



Standard & Poor's Approach To Hybrid Capital

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Sixteen Deals Since Jan 2005, averaging c.€900m

All 'Intermediate' except MOL ('Minimal') and Bayer 2006 ('Strong')

<i>Issuing group (European corporates only)</i>	<i>Size (€m equiv.)</i>	<i>ICR / outlook *</i>	<i>Hybrid's rating *</i>
Casino	600	BBB/st	BB+
Vattenfall	1000	A-/st	BBB-
Dong	1100	BBB+/st	BBB-
Suedzucker	700	A-/st	BBB-
Bayer 2005 / 2006	1300 / 2000	A, st / WNeg	BBB (WNeg)
Fenosa	750	BBB+/st	BB+
Thomson	500	BBB+/st	BBB-
Henkel	1300	A-/st	BBB-
Tui	300	BB+/pos	B+
Vinci	500	BBB+/WNeg	BBB-/WNeg
Mol	610	BBB-/st	BB
Lottomatica	750	BBB/Wneg	BB+/WNeg
Solvay	500	A/st	BBB+
Linde 2006	1050	BBB+/WNeg	BBB-/WNeg
Siemens	2000 ?	AA-/WNeg	A-/WNeg
Total / average	14710	Strong BBB+	BBB-

* at issuance. Unrated: Porsche, Otto Versand

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Take-aways from issuance to date

We have rated close to 95% of European Corporate Hybrid issuance 05-06 YTD

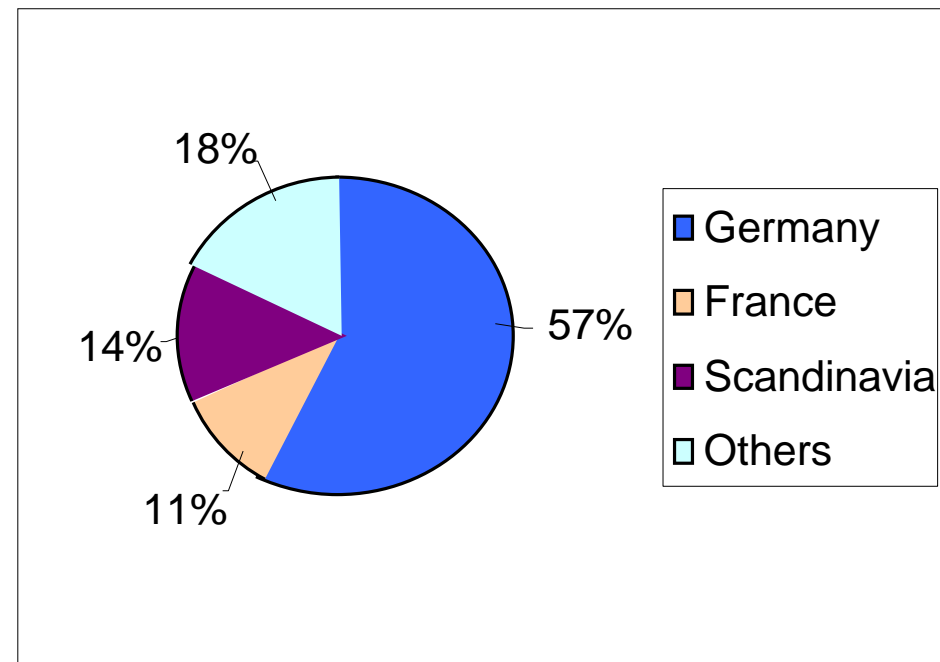
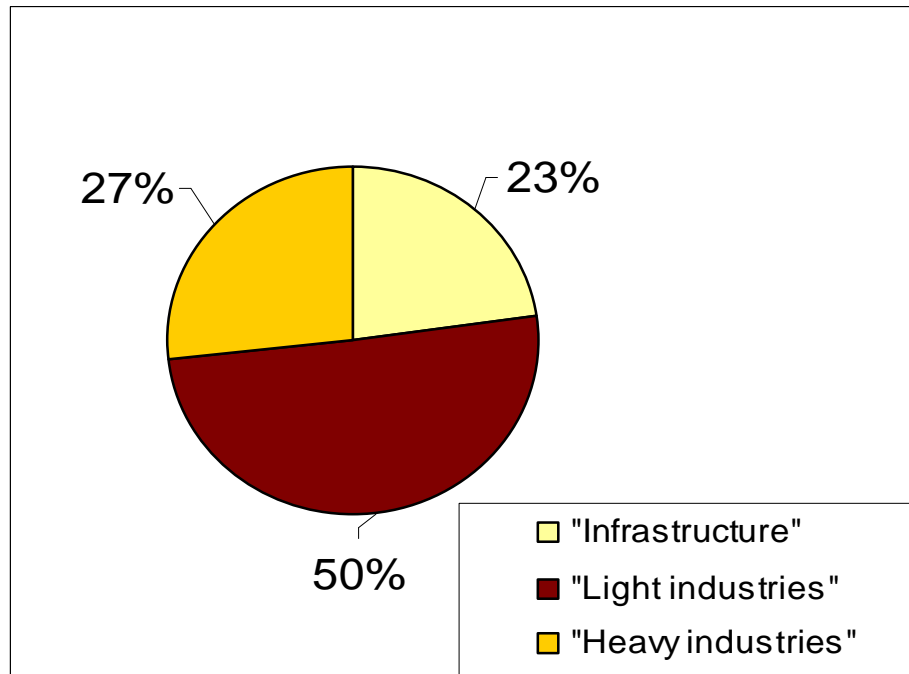
- A consequence of the high proportion of corporates rated by S&P on a senior-debt basis
- We have published the rationales for our specific rating and equity-content determinations on virtually every deal.
- **By geography**
 - Germany clearly predominates
 - The UK and Netherlands still absent...
 - ... But emerging Sterling tranches suggest UK investors have appetite.
- **By sectors**
 - Most sectors have issued
- **By credit strength**
 - One high-yield issuer + actual or prospective 'BBB-' credits
 - About a third of instruments high-yield at issuance or prospectively

