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# *SVO Special Report*

## *Hybrid Securities*

May 21, 2007

### Applying Classification Methodology, Examples of Deferral and Default

*This is the fourth in a planned series of five articles discussing the classification process developed by state insurance regulators in 1994, and how it is applied to hybrid securities (sometimes hereinafter referred to as equity content or high equity content securities). This article reviews SVO experience in classification of hybrid securities over the past 10 years. It focuses on both the development of securities with higher equity content and the classification implications for such securities. The fifth article discusses synergistic analysis in the context of actual examples and will be published on the NAIC website on May 29.*

*These articles were given to the Task Force for review and comment prior to their publication.*

#### **1. MECHANICS OF APPLYING CLASSIFICATION METHODOLOGY TO HYBRID SECURITIES**

In a previous article, the “investor expectations and rights” traditionally associated with debt, preferred, and equity instruments were identified. The classification analysis of hybrid securities, which often combine features of all three asset classes, must extend beyond a simple cataloging of the terms of the indentures to evaluate how the hybrid would perform in a dynamic environment. Application of the process involves two distinct steps — a determination of the predominant characteristics of the hybrid security, followed by a synergistic analysis.

The analysis starts with a review of the terms of the agreements that govern the security; and a comparison of the rights held by the investor and the issuer to the classification benchmarks. There may be, and frequently are, contractual provisions in the documents that do not correspond, or correspond only loosely, to features in the profiles. These unique features are also evaluated as part of the classification procedure.

Following the analysis of the documents, the analyst then makes a preliminary determination of the securities predominant characteristics. The conclusion could be that the predominant characteristics are weighted toward one of the profiles; or that the security has features that are split among two or three profiles. Especially in the latter case, the next level of analysis requires a comprehensive evaluation of how the various clauses, features, and provisions in the agreements are likely to interact. Both favorable conditions, as well as distress scenarios are examined. The analyst considers the significance of the different provisions to arrive at an overall, or synergistic, determination of the true economic nature of the transaction. For example, the terms and degree of subordination in the hybrid security in question could affect the right to receive payment in priority to another security in the issuer’s capital structure.

*(Continued on page 2)*

# Applying Classification Methodology, Examples of Deferral and Default (Continued)

## 2. CLASSIFICATION ANALYSIS OF TRUST PREFERRED SECURITIES

The SVO classified Trust Preferred securities when they were first introduced.<sup>1</sup> The structural aspects of earlier offerings tended to differ in some ways, but converged and became substantially similar as the market matured. The typical Trust Preferred security became therefore largely homogenous — utilizing an almost identical structure. The common structure would start with creation of two (although sometimes just one) special purpose trusts. What follows uses the two trust structure as an example. The first trust sells a Trust Preferred security to investors and uses the funds obtained to purchase a security from a second special purpose trust. The second special purpose trust uses the proceeds of its own issuance to purchase a subordinated debenture of an issuer (usually a financial institution), who is the intended beneficiary of the structure. The terms of the security purchased by the first trust essentially mirror the terms of the security purchased and held by the second special purpose trust. Under the indenture, if and when the issuer made payments to the second special purpose trust, these payments were transferred to the first special purpose trust, providing the first trust with the cash-flow to make the promised payments to the investors.

The trust preferred security purchased by the investors had a maturity of up to 30 years. It promised the investor payment of dividends and a specified liquidation value at maturity. Under the terms of the security issued to the second special purpose trust, the issuer had a contractual right to defer dividends for up to 5 years at a time. This right was mirrored in the contract issued by the second trust to the first trust. If the issuer elected to defer interest payments on the subordinated debenture, interest continued to accumulate during the deferral period. In this case, the hybrid security would suffer the same fate-deferral of dividends and accumulation of unpaid dividends. Also upon deferral, a dividend stopper provision prevented the issuer from paying dividends on its common or other equity securities. Non-payment of the accumulated deferred dividends at the end of the deferral period would trigger a default, enabling the trustee holding the subordinated debt to accelerate the obligation. In the event of the ultimate issuer's insolvency the documentation showed: a) clear, but limited, creditors' rights in bankruptcy; and b) a clear right for the preferred investor to receive a stated liquidation value before common investors were to receive anything. Typically, however, these Trust Preferreds were subordinated to all of the ultimate issuer's debt securities and junior to traditional preferred stock; but were specifically senior to common stock.

