III
Debt (Senior Unsecured)	600	600	600
Debt Charge for Hybrid Issuance	125	250	375
—Debt + Hybrid Charge	$725	$850	$975
Shareholders' Equity	1800	1800	1800
Equity Credit for Hybrid Issuance	375	250	125
Equity + Hybrid Credit	2175	2050	1925
—Capital	$2,900	$2,900	$2,900
Debt + Hybrid Charge to Capital	25.0%	29.3%	33.6%

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METHODOLOGY

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