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Breakdown of 2005-to-date issuance by sector and geography



Variety of sectors, predominance of Germany-based issuers

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Catalysts and Drivers

Several constituencies contributed

- Improved structuring and rating criteria clarification
- Liquid market and low interest rates – “yield hungry investors”
- Equity accounting treatment possible under IFRS
- Increasingly supportive legal & tax systems
- Multiple issuer objectives

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Rationale for the Issuer

- **Reduce average cost of capital**
- **Coupon payments tax deductible (in contrast to dividends)**
- **Diversify funding**
- **Non dilutive equity substitute (attractive for government-owned & family owned companies)**
- **Funding of acquisitions, pensions, share repurchases, refinancing of debt**
- **Bolster credit ratings and enhance financial flexibility**

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Key Features/Aspects to Consider

- **Term**
- **Call/redemption provisions**
- **Step-ups**
- **Replacement provisions**
- **Put provisions**
- **Conversion provisions**
- **Optional deferral (limitations; cumulative versus non-cumulative)**
- **Mandatory deferral**
- **Regulatory deferral**
- **Alternative payment mechanisms and requirements**
- **Dividend look-backs**
- **Subordination**
- **Management intentions**
- **Market expectations**
- **Regulatory classification and intent**
- **Legal form/nomenclature**
- **Tax treatment**
- **Accounting treatment**

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The Two Key Ratings Aspects on Hybrids For S&P

- **Equity content**

What does it mean for the senior debt investor and overall credit quality?

- **Subordination/notching**

What risk does the hybrid carry for its investor?