Trust Preferreds allow for a 5 year dividend deferral period. This provision clearly offers less protection than traditional preferreds, but other factors tend to counteract this feature. For example, for these hybrids, deferral does not eliminate the ultimate obligation to make Trust Preferred dividend payments. The issuer, if unable to make payments after the deferral period, faces the risk that the preferred investors would prompt the property trustee to accelerate the subordinated debenture. Moreover, the issuer's common stockholders, their dividends stopped as a result of Trust Preferred dividend deferral, can exercise their rights to take steps to get dividends reinstated. Such contractual provisions act to limit issuer management discretion to defer subordinated interest and thus preferred dividends. In some cases, the indenture or the regulatory requirements contained a trigger based on capital ratios, suggesting that this would be the only case the issuer would defer trust dividends.

The SVO has typically classified Trust Preferred securities, such as illustrated above, as redeemable preferred stock. The SVO's rationale is that the structure and accompanying contract terms provide strong protections consistent with the profile for preferred, because issuer management must take several difficult strategic actions prior to payment deferral. Classification analysis of other types of hybrids does not always yield such consistent outcomes. Notable among these is a type of hybrid issued by a non U.S. bank, known as Yankee Tier 1s, which are prevalent enough to address in greater detail in the following section.

## 3. CLASSIFICATION OF YANKEE TIER 1S

Foreign issues of U.S. dollar denominated debt are called "Yankee" issues. Tier 1 Capital is considered to be permanent capital, according to the nomenclature employed by bank regulators around the world. Hence, Yankee Tier 1 securities are those issued by European or Japanese (typically) banks or bank holding companies as U.S. dollar denominated obligations. Non U.S. banks have issued Tier 1 hybrids in their native currency, although these are less frequently seen in insurers' portfolios. Tier 1 hybrids issued by U.S. banks are also sometimes seen in insurers' portfolios.

The first Yankee Tier 1 hybrid issues date from the early period of hybrid issuance. Some of the "classic" Trust Preferreds were, in fact, Yankee Tier 1s. As hybrids have evolved, so have Yankee Tier 1 hybrids, and are representative of the types of innovations the NAIC has

*(Continued on page 3)*

<sup>1</sup> The first guidelines were adopted in October 1996. The current guidelines were adopted on October 5, 1999, effective as of January 1, 2000.

# Applying Classification Methodology, Examples of Deferral and Default (Continued)

seen in this area. The newer generation of Yankee Tier 1s are usually perpetual — even in transactions that carry the title “debt”. Unlike the typical Trust Preferred securities discussed in section 2, the structures are different from one another and can be quite complex. For example, periodic interest or dividend payments are more typically non-cumulative. There are either no deferrals, because payment is due only if the issuer’s Board actually declares a dividend; or deferrals are open-ended (mandatory or optional). Permitted deferrals, or the Board’s failure to declare a dividend, do not trigger the right to declare an event of default or to accelerate payment.

The greatest obstacle to obtain classification of this type of hybrid as preferred is the relative lack of protective elements consistent with the preferred stock profile. Importantly, a bank’s Tier 1 capital is deeply subordinated. Considering it part of the bank’s permanent capital, the regulator has the right to pay structurally or contractually senior issues, relying on Tier 1 capital, if the issuer’s net asset value falls below the threshold. Issuer management has greater incentive to make allowed deferrals (or not declare the dividend) due to the hybrid’s non-cumulative features; dividend stoppers that are weak or lacking; and limited or no voting rights.

In the most recent assignment conducted for the New York Insurance Department (NYID), the observed trend in the documentation of Tier 1s was away from contractual protections and toward greater issuer discretion. These discretionary features - the much greater degree of subordination, the shift to perpetual maturity, non-cumulation of dividends, the inability to call an event of default and accelerate after the end of a defined deferral period — represent significantly less contractual protection compared to Trust Preferred securities. In the sample of Tier 1s reviewed by the SVO as part of the classification assignment conducted for the New York Insurance Department in 2006, the SVO classified 12 as perpetual preferred, and 17 as more common like.

