Hybrid Instruments: Equity Credit and Notching Criteria

Rating Criteria

Scope of the Criteria

Lianhe Ratings Global Limited ("Lianhe Global") applies the hybrid instruments criteria to general corporates, banks and non-bank financial institutions ("NBFIs"), and may also apply the criteria to other types of institutions. Although the principles are generally the same across sectors, the treatment of hybrid instruments and notching of credit ratings may vary to reflect sector-specific characteristics and other features.

The criteria do not represent a comprehensive coverage but only address key rating factors to form our credit opinions. We may revise the criteria when we deem it necessary.

Overview

The criteria explain our key considerations to assess the features of hybrid instruments and other similar instruments other than ordinary senior debt, and the likely effects of these instruments on the credit profile of rated entities primarily via the assignment of equity credit. We also apply the criteria to determine how to rate these instruments by notching from the issuer's global scale Long-term Issuer Credit Rating ("LTICR").

Hybrid instruments usually have both debt- and equity-like features. We access the features of hybrid instruments mainly focusing on its effective maturity, coupon payment omission or deferral, seniority ranking and other covenants which may provide more financial and liquidity flexibility compared with ordinary senior debt. We grant equity credit of 0%, 50% or 100% based on our assessment of these elements and consider its impact on the issuer's credit profile.

A hybrid instrument with strong equity element can enhance the capital strength of the issuing entity and may benefit its credit worthiness. However, such instrument qualifying for equity credit usually has lower recovery prospect in liquidation or bankruptcy compared with senior debt due to its subordination status and usually rated at least one notch below the issuer's LTICR. Wider notching will be applied if we consider that the instrument has poor recovery prospect. Further notching will also be considered for non-investment-grade issuers given the lower certainty for continuous coupon and principal payments compared with investment-grade issuers. In addition, wider notching will be deployed if the issuer's LTICR benefits from external support and we consider that the support will unlikely extend to the hybrid instrument.

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Key Features of Hybrid Instruments for Equity Credit

Hybrid instruments usually have both debt (regular coupon and principal payment) and equity characteristics falling between ordinary senior debt and ordinary shares, such as subordinated debt, perpetual debt, and preferred stock. Due to the differences in certain provisions, some hybrid instruments have greater equity elements and some have more debt. The equity nature usually refers to the characteristics similar to ordinary shares, which mainly include long maturity or no maturity, no mandatory requirements for continuous payment, and lower order of priority in claims.

A hybrid instrument with strong equity element can enhance the capital strength of the issuing entity and may benefit its credit worthiness. Under normal circumstances, we grant equity credit of 0%, 50% or 100% based on our assessment of the aforementioned key elements and consider its impact on the issuer's credit profile. We may also consider other covenants, such as equity conversion, events of defaults, etc., which may affect our assessment of equity credit.

Effective Maturity

The equity element of a hybrid instrument usually increases as the maturity increases. In general, we consider granting equity credit for a hybrid instrument with a remaining effective maturity of more than five years, meaning that an instrument with an effective maturity of 10 years is only granted equity credit during the first five years from the issue date. A hybrid instrument with a remaining effective maturity of 5-30 years or more than 30 years would usually be qualified for 50% or 100% equity credit, respectively.

Callable with Coupon Step-up

Certain terms may affect the effective maturity of a hybrid instrument, such as the call option. We usually consider the call option together with a coupon step-up mechanism, if any. In general, we consider that the call date as the effective maturity date with a coupon step-up of greater than 1% as we believe that the issuer has a strong incentive to exercise the redemption right to avoid higher interest cost.

Coupon Payment Omission or Deferral

One of the key features makes hybrid instruments closer to equity is the coupon deferral mechanism - the issuer may defer or cancel the coupon payments either at its discretion or with mandatory triggers. To avoid the damage of the issuer's reputation and potential negative reaction of the capital market, we believe that the company management is less willing to delay or cancel interest payments on hybrid instruments compared to reducing or cancelling ordinary dividends of common equity unless in case of financial distress or when the mandatory deferred conditions appear.