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Equity Content

Common equity features = What the hybrid aim at replicating

- **Equity requires no ongoing payments that could lead to default**
Deferral of coupon (optional, mandatory, ASCM, regulatory)
- **Has no maturity or repayment requirement**
Term of hybrid
Call/redemption requirements
- **Provides a cushion for creditors in case of bankruptcy**
Subordination
- **Expected to remain a permanent feature of the capital structure**
Step-ups and incentive to repay
Replacement provisions
Management intentions
Tax and accounting treatment

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Equity Content: Taking a Holistic Approach

Deferability and Permanence matter most: our issuer ratings focus on default

- No specific equity credit for 100-year sub debt, plain convertibles (ditto: conversion not mandatory)
- **Subordination:** whether deep or not is secondary. Mustn't be linked to a specific debt package (= *where LBOs' PIK and sh'h loans typically fail the test*)

Being strong on just 1-2 features attracts no significant Equity Credit

- Ex.: instrument that can defer anytime but will be repaid in only ten years.
- → an extra layer of subordination ('deeply-', 'most-subordinated') doesn't offset difficult deferability

Our typical assumptions

- Non-Payment is not a legal default. No cross-default.
- **Unfettered, unconditional and instant deferability for 5+ years.** Common dividend stopper ok.
- **No step-up in remuneration.** 5+ year Call without in-built motivation to exercise.
- Tax-Deductible, no tax-call. No Compensation to Investors if their tax regime changes.

Hybrid needs be strong on all dimensions + shine on Deferability or Permanence.

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A Pragmatic View on Equity Content

Economic vs. Legal/Stated maturity

- We assesses redemption/repurchase scenario: rationale, timing, likelihood
- 25 year of remaining life is minimum

Cost effectiveness is key to permanence (and deferrability)

- Step-up incentives redemption and could destroy permanence
- Optional deferral linked to reputation risk

Different remedies to step-ups imply different equity content

- Intent based tight replacement language partial remedy but remain legally non-binding and untested
- Legally enforceable replacement covenants requirement for high equity content

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Other Relevant Points

Guidance on maximum amount for Corporates

- **15% of total book capitalization** (equity + debt + hybrids, adjusted as usual) is a guidepost as to when a balance-sheet structure could become overengineered.
- Numerator includes all outstanding hybrids at full principal value, not weighted by equity content – even if ‘Minimal’.
- To the degree equity content hinges on the optional deferral, would the issuer be more reluctant to defer and alienate a powerful constituency?

What can reduce an instrument’s equity content over time?

- Passage of time, as residual life reduces
- The actual experience: repeated tax-law changes, weak replacements of stepping-up instruments.
- Analysis of legal feasibility of covenanted replacement language

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Equity Content Categories

High

- Includes features that support current rating. Typically involve mandatory component — either regarding deferral of ongoing payments or near-term conversion into common

Intermediate

- Encompasses most preferred stock instruments, from 30-year trust preferred with five-year cumulative deferral rights to perpetual, with non-cumulative deferral rights

Minimal

- Includes instruments with little or questionable permanence; terms or nomenclature that restrict or discourage discretion over payments; costs or conversion terms that may become unattractive to issuer

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Equity Content Categories Applied to Financial Ratios – Corporates

High

- Treated entirely as equity

Intermediate

- Now to be treated 50/50, debt/equity. Alternatively, as before: ratios calculated based on 100% equity, 100% debt

Minimal

- Treated entirely as debt

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Classification of Hybrid Securities for Financial Services Companies

Category	Inclusion in Capital Measures	Examples
Category 1: High Equity Content	Up to 35% of ATE or up to 25% of TAC	<ul style="list-style-type: none"> • Short-dated mandatory convertible securities (< 3 yrs) • High quality hybrids with participating coupons
Category 2: Intermediate Equity Content Category 2: Strong	Up to 25% of ATE or up to 15-25% of TAC	<ul style="list-style-type: none"> • Perpetual preferred shares • Most bank and insurer undated deferrable Tier 1 instruments • Insurance long-dated deferrable instruments with residual maturity of > 20 yrs
Category 2: Adequate	Up to 10% of ATE or up to 15-25% of TAC	<ul style="list-style-type: none"> • Most, but not all, bank Upper Tier 2 instruments • Limited life preferred shares (e.g. U.S. trust preferred) • Insurance deferrable instruments with residual maturity < 20 yrs
Category 3: Minimal Equity Content	Not included in ATE or TAC	<ul style="list-style-type: none"> • Dated hybrid instruments with a residual maturity < 5yrs • Auction-preferred securities • Nondeferrable subordinated debt • Instruments with put options

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Why Different Approaches for Financial Services versus Corporates?