## 4. CLASSIFICATION OF DEBT-EQUITY HYBRIDS<sup>2</sup>

Hybrid issuance has historically been popular with banks, and other financial institutions. Debt-Equity Hybrids are increasingly popular with corporate issuers of all types, including industrial companies. Just as Yankee Tier 1s differ from Trust Preferred Hybrids, Debt-Equity Hybrids have important differences from the Tier 1 issues. Also like the Yankee Tier 1 issues, Debt-Equity Hybrids differ from transaction to transaction. Some of these important differences include:

- Where Trust Preferred securities have a stated 30 year

maturity, and Tier 1s are typically perpetual, Debt-Equity Hybrids can have lives as long as 60 years — essentially equivalent to perpetual.

- Where Trust Preferred securities trigger contract rights at 5 years, and Tier 1s may never do so, debt equity hybrids can provide for deferrals of as long as 12 years before the investor would be able to exercise any protections provided in the structure.
- Some Debt-Equity Hybrids provide for cumulative dividends, but most do not.
- Those that provide for dividend accumulation during deferral also provide that failure to pay accumulated dividends at the end of the deferral period is not an event of default and provides no right to accelerate.
- For some Debt-Equity Hybrids, the only obligation of the issuer to raise funds to pay any accumulated dividends, is to try to sell equivalent or junior securities (another hybrid or common stock).

The SVO considers this last provision to be very weak creditor protection since it would be unlikely that an issuer in financial distress will be able to raise funds through the issuance of hybrids or common stock. As in a Tier 1 Hybrid, default and acceleration in a Debt-Equity Hybrid can only occur in the case of the issuer’s insolvency. Due to the nature of Debt-Equity Hybrids (i.e. loss absorption), they are likely to delay the issuer’s insolvency, meaning the Debt-Equity Hybrid’s value will be depleted before insolvency or default on senior obligations.

The result of these contractual provisions, as far as classification analysis is concerned, is to introduce the risk of **asset dissipation** – that the issuer’s going concern value will be depleted as it struggles with the financial stress that triggered dividend deferral. This would leave the Debt-Equity Hybrid holder with little meaningful hope of recovery. Here, the contract provisions function in much the same way that common does — to hold the hybrid investor in the issuer’s capital structure and exposed to the issuer’s enterprise risk.

## 5. EXAMPLES OF HYBRID DEFERRAL AND DEFAULT

Two companies, Consec Inc. and Fleetwood Enterprises Inc., used the deferral mechanism in their hybrid securities to aid liquidity during a period of unusual stress. In both cases, the Hybrid’s market price reacted earlier and deeper to the negative credit developments than senior debt. (By definition, NRSRO ratings do not take into account “market price risk”, while the classification analysis, done

*(Continued on page 4)*

<sup>2</sup> Debt-equity hybrids are an iteration of hybrid securities that were first issued late in 2005.

## Applying Classification Methodology, Examples of Deferral and Default (Continued)

for RBC purposes, attempts to reflect these concerns.) Conseco is an insurance holding company and Fleetwood is a maker of recreational vehicles and manufactured housing. Interestingly, the severe stress that prompted both deferrals stemmed from large, unanticipated losses in both firms' sub-prime loan portfolios – the financial services side of their businesses – coupled with the difficult economic environment of 2000 and 2001.

Conseco Inc. issued, through five trusts, Trust Originated Preferred Securities (SM) (TOPERS) and similar hybrids over 1996-1998 for proceeds that totaled \$1.9 billion. Below, the effects of Conseco's developing financial stress on two securities are reviewed: The \$500 million, 8.7% TOPRS due September 30, 2028, issued in August 1998 with a liquidation value of \$25 per share, originally rated BBB- by Standard & Poor's and "ba2" by Moody's, and the \$800 million 8 ¾% senior notes due February 2004, issued February 2000 and originally rated BBB- by Standard & Poor's and Ba3 by Moody's. (Price histories are available for both issues and shown in the two graphs on page 6.)