Mandatory or Optional Deferrals

The trigger conditions of coupon payment deferral can be divided into mandatory or optional deferrals. The strength of equity elements usually depends on the length of time can be deferred and how easy of the deferral mechanism can be activated. A hybrid instrument may receive high equity credit if it carries optional coupon deferrals (at least five years) at the issuer's full discretion or mandatory deferrals with tight triggers that can be breached well in advance of a company default.

Cumulative or Non-cumulative

Cumulative deferral mechanisms exist when deferred interests are due to investors as a whole when the issuer starts to pay the interests again. We believe that cumulative hybrid instruments are less equity-like than non-cumulative hybrids, which allow omission of coupons. In general, no more than 50% equity credit would be assigned for cumulative hybrid instruments.

Seniority Ranking

Hybrid instruments which qualify for equity credit are typically subordinated instruments ranked below all senior creditors in terms of the order of priorities in claims. The instruments

should have low recovery prospect in case of liquidation or winding-up of the issuer. In most cases, we only assign 100% equity credit for hybrid instruments which are subordinated to all other types of debt and only senior to common equity.

Other Considerations

Mandatory or Optional Convertible

In terms of the convertible attributes of hybrid capital instruments, we distinguish them into optional conversion and mandatory conversion. We consider that an instrument with mandatory conversion into equity can increase the issuer's financial and liquidity flexibility by reducing interest and principal payments. The closer the conversion date is set, the greater the equity credit can be granted. On the other hand, we consider that optional conversion generally has neutral impact on the equity credit assessment.

Material Covenants or Constraints

We also assess any structural features or covenants of a hybrid instrument which may reduce the instrument's loss absorption capacity and constrain the issuer's financial flexibility. A hybrid instrument may not receive any equity credit if the terms of the instrument include acceleration of repayments of the hybrid instrument or events of defaults or cross-defaults that could trigger a company-wide default or liquidity need.

Regulatory Considerations for Banks and NBFIs

For regulated banks and NBFIs, we usually assign 0% equity credit to the hybrid instrument that is not included in regulatory capital. In jurisdictions where the regulators have no clear view on a specific hybrid instrument, we will base on our assessment of the likely regulatory policy with respect to the instrument.

	Debt Like	**Equity Like**
Effective Maturity	<=5 years	
Coupon Step-up	Callable within the next 5 years and aggregate coupon step-ups >=100 bps	
Coupon Omission/Deferral	Optional deferral with constraints; mandatory deferral with low triggers	Optional deferral (at least five years) with full discretion; mandatory deferral with tight triggers
Settlement	Cumulative	Non-cumulative
Seniority Ranking	Senior	Junior
Other Considerations	Exclusion from regulatory capital	Mandatory convertible, no acceleration rights, no event of defaults/cross-defaults

Notching from Issuer Rating

We usually assess the loss recovery prospect of a hybrid instrument compared with senior unsecured debt. The number of notching down from the issuer's LTICR for the issuance rating of a hybrid instrument mainly reflects the instrument's claim order and loss severity.

A hybrid instrument is typically rated at least one notch below the issuer's LTICR due to its subordination status. Additional notching will be applied if we consider the instrument has poor recovery prospect due to coupon omission or deferral and/or easy to activate the trigger for loss absorption or equity conversion. For regulated banks and NBFIs, we may consider the instrument has poor recovery prospect if it is classified as a regulatory Tier 1 or Tier 2

instrument and/or it has a mandatory loss-absorption trigger that is linked to a specific regulatory capital ratio. The loss recovery prospect is usually poor for non-investment-grade issuers given the lower certainty for continuous coupon and principal payments compared with investment-grade issuers. Therefore, we may consider widening the notching for non-investment-grade issuers.

Minimum Number of Notching Down from the Issuer's LTICR

	Investment Grade	Non-Investment Grade
Subordination	1	1
Poor Recovery Prospect	1	1-2

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