- **Different leverage characteristics of financial services entities versus corporates**
- **Greater funding appetite of financial services entities versus corporates; hence, greater concern with preserving capital markets access**
- **Role of REGULATION in financial services**

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Regulatory Policy Drives Analysis of Bank Hybrid Capital Securities

Bank regulators have broad powers over banks. They...

- **determine what is capital.**
- **define and enforce minimum capital standards.**
- **determine if a bank is solvent.**
- **set the terms for qualifying hybrid capital (maturity, triggers for payment deferral, calls and replacement).**
- **have power to intervene and stop payments on hybrid securities.**

S&P's approach to analyze and rate hybrid capital securities parallels regulatory policy.

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Different attributes of equity hybrids are relevant to different elements of Standard & Poor's analytical methodology

- **Aspect of ongoing payments is considered in fixed-charge coverage and cash-flow adequacy**
- **Equity cushion in leverage and asset protection**
- **Need to refinance upon maturity in liquidity**
- **Potential for conversion in financial policy**
- **Cost of paying for funds also is a component of both earnings and cash flow analysis**

In any case, hybrid capital is just one of many aspects that determine rating

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Assigning Issue Ratings/Notching

Two types of Standard & Poor's ratings:

- **Issuer credit rating (ICR).** Current opinion of issuer's ability and willingness to meet its financial commitments on timely basis
- **Issue ratings.** Address timeliness; Also address potential for recovery of principal in event of bankruptcy or liquidation of issuer — that is, ranking of issue

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Assigning Issue Ratings/Notching: Rationale

Conventional preferred stock and certain other equity hybrids afford equity benefit to issuers:

Deferrability - ongoing payment requirements are more flexible than conventional debt interest

Subordination - contractual lower ranking to conventional debt

These characteristics make instruments more risky for investors than debt

Issue ratings reflect these incremental risks compared to ICR and conventional debt

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Assigning Issue Ratings/Notching: Subordination

Subordination

- Adversely affects ultimate recovery prospects of subordinated obligation holders in bankruptcy, since claims of priority creditors must be satisfied first
- For investment grade issuers, we take away one notch from ICR for issues that are subordinated (but not deferrable)
- We do not distinguish in notching between gradations of subordination
- Ultimate recoveries for different classes of subordinated instruments tend to be similar — and poor

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Assigning Issue Ratings/Notching: Deferral

Payment risk can be heightened in case of equity hybrids due to:

Optional deferral

- Management entitled to suspend/cancel distributions without triggering a legal default)
- We assume reluctance to exercise given reputation risk
- Risk for financial distress increases the likelihood
- "Pressure point" may differ for different types of issuers

Mandatory deferral

- Requirement to suspend payments at breach of predetermined triggers
- Typically linked to financial parameters
- Dividend pusher can reduce the risk (but also equity content)
- Payment risk linked to risk of breaching trigger

Regulatory deferral

- Regulator authority to direct companies to defer hybrid's payments
- Payment risk assessment requires consideration of sector and country-specific factors
- Identification of financial measures to which the regulator is particularly sensitive is key
- Regulatory triggers — whether or not clearly defined — amount to de facto mandatory deferral

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Assigning Issue Ratings/Notching: Payment risk