Conseco's financial stress and eventual bankruptcy filing were widely attributed to its 1998, \$6 billion purchase of Green Tree Financial Corp. — a provider of financing for manufactured homes, home equity and similar products that targeted the sub-prime market. On March 31, 2000 Conseco announced its intention to take a \$350 million charge against 1999's earnings and put its Conseco Finance Corp. unit (formerly Green Tree) up for sale. Reportedly, the loss stemmed from interest only bonds held by Conseco Finance. As illustrated by the charts on page 6, the 8.7% Hybrid traded at or near its \$25 liquidation value until August 1999, when its price started to slide, along with Conseco's common stock value, as concerns began to mount over Conseco's ability to turn around Conseco Finance. On the other hand, the February 2000-issued 8 ¾% bonds, with nearly the same coupon as the Hybrid, traded at or near its par value until the March 31, 2000 announcement. Clearly, the Hybrid's price began to react to credit deterioration months before the bond price did. Following the announcement, the Hybrid's value fell dramatically compared to the bond. From the beginning of March 2000 to June 2000, the Hybrid's price fell from about \$20 to \$10 per share — a 50% drop — while the bond fell from 100 to about 65 — a 35% decline. *Recall that, prior to March 2000; the Hybrid's market value had already declined 20%.*

Over the next year, Conseco made several positive moves to enhance its access to financing and improve liquidity. The Hybrid's price improved to slightly over \$20 per share by July of 2001 while at the same time the bonds rose in

