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General Criteria:

Methodology And Assumptions: Assigning Equity Content To Corporate Entity And North American Insurance Holding Company Hybrid Capital Instruments

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General Criteria:

Methodology And Assumptions: Assigning Equity Content To Corporate Entity And North American Insurance Holding Company Hybrid Capital Instruments

1. This criteria article follows the publication of "Request For Comment: Criteria: Assigning "High" Equity Content To Corporate Hybrid Capital Instruments", on Nov. 14, 2012. Standard & Poor's Ratings Services is revising its hybrid capital criteria for corporate and North American insurance holding company issuers to recognize the effect of the potential reduction of equity content on the permanence of a hybrid instrument with a stated or effective maturity date (which makes an instrument ineligible for high equity content). This revision does not apply to a mandatory convertible security that meets the criteria for high equity content, which is described in the section "High Equity Content Due to Mandatory Convertibility" of the "Hybrid Capital Handbook", published Sept. 15, 2008, nor to a hybrid capital instrument that is strategically held by a group entity of the issuer as described in "Credit FAQ: Knowing The Investors In A Company's Debt And Equity", published April 4, 2006, or by a government. These criteria amend and partially supersede "Hybrid Capital Handbook: September 2008 Edition", published Sept. 15, 2008, and the references to high equity content in "Criteria Clarification On Hybrid Capital Step-Ups, Call Options, And Replacement Provisions," published Oct. 22, 2012. It supersedes "Unregulated Issuers' Hybrid Instruments: Rating Methodology And Assessment Of Equity Content", published March 17, 2011. In addition, the article contains text that clarifies the impact of management intent on "high", "intermediate", or "minimal" equity content classification under existing criteria.

2. This article is related to "Principles Of Credit Ratings," published Feb. 16, 2011.

SUMMARY OF THE CRITERIA

3. A hybrid capital instrument issued by a corporate entity or North American insurance holding company issuer is only eligible for "high" equity content if the following characteristics apply:
a. There are no indications that management intent is anything other than that the instrument will act like equity capital in a time of stress, with respect to its willingness or capacity to impose losses on investors and to maintain the instrument on the balance sheet; and
b. At least one of the following three situations applies:
(1) The security is subordinated to all conventional debt, has no stated or effective maturity (see "Table 6: Provisions In Hybrid Instruments Viewed As The Equivalent Of Maturity" in "Hybrid Capital Handbook: September 2008 Edition", Sept. 15, 2008, for the definition of an effective maturity); no step-up coupon feature (or equivalent financial incentive to redeem); and no option to redeem the security within 10 years of the issue date unless the call is driven by an external event outside the issuer's control. Additionally, distributions on the security are either subject to mandatory deferability in line with ¶¶15 and 16, or tied sufficiently directly to the common stock dividend (see paragraph entitled ""High" equity content through linkage to common shares" in the "Equity Content Categories" section of "Hybrid

Capital Handbook", Sept. 15, 2008); or
(2) The security is mandatorily convertible into common equity, in line with the section "High Equity Content Due to Mandatory Convertibility" in "Hybrid Capital Handbook", published Sept. 15, 2008 ; or
(3) The security is strategically held by a group entity of the issuer or by a government.

4. We are clarifying the circumstances under which a hybrid capital instrument issued by a corporate entity or a North American insurance holding company issuer would be assigned minimal equity content under our existing criteria due to concerns over management intent, even though it has features that would otherwise support "high" or "intermediate" equity content.

5. We also clarify the characteristics consistent with "intermediate" or "high" equity content.

SCOPE OF THE CRITERIA

6. The criteria apply to hybrid securities (other than those referred to below) issued by corporate entities (except for leveraged buyouts [LBOs]) and North American insurance holding companies ("North American" is used in this article to refer to U.S. and Bermudan insurance holding companies; insurance holding companies elsewhere, including Canada, are subject to consolidated prudential regulation that includes the adequacy of their capitalization). These criteria do not apply to a mandatory convertible security (MCS) that is consistent with the criteria for high equity content (see page 12 of "Hybrid Capital Handbook", Sept. 15, 2008), or to hybrid capital instruments that are strategically held by a group entity of the issuer (see "Credit FAQ: Knowing The Investors In A Company's Debt And Equity", published April 4, 2006, for the treatment of such instruments) by a government.

CHANGES FROM REQUEST FOR COMMENT

7. On Nov. 14, 2012, Standard & Poor's published "Request for Comment: Criteria: Assigning "High" Equity Content to Corporate Hybrid Capital Instruments". We received 15 written responses, primarily from issuers of hybrid capital instruments currently qualifying for "high" equity content. Although a majority of responses supported the use of legally binding replacement capital covenants (RCC) as an effective way to mitigate any concerns around the permanence of hybrid capital instruments qualifying for "high" equity content, we did not alter the proposed criteria because, with the benefit of a better understanding of typical issuer intention and market expectations, the effectiveness and enforceability of such contractual obligations do not meet the higher standards that we consider necessary to support permanence expectations for "high" equity content instruments (see ¶17, acknowledging the different standard applied to "Intermediate" equity content instruments).