Factoring payment risk into issue ratings

- **Key consideration: What is combined significance of different sources of deferral risk?**
- **Where risk is relatively remote, but still material, one-notch differential versus subordinated rating (-- i.e, 2 notches versus ICR). This is typical notching for issues with optional deferral alone**
- **When we have heightened concerns that issuer may defer, we increase gap between ICR and issue rating**
- **Combinations of different forms of deferral may/may not increase deferral risk**
 - *Mandatory trigger with significant erosion, or before optional deferral is likely, increases payment risk → additional notching*
 - *Mandatory trigger remote and optional deferral likely before breach does not increase payment risk → no additional notching*

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Assigning Issue Ratings/Notching: Payment risk in FI

Factoring payment risk into financial institution issue ratings

- In case of regulated financial institutions, explicit mandatory deferral triggers do not add to risk stemming from regulation if triggers just replicate capital standards that regulator applies in determining whether to order deferral
- With banks, it is particularly unlikely optional deferral would be unilaterally exercised
- We presume bank regulators would act preemptively to force banks to raise capital to prevent regulatory capital guidelines from being breached
- Thus, in most instances we take away only one notch for deferral risk in rating issues of investment grade banks, even where there is combination of optional + regulatory deferral

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Fast-moving primary market calls for ongoing criteria responses

A radical transformation in just two years

- 2003: hybrids posted low equity-content. 2005-2006: an active primary market for European Corporate Hybrids emerges
- Unexpectedly large deal sizes. Variety of sectors and, to a degree, of jurisdictions.
- Constant innovations. Expansion into sectors with less earnings stability, high-yield issuers, small companies / CLOs.

Key European innovations:

- Mandatory Deferrals
- Tight replacement clauses
- ACSMs
- Change of control clauses
- Conversion calls
- Rating-agency / equity-content calls

Key '05 US innovations have not been imported to Europe -- yet:

- Legally binding replacement covenant.
- Immediate stock settlement

We constantly refine & clarify our criteria as potential for innovations is infinite

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Standard & Poor's New Instruments Committee

Selected Recent Publications

- “Equity Credit for Bank and Insurance Hybrid Capital, a Global Perspective,” February 16, 2006
- “Recent Hybrid Capital Issuances by U.S. Bank Holding Companies May be Models for Future Transactions,” February 16, 2006
- “Knowing the Investors in a Company’s Debt and Equity,” April 4, 2006
- “Criteria: Equity Credit for Corporate Hybrid Securities,” May 8, 2006
- “Standard & Poor’s Changes Ratio Calculations for Hybrid Securities in Corporates,” May 8, 2006
- “Criteria: Assigning Ratings to Hybrid Capital Issues,” May 8, 2006
- “Credit FAQ: Rating Insurers’ Hybrid Capital Instruments,” May 8, 2006
- “S&P Will Not Implement Alternative Ratings Approach to Hybrid Capital Issues,” May 8, 2006
- “Credit FAQ: An Advance Glimpse at the Upcoming Changes to the Insurer Capital Model,” June 1, 2006
- “Criteria: Equity Credit for Finance Companies’ Hybrid Securities,” July 10, 2006
- “Credit FAQ: Gauging the Effects of Hybrid Securities on Bond Insurer Capital,” July 27, 2006
- “Criteria for Hybrid Capital Issues with Optional Deferral Clarified,” August 1, 2006
- “FI Criteria: Assessing Hybrid Capital of U.S. Securities Brokers,” August 7, 2006

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Conclusion: useful take-aways

- **Equity credit crashes in unmitigated step-up & call situations**
- **Overreliance on hybrids could raise issues about financial policy, disincentives to defer.**
- **ACSMs can disincentivise deferral.**
- **Final benefit to ICR depends on specific issuer factors**
- **Mostly a defensive play in the European experience so far!**

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Appendix: Corporate Hybrid Ratings

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Deferability in European Corporate deals

(1) Optional

- When, how and for how long much cash is preserved for the benefit of senior debtholders?
- **When? Any condition or delay in deferring?**
 - **Any hindrance reduces equity content, as do 'pushers'** (eg, cannot defer just after a shareholder distribution; if net income exceeds coupons; if a given credit ratio is too strong)
 - Long 'lookback periods' are problematic: **> 12 months (6 for HYs) disqualifies for 'Intermediate'**.
 - **'Dividend stopper'** typically does *not* reduce equity content.
 - **ACSM may disincentivise deferral**
- **How much for how long?**
 - (If cumulative) forced settlement before five years is inconsistent with 'Intermediate' equity content.