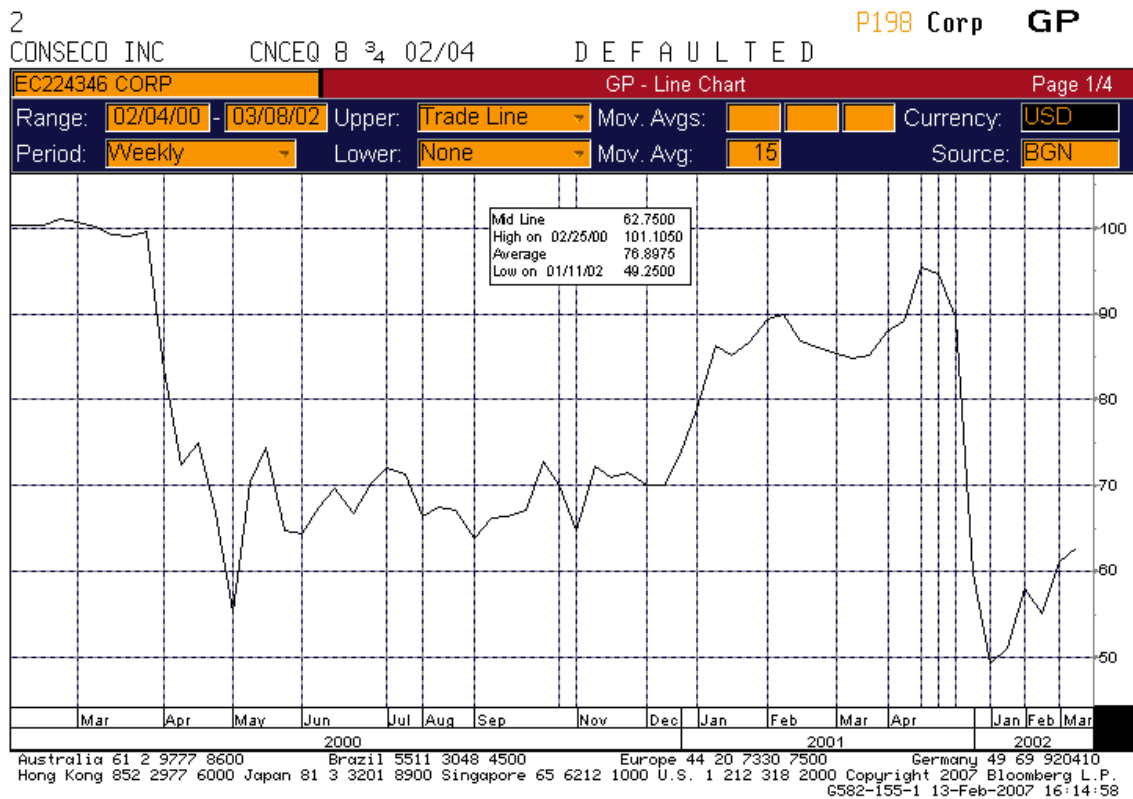
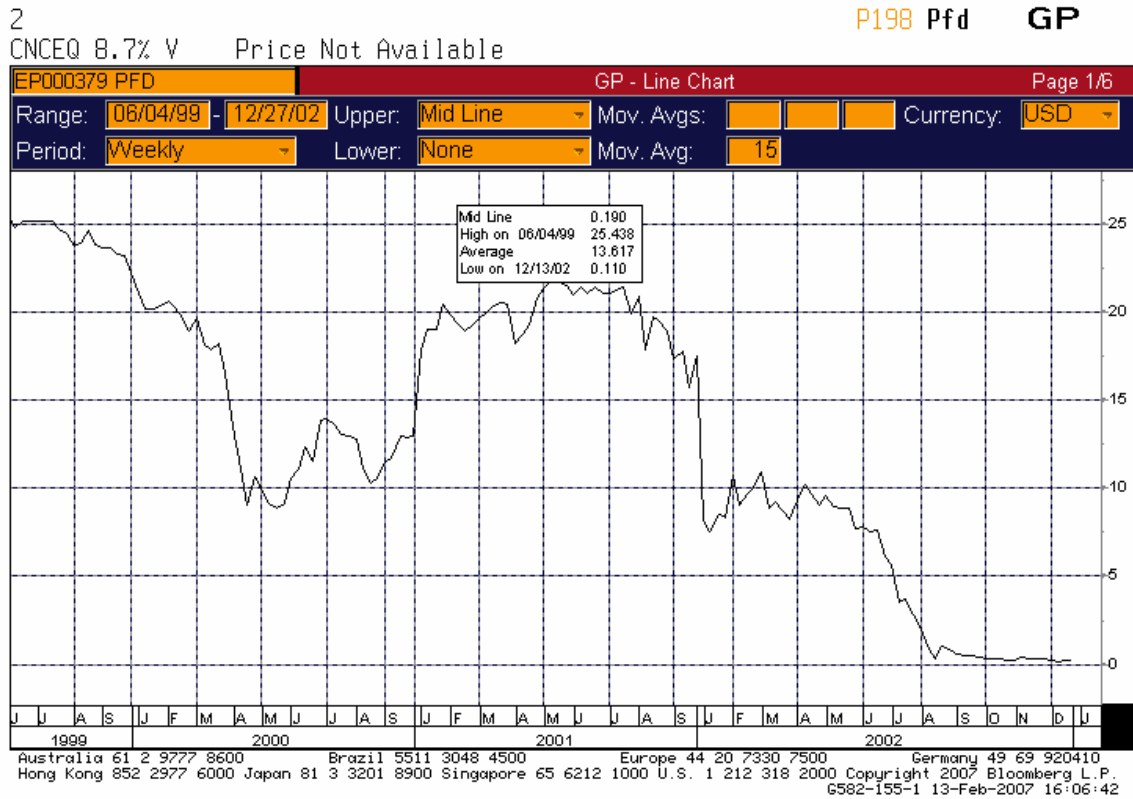
value to nearly 95. Nonetheless, concern mounted over the firm's ability to meet its heavy 2002 debt maturities. Beginning in July 2001, the Hybrid's price began to slide below \$20 to about \$17 in October 2001 while the bonds' price dropped slightly. On October 30, 2001, Conseco announced that it wrote down \$471 million in bonds, mortgage debt, and other assets and recorded its second consecutive quarterly loss. From October 2001 to January 2002, the Hybrid's price fell 47% from about \$17 to about \$9 while the bond dropped 44% from 90 to 50. Over 2002, the Hybrid's price struggled and then from June 2002 to the end of July 2002 fell from nearly \$8 to slightly above zero at the start of August 2002. Once more, the Hybrid's price reacted to credit concerns prior to the bonds. On August 9, 2002, the firm's Chairman announced that the turnaround had failed and it would not make bond interest payments. Fitch ratings announced that a dividend deferral on the preferred securities "is inevitable." The Hybrid's market value fell to nearly zero. The bond gained in value until March 2002 (trade data was not available to us after that date).