8. The criteria have also been amended to expand on the effect of management intent on equity content in order to consolidate and clarify certain criteria articles issued since the publication of the "Hybrid Capital Handbook: September 2008 Edition". As a consequence, the article "Unregulated Issuers' Hybrid Instruments: Rating Methodology And Assessment Of Equity Content" has now been superseded in its entirety.

IMPACT ON OUTSTANDING RATINGS

9. These criteria could affect the issuer credit rating (ICR) and consequently the hybrid issue credit rating of two entities due to the reclassification of equity content for hybrid capital instruments issued by that entity. We expect that approximately 10 other hybrid capital instruments issued by corporate entities could have lower equity content, but the effect of the reclassification would not affect the ICR of those entities. The change in methodology could directly affect up to two issue credit ratings on hybrid capital instruments issued by corporates, for which the mandatory deferral provisions in the instruments' documentation are contingent on the instruments maintaining their initial equity content. The ineffectiveness of the mandatory deferral provision would alter the likelihood of interest being deferred and therefore affect the notching of the issue credit rating of the instrument downward from the entity's ICR. Other issue credit ratings would not be directly affected; they would only be lowered as a result of the criteria revision if the change in equity content contributed to a lower ICR on their issuer or guarantor. We do not expect any changes to the equity content assigned to hybrid capital instruments issued by North American insurance holding companies and therefore no direct effect on the ICR of any of these companies as a consequence of the release of these criteria.

EFFECTIVE DATE AND TRANSITION

10. The criteria are effective immediately. We expect to update our ratings over a period of up to six months.

METHODOLOGY AND ASSUMPTIONS

A. The effect of management intent on equity content

11. The criteria for assessing equity content take account of our assessment of the entity's future capital structure, including management's financial policies and intentions. Our assessment of management intent reflects the reality that corporate financial policies and management teams can change over the life of the instrument, and therefore indicates our view of the likely behavior of the issuing entity. In assessing the credit implications of any actual transaction, issuer-specific considerations can always trump any generalized conclusions based on the structure of the instrument. To clarify: even where the terms and conditions of a hybrid capital instrument are consistent with the criteria for intermediate or high equity content, the instrument can still receive minimal equity content if there are indications that management lacks the intention to position and maintain for sufficiently long the instrument as a form of loss-absorbing capital. Examples of such circumstances include:

- The entity's past or expected future behavior concerning hybrid issues, which suggests a lack of long-term commitment to the balance sheet or lack of willingness to defer payments;
- When Standard & Poor's assessment of the issuer's financial policies indicates that the hybrid's overall effect on the entity's credit profile would be muted by other considerations, such as the potential impact on the dividend stream to a holding company if a dividend stopper is triggered by nonpayment of the hybrid coupon;
- The entity seeks (or indicates an intention) to circumvent any restrictions on optional calls through on-market repurchases, or there are reasonable grounds to believe that the entity could do so in the future; and
- Any information indicates that the hybrid security, or a similar replacement security, will not remain a sufficiently permanent feature of the entity's capital structure.

12. In addition to assessing management intention by reviewing a management's behavior and policies, we believe that intention can be reinforced through contractual terms that are clear, concise, and certain. For example, we consider the implications of a replacement capital covenant (RCC) executed on or prior to the issuance of the hybrid instrument to be more predictable than those where issuers commit to a future execution of an RCC. Likewise, the fewer (if any) and more limited in scope the call options or carve-outs are under an RCC, the more our view that a company's intention to maintain a hybrid capital instrument or replace it with instruments, including common stock, of at least similar equity classification is reinforced. We would generally have a neutral view on calls or carve-outs relating to loss of deductibility of distributions for: corporate income-tax purposes; a change of accounting standards resulting in a change of the equity classification of the instrument; or a change in rating agency methodology leading, upon the adoption thereof, to a weaker equity-content classification. Provisions that seek to capture a wider range of circumstances would, in our view, weaken the permanence expectation. See "Criteria Clarification On Hybrid Capital Step-Ups, Call Options, And Replacement Provisions", Oct. 22, 2012, for more details on the role of RCCs for intermediate equity content hybrids.

13. Such qualitative assessment of management intentions regarding the issue's permanence is undertaken over the life of the instrument and could therefore lead to a reassessment of the equity content after the security has been issued.