Aim: preserve cash as soon + as long as stress requires.
Optional deferral's value to *the particular credit* depends on management's attitude

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Deferability (1) *Optional*. Alternative Coupon Settlement Mechanisms (ACSM)

- In common shares, other hybrid or like securities (=‘PIK’), or combinations thereof
- At first sight, sounds like contributing to cash preservation, but...
- **To assess unfettered optional deferability, we closely look at ACSMs for optionally deferred amounts** that were restricted to common shares, or where stock dilution was not tightly capped or with a hard settlement deadline earlier than five years
 - Heavy common-stock dilution (at a potentially low price) makes repurchasing unwieldy, ie...
 - ... disincentivizes deferring in the first place
- For Corporates with maximum five-year deferrability, an optional deferral with the following settlement alternatives is consistent with ‘Intermediate’ equity content:
 - ✓ PIK (the least problematic)
 - ✓ 25% cap on hybrid settlement
 - ✓ **2% cap on common share issuance** (refers to the whole cumulative deferral, not per year of settlement nor per year of coupon deferred; to the underlying shares in case of settlement by warrants)
 - ✓ More structuring flexibility If the first hard deadline is after five years.

Deferability in European Corporate deals

(2) Mandatory

Present in 56% of 2005-06 YTD issuance, even if excepting Lottomatica.

- Possibly would have been more if not for the desire that the issue be rated investment-grade.
- Europe-specific bias?
- Entail additional notching.

Trigger definitions influence equity content

- **The most credit-quality correlated mandatory deferrals:** Vattenfall, Siemens: cash flow / interest < 2.5x / 3.0x. Henkel: 15% cashflow / adjusted debt. -- But trigger levels are fairly low.
- Less – but still some – equity-content in the mandatory deferrals of Südzucker, Bayer 2005: cash flow from operations / revenues < 5% / 7% -- far-away profitability ratio triggers.
- Lottomatica: liquidity test.

If ill-structured, mandatory deferrals attract extra notching,
without necessarily raising equity content

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Pragmatic view on permanence means step-ups can be problematic

- **Economic vs Legal / Stated Maturity**
 - We assess repurchase scenario: rationale, timing, likelihood
 - 25-year remaining life is a minimum
- **Cost effectiveness is key to permanence!**
 - At issuance & during life versus financing alternatives.
 - Need for tax stability, or comfort on absence of current tax change risk, especially with tax calls
 - Accounting calls are acceptable without, but better with, replacement.
- **Step-up = *in-built, instrument-specific incentive to call*** (destroys permanence):
 - Absent step-up, typical five-year call does **not** reduce equity content – a routine financial-policy issue. Issuers needn't be stuck with the hybrid forever!
 - Insignificant step-up is ok.
 - We appreciate step-ups differently for a high-yield vs an investment-grade issuer.

If not properly addressed, step-ups drastically reduce equity content

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Different remedies to step-ups imply different equity-content benefits

- **Tight intent-based replacement language**

- 'As equity-like as': too controversial / ambiguous.
- Statement of intent *within T&C*: not binding but potentially morally strong.
- Remedies step-ups that are **ten years out or more (seven for high-yields)**.
- Must **unambiguously require identical** key features of replacing vs replaced instruments
- **Remains non legally binding and untested**. Absence of step-up still significantly better!

- **The binding approach: legally-enforceable covenants**

- In investment-grade, **enables calls to be before year ten but not step-up to exceed 100bp**
- Assumes supportive local law
- Necessary for 'High Equity Content'
- Even for 'Intermediate', we would question why such a tool would not be used if available in the specific jurisdiction.