Conseco Inc. filed for creditor protection under Chapter 11 on December 18, 2002. When it emerged the following year, September 10, 2003, the unsecured note holders received new common stock and a projected recovery of about 42%, according to Conseco. The Hybrids, however, received common and warrants with a projected recovery of only 1.27%.

Fleetwood Enterprises Inc's experience was not nearly as dramatic as Conseco's—it did not file for creditor protection-but the company did defer dividend payments on its Hybrid. In this case, Fleetwood Enterprises, via Fleetwood Capital Trust, issued on July 9, 1998 6% Convertible Trust Preferred Securities due February 2028 with a liquidation amount of \$50 for total proceeds of \$287.5 million. The issue's structure is similar to the typical hybrid described above, with preferred dividends deferrable for up to 20 quarters. Similar to Conseco, this firm began to experience credit problems with its manufactured housing business over 2000 due to economic weakness. During 2000, the Hybrid's price traded below its \$50 par to as low as \$18 (see chart on page 8). The data on the chart is incomplete since the issue does not trade often. However, at the start of December 2001, the issue traded at \$48.625. Then, on December 6, 2001, Fleetwood Enterprises announced that it would defer the Hybrid's preferred distributions "for at least the following few quarters". Common dividends were also halted. In early January 2002, the company accepted \$86.25 million par amount of the Hybrid for \$37.95 million par amount of

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# Applying Classification Methodology, Examples of Deferral and Default (Continued)



# Applying Classification Methodology, Examples of Deferral and Default (Continued)

9.5% convertible trust securities due 2013, another Hybrid. This exchange implied a 44% recovery of the Hybrid's par amount, ignoring the higher dividend rate and shorter term. The Bloomberg chart on page 8 indicates that the Hybrid's price fell 65% from the December 2001 level to \$17 in April 2002, despite the exchange. In July 2005, Fleetwood attempted another exchange offer for the Hybrid, but terminated the offer and in November 2005 issued common stock privately in an amount necessary to pay all accumulated and unpaid Hybrid preferred distributions. The price of the Hybrid hit its high of \$53.81 in October 2005 and traded at or about \$50 for the next three months. On January 19, 2006, the company announced its intention to pay previously deferred dividends, totaling 17 quarters, as well as the associated interest and the current distribution for February 15, 2006. The company could therefore again defer dividends for another maximum period.

In Fleetwood's case, the deferral feature accomplished its goal — the company was freed from dividend payments on the Hybrid during a time of stress, although its stockholders had to share the pain in the form of the dividend stopper. While Fleetwood had no bonds outstanding at the time, the rating history (Figure 1) illustrates the marked difference in credit quality between senior "issuer" rating and the rating on the deferred Hybrid.

## 6. CONCLUSION

Innovation is a fact of life in the capital markets. The characteristics of hybrid securities, in their evolution from Trust Preferred to Yankee Tier 1, Debt-Equity Hybrids and beyond are evidence of how fruitful financial innovation can be. Investors can benefit from the higher yields that hybrid securities can offer. Issuers can benefit as well, from increased access to low cost, tax efficient capital. It is important, however, for investors, especially insurers (who act on behalf of their policyholders) to fully understand the