B. Hybrid capital instrument characteristics consistent with "high" equity content

14. With the exception of mandatory convertible securities that are convertible into common equity in line with the section "High Equity Content Due to Mandatory Convertibility" in "Hybrid Capital Handbook", published on Sept. 15, 2008 and instruments strategically held by a group entity or by a government, a hybrid capital issued by a corporate entity or by a North American insurance holding company would be assigned "high" equity content only if all of the following conditions in this paragraph apply, and the conditions in either of ¶¶15 or 16 apply:

- There are no indications of a lack of management intention to ensure that the instrument will absorb losses in a time of stress, in terms of both the willingness and capacity to impose losses on investors and to maintain the instrument on the balance sheet (see ¶¶11 and 12).
- The instrument has no stated or effective maturity. Potential redemption risk at the point when the instrument has the minimum residual life consistent with "high" equity content is inconsistent with the permanence expectations for a "high" equity content instrument under our criteria.
- The instrument can only be redeemed or cancelled by the issuer on or after the date falling 10 years after the issue date. Before 10 years, the only call option that is consistent with high equity content is one driven by an external event such as a tax change (only to the extent that such change refers to the deductibility of distributions for corporate income-tax purposes), accounting (only to the extent that the initial equity classification of the instrument were to change) or rating agency methodology change (only to the extent that such methodology change was to lead to a lower equity content than that assigned to the instrument immediately prior to such change). In addition, any tax- or accounting-related calls are acceptable provided there is no reasonable basis for questioning the longevity of the currently applicable Generally Accepted Accounting Principles (GAAP) or tax regime involved.
- The instrument has no step-up or any other equivalent financial incentive to redeem.
- The instrument allows for no more than approximately six months to elapse between the start of the entity's credit deterioration and the day when the trigger for payment deferral has been reached (although actual deferral would only occur on the immediately following payment date) or, in the case of an instrument linked to common shares, the day when interest or dividend payments are reduced.
- If there is a common-dividend stopper feature, we assess that the trigger is only likely to be applied when the

entity's ICR is 'B+' or lower. We believe that otherwise entities would have a significant incentive to repurchase the hybrid instrument, because shareholders might still expect some distributions. "High" equity content does not apply to an instrument with a dividend stopper that allows paying a common dividend in scrip or that refers to the intention of the issuer's board to recommend nonpayment of a dividend at the annual general meeting in the wake of a hybrid deferral. For subsidiary and government-related entity (GRE) issuers with common dividend stoppers that could trigger when the ICRs exceeded 'B+', the "high" equity content classification might still apply if we believe the controlling parent or government would be comfortable with the stopper.

- The instrument must be subordinated in liquidation to all senior obligations of the entity or the entity's guarantor.

15. In addition to having the features outlined in ¶14, an instrument can also be eligible for "high" equity content if it has a mandatory deferral feature based on a set trigger (or combination of triggers), with the trigger (even if not directly linked to the rating) set to activate within three notches of the entity's ICR. However, an investment-grade entity might be under pressure for reputational reasons to redeem or call an instrument to avoid deferring on the coupon. We would then assess the instrument as not being sufficiently permanent if the trigger were set at a level whereby the entity could still be considered investment grade. Consequently, we do not consider the equity content as "high" on the basis that a mandatory deferral feature for issues of entities rated 'A-' or above.

16. In addition to having the features outlined in ¶14, an instrument can also be eligible for "high" equity content if it has a mandatory deferral feature that is linked to a reduction in common dividends, and more precisely to a decrease from the most recent peak in common dividends rather than to the common dividend level at the time of issuance. In this way, deferrals account for potential dividend increases between the issue date of the securities and the point of deferral. (See ""High" equity content through linkage to common shares" in the "Equity Content Categories" section of the Hybrid Capital Handbook, Sept. 15, 2008)

C. Clarification on hybrid capital instrument characteristics consistent with "intermediate" equity content

17. We recognize that the incentive to redeem may also extend to an intermediate equity content hybrid capital instrument at the point when it loses its partial equity treatment. However, the incentive is less when the equity content and its effect on calculated metrics is only half that of a "high" equity content security. Even an instrument with an expected maturity date is eligible for intermediate equity content as long as the residual time to maturity exceeds the minimum standards regardless of any intervening loss of equity credit, if the instrument's other features together with management intent are consistent with the intermediate category. (See the section "Issue Features: Maturities/Scheduled Maturities" in "Hybrid Capital Handbook: 2008 Edition", Sept. 15, 2008, for details of the residual maturity standards by rating category).

RELATED CRITERIA AND RESEARCH

- Criteria Clarification On Hybrid Capital Step-Ups, Call Options, And Replacement Provisions, Oct. 22, 2012
- Standard & Poor's Ratings Definitions, June 22, 2012
- Hybrid Capital Handbook: September 2008 Edition, Sept. 15, 2008
- 2008 Corporate Criteria: Rating Each Issue, April 15, 2008
- Credit FAQ: Knowing The Investors In A Company's Debt And Equity, April 4, 2006

These criteria represent the specific application of fundamental principles that define credit risk and ratings opinions. Their use is determined by issuer- or issue-specific attributes as well as Standard & Poor's Ratings Services' assessment of the credit and, if applicable, structural risks for a given issuer or issue rating. Methodology and assumptions may change from time to time as a result of market and economic conditions, issuer- or issue-specific factors, or new empirical evidence that would affect our credit judgment.

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