Even if remedied, step-ups highlight investors' short term-orientation
Covenants strongly enhance structuring flexibility

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Which calls are problematic, which are not

‘Change-of-control’ clauses typically don’t require replacement language.

- Wording should not endanger financial standing pre-change of control;
- Doesn’t require replacement language: we re-rate the new credit situation anyway.
- Are senior bonds at least as well protected?

‘Conversion calls’ typically don’t require replacement language.

- Issuer can call the portion of the hybrid whose equity-content equates the amount of equity stemming from the conversion of a convertible bond
- Acceptable because we do not give specific equity credit to plain-vanilla convertibles
- Does not require replacement clause

‘Rating-agency / equity-content calls’ do require replacement language.

- Issuer can call entire instrument if any agency has lowered its equity-content denomination
- Initial equity content need to be put back in place.

Different types of calls imply different replacement requirements

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Other Relevant Points

Guidance on maximum amount for Corporates

- **15% of total book capitalization** (equity + debt + hybrids, adjusted as usual) is a guidepost as to when a balance-sheet structure could become overengineered.
- Numerator includes all outstanding hybrids at full principal value, not weighted by equity content – even if ‘Minimal’.
- To the degree equity content hinges on the optional deferral, would the issuer be more reluctant to defer and alienate a powerful constituency?

What can reduce an instrument’s equity content over time?

- Passage of time, as residual life reduces
- The actual experience: repeated tax-law changes, weak replacements of stepping-up instruments.
- Analysis of legal feasibility of covenanted replacement language

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Payment Deferrals and Defaults of Corporate Hybrid Securities

Key preliminary conclusions

- Many more defaults, in total, than for Banks and Insurance combined
- Happen on an ongoing basis, despite possible influence of economic cycles
- Corporates very rarely defer when BB-category rated:
 - We would typically expect low BB-rated companies to start considering deferring
 - Over 1999-2006 YTD, only some three BB-category Corporates have deferred (\$545m involved). All eventually defaulted, several semesters later.
 - Even deferrals by B+ rated Corporates are fairly rare
- Timing issues
 - Approx. two fifths of hybrid defaults appear to occur after or same-day as debt default or filing for bankruptcy
 - Few issues have deferred for long.

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Case Study

Objectives

- Applying theory in practice
- Aims at comparing three types of instruments:
 - With mandatory deferral, step up and lookback (Vattenfall)
 - Only optionally-deferrable with step up but no lookback (DONG)
 - Only optionally-deferrable with lookback but non-cumulative and with no step up (Casino)

Key take-aways

- Vattenfall closest to Suedzucker, Bayer 2005, Henkel
- Dong weaker (absence of mandatory deferral), but has no lookback
- French *Titres Super-Subordonnés* the weakest, but being non-cumulative, remain intermediate

None combined uncovenanted step-up, lookback, cumulativity
and absence of mandatory deferral

Three Typical 'Intermediate' Hybrids (1)

Company (all data at issuance)	Siemens *	DONG	Casino **
Corporate Credit Rating	AA-/WatchNeg	BBB+/Stable	BBB/Stable
Nomenclature	Subordinated Bonds	Subordinated Capital Securities	Deeply Subordinated Security
Notching from CCR (instrument rating)	3 (A-/WatchNeg)	2 (BBB-)	2 (BB+)
Equity content category	Intermediate	Intermediate	Intermediate
Ranking	Unsecured, junior subordinated	Unsecured, junior subordinated	Unsecured, deeply subordinated
Maturity (years, if applicable)	60 years	1,000	Perpetual
Issued amount (€ million)	1,500-2,000	1,100	600
Total capitalization (€ billion or equivalent)	>35	10.0	12.1
Issue % of total capitalization	<6%	11.0%	5.0%
Permanence	Satisfactory	Satisfactory	Strong
Coupon step-up rate (year / amount in bp)	10 / 100	10 / 100	None
Conversion, 'rating-agency' call	Both covered by intent-based replacement	No	No
Existence of tax and / or accounting calls	Yes	Yes	Yes
Replacement language	Tightly-worded Statement of Intent	Tightly-worded Statement of Intent	None needed
Replacement instrument issuance timing (months prior redemption)	6	12	None