**FIGURE 1. FLEETWOOD SENIOR DEBT & HYBRID RATING HISTORIES**

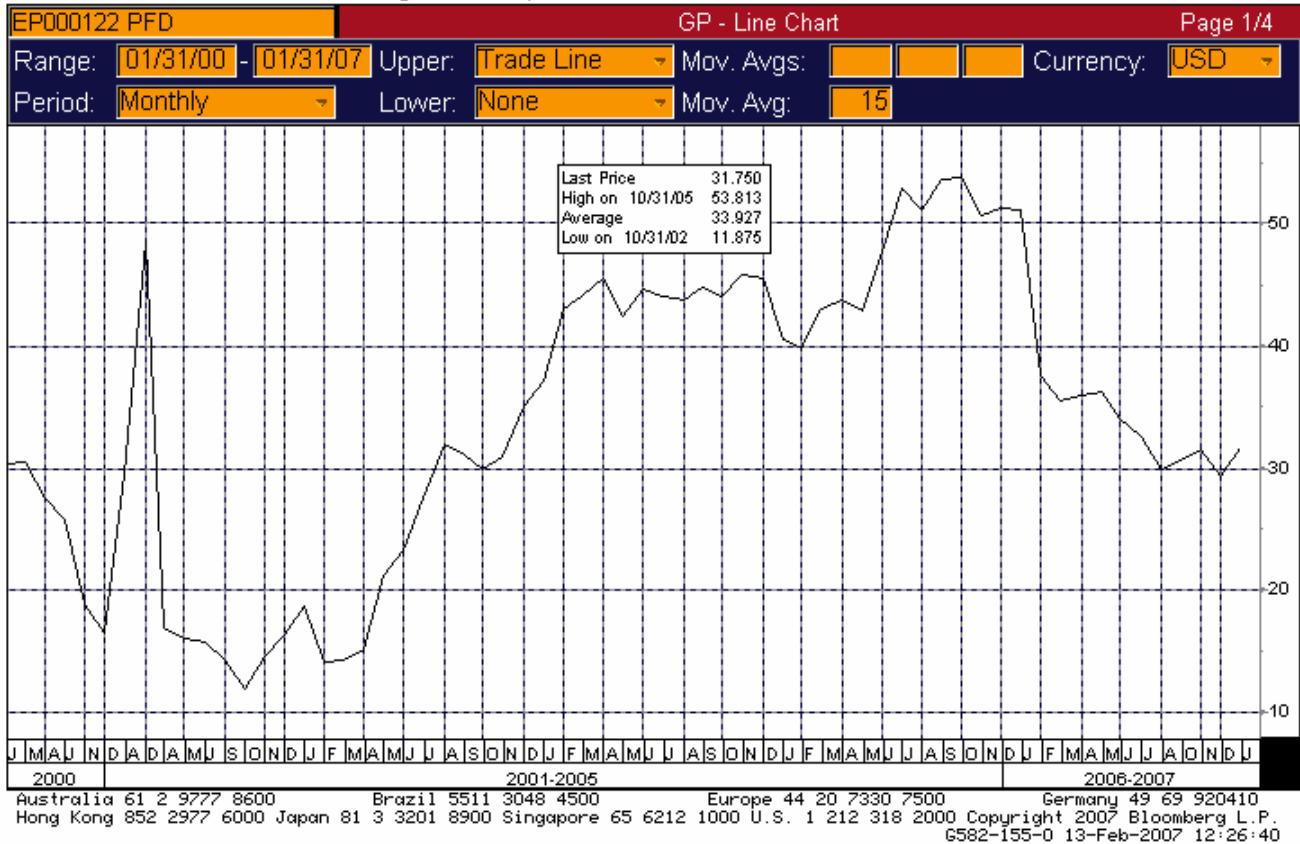
Date	S&P		Moody's	
	Fleetwood Enterprises Inc.	Fleetwood Capital Trust I	Fleetwood Enterprises Inc.	Fleetwood Capital Trust I
1/22/98				"baa3"
2/3/98	BBB+	BBB+		
2/23/99	BBB+	BBB-		
10/25/99			Baa2	
4/7/00				"baa3"
10/20/00			Ba1	"ba3"
3/1/01	BB+	B+		
2/26/01			B1	"b3"
7/27/01				B3
11/16/01			B2	Caa3
12/6/01	BB-	D		
7/20/05	B+			
7/21/06	B+	CCC+		
9/22/06			B3	Caa2

Source: S&P and Moody's web sites; Bloomberg

risks, and how those risks, inherent in hybrid securities may evolve in a dynamic market. In this article those risks, embodied in contractual rights and investor expectations, were highlighted from both the analytical and the market perspectives. In a benign credit market, such as we have enjoyed for the last few years, features of hybrids meant to protect senior creditors may not be put to the test. Past examples, however, demonstrate that hybrid securities do indeed exhibit equity-like characteristics in times of financial distress. Classification analysis for purposes of RBC allocation is designed to address these concerns.

# Applying Classification Methodology, Examples of Deferral and Default (Continued)

FLE 6% \$ C **32.625** **-.475** V --x-- EXCH Pfd GP  
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**In both cases, fluctuation in price conveyed the market's sense of increased risk of deferral, relative to their sense of the risk of default on the senior obligations of the issuers.**



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