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Three Typical 'Intermediate' Hybrids (2)

	Siemens	DONG	Casino **
<u>Optional deferral</u>			
For how long?	Five years non compounding	Yes, indefinite	yes
Shareholder-distribution stopper	yes	yes	yes
Pusher (Shareholder distribution lookback period)	Yes (previous AGM)	None	Yes (12 months)
Cumulativity / settlement mode	Yes	Yes, ACSM	No
<u>Mandatory deferral</u>			
Deferral trigger type	CFO Interest Cover, last annual statements	N.A.	N.A.
Deferral trigger level	3.0x	N.A.	N.A.
Recently experienced level of trigger ratio	>10x	N.A.	N.A.
Cumulativity / settlement mode	Cumulative, up to five years, ACSM, capped	N.A.	N.A.

* Differential analysis: Bayer and Henkel 99-100 years, Vattenfall perpetual. Vattenfall's mandatory deferral (MD) triggered by FFO/interests < 2.5x. Henkel's optional deferral is predicated on OCF/debt < 20%; MD on < 15%. Bayer and Suedzucker's MD are based on OCF/revenues.

** Vinci's Titre Super-Subordonné is identical to Casino's except for year-ten step-up, substantially mitigated by tightly-worded replacement 'statement of intent'. Thomson's added to Vinci's a Change-of-Control clause, neutral to our analysis.

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Appendix: Financial Institution Hybrid Ratings

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Regulation less Clear for Insurers, U.S. Broker-Dealers

- In U.K., Netherlands, Belgium, Finland, Ireland and Norway, bank and insurance regulation under one roof
- Rest of Europe, Canada, Australia likely to evolve towards that state
- Convergence of regulatory policy possible, but we're not there yet
- In U.S., operating insurance companies regulated at state level -- holding company hybrid issuers outside authority of state regulators
- SEC regulates U.S. broker-dealers; SEC follows Fed hybrid policy, but SEC intent and authority unclear
- Finance companies largely unregulated
- Leverage key for insurers; confidence important for broker-dealers, finance companies

Result: S&P sets its own hybrid policies, taking regulatory differences into account.

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Payment Deferrals and Defaults of Hybrid Securities in Financial Institutions Sector 1981 - 2005

- Most hybrids issued during past 12 years, which have been calm and largely default free in sector
- Hundreds of issues and issuers, rough estimate of \$1 trillion outstanding
- Over 20 separate FI groups deferred or defaulted on hybrids *rated by S&P*
- Many other cases of hybrids unrated by S&P (mostly small U.S. BHCs, but also in Japan and Germany)
- Before 1993, most hybrids stopped paying due to general default of the issuer. Examples: First City, FirstRepublic, MCorp, CenTrust, Crossland
- Since 2000, most cases are deferral then resumption of payment. Examples: Bay View, Resona, Riggs, UFJ
- The time of suspension ranged from 6 months to 3 years

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Payment Deferrals and Defaults of Hybrid Securities in Financial Institutions Sector

Conclusions

- Deferrals and defaults happen
- Regulatory policy increasingly favors market discipline
- We expect higher incidence of deferral the next period of banking system stress
- Outright defaults less likely, because default of issuing bank less likely
- But in a liquidation, we expect recovery to be low or non-existent

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Bank and Insurer Hybrid Capital Securities Simplified Continuum

- Mandatory convertible preference shares that convert within 3 years
- Irredeemable perpetual preference shares
- Callable perpetual preference shares with no step-up
- Perpetual preference shares with step-up
- Perpetual subordinated debt
- Dated subordinated debt with deferrable coupons
- Dated subordinated debt with non-deferrable coupons

Highest Equity Content



Lowest Equity Content

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