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# SVO Special Report

## Hybrid Securities

May 29, 2007

### Case Studies of the Application of Synergistic Analysis

*This is the last 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 discusses synergistic analysis in the context of actual examples.*

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

#### 1. INTRODUCTION

This article focuses on actual transactions classified by the SVO. Its intent is to show the manner in which the classification was conducted and the factors that influenced the classification category that was assigned. To protect any proprietary interest the issuer or its representatives may have, any language that would tend to describe the parties or the name of the transaction has been removed.

#### 2. CASE STUDIES

##### a. Case A

**Security Characteristics:** The security is perpetual. The contract promises the investor regular dividends every six months in perpetuity but such payments need not be made if funds are not available to pay shareholders. In addition the documents do not provide for a return of principal unless the issuer redeems the security with the consent of the relevant foreign financial regulators. Upon the occurrence of certain events discussed below, the investor also agrees to exchange the above security (and related expectations) for a second security (and the expectations contained in it). If the conditions for the exchange obligation are triggered, the investor's perpetual preferred security is exchanged for the issuer's conditional securities which are perpetual and non-cumulative. The sole condition for such an exchange is a vote of shareholders to avoid entering liquidation.

This second security, called a conditional capital contribution, makes clear the issuer is not under an obligation to make any dividend payments and that the issuer can continue to pay dividends to common even when it cannot pay dividends on the exchange or second security. The investor lacks any rights to influence management. Further, the security contains a clause that provides that if the issuer is in financial distress, the issuer's shareholders (cooperating with the foreign regulators) may decide that all principal pertaining to the subject securities may be utilized to absorb losses without allowing the holder of the capital contribution security to declare a default, demand payment, or even force a liquidation or bankruptcy.

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## Case Studies of the Application of Synergistic Analysis (Continued)

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**CLASSIFICATION ANALYSIS:** Under the guidelines:

The contractual promise was deemed to be junior to all debt and generally senior to common. However, typically, when this feature is considered in context of a security that lacks in certain circumstances, the priority over common is reversed so that the issuer's common dividends may be paid while these securities remain unpaid. When these two contractual provisions are viewed together, this component of investor expectations was deemed to be more closely associated with the profile for common.

The investor has no voting rights, a feature typically viewed as a characteristic of debt when debt-holders protections exist. However, when this feature is considered in context of a security that lacks typical debt-holder protections, the lack of voting rights is seen as more closely associated with the profile for common. The investor has no expectation of profit participation which is associated with the debt or preferred profiles. Under the terms of the contract, dividends are non-cumulative and under certain circumstances common dividends may be paid while this security remains unpaid. We reconciled these various attributes as more closely associated with the common profile.

Payments are scheduled but become non-cumulative upon a conversion. A literal reading is that scheduled payments are associated with the preferred profile. However, the fact that payments are not mandatory can suggest common since common is associated with payments as (and if) declared. Non payment is not an event of default and the contract permits the issuer to continue to make dividend payments to common stock during the deferral period (thereby ranking the distribution to these securities as junior to common stock). Taken together this characteristic is viewed as most closely reflecting the common-like profile.

With respect to maturity, the security is perpetual and although it provides for the possibility of redemption, the redemption is at the option of the issuer and subject to foreign regulator approval. Redemption would likely only occur in bankruptcy or at the direction of the foreign regulator. This characteristic was viewed as most resembling the common profile. The investor's claim is senior to common equity in liquidation, subject to availability of funds. However, the obligor is a large international bank. Such institutions rarely enter bankruptcy or liquidation. Rather, bank regulators take an active role in either "rescuing" or selling the institution. Thus, priority over shareholders in this situation is a chimerical right since bankruptcy or liquidation seldom occur. Absent such an unlikely liquidation, the shift in

priority creates subordination such that it is unreasonable to expect the investor to have a chance at any recovery.

Given the above factors, the classification was common-like.

*b. Case B*

**Security Characteristics:** The securities were issued by a bank holding company. The contract provides that the proceeds of issuance are to be invested in and backed by a portfolio of highly rated short term obligations, such as T-bills and A1/P1 commercial paper. The security itself is perpetual and promises fixed dividend payments every six months for the first five years. Thereafter, the security reverts to floating rate at a specified spread over a benchmark. The issuer also has the option to redeem the security after 5 years. Therefore, the investor expects to receive a fixed return for the first 5 years and then a floating rate return over the life of the investment, unless the issuer redeems. However, under the contract, the trust managing this investment grants the issuing holding company the right to require the trust to purchase a newly issued preferred stock of the holding company issuer in return for the assets then held by the trust. The investor agrees that if and when this happened, it would be subject to the terms of this new security. The new security is perpetual unless redeemed by the issuer with the consent of the regulator. Dividends are non-cumulative, and are not scheduled, but must be declared by the Board. The investor has no rights to assert to influence management.

**CLASSIFICATION ANALYSIS:** Under the guidelines:

Contractual Promise — Junior to all debt and senior only to common stock, a preferred security feature.

Rights — Voting — Lack of voting rights are indicative of debt, but this security offers the investor no typical debt-holder protections, so lack of rights viewed as common like. Profit participation — None: a feature of debt or preferred securities. Periodic Payment — Scheduled but not mandatory, and non-cumulative: Viewed as preferred-like. Non-Payment is not an event of default; Dividends not paid are permanently lost: Viewed as a common-like feature.

Maturity/Redemption — Perpetual; may be redeemed only in bankruptcy or with permission of the regulator. This is viewed as a more common-like security. There is an Involuntary Redemption Claim that is senior to common equity for full liquidation value, subject to availability of funds after payment of all debt and traditional preferred

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## Case Studies of the Application of Synergistic Analysis (Continued)

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obligations. This is viewed as a common like or preferred like feature of the security

The contractual expectation of the investor is clearly that the initial security will be redeemed at the first opportunity. However, the investor has also agreed to the possibility that the holding company will exercise its right to substitute the investment grade portfolio with a perpetual non cumulative asset redeemable only with approval of the regulator. To reconcile these two provisions for regulatory purposes, the SVO is constrained to conclude that contractually speaking, the original expectation is unrealistic. The contract provides that in liquidation, the exchange security is subordinated to the full payment of the holding company's traditional preferred but ahead of common, a feature typically associated with the preferred profile. However, the new security is issued by a holding company and is therefore structurally subordinate to the obligations of all of the operating companies and equal to their bottom most residual level obligation. Accordingly, while the claim status in the holding company hierarchy is preferred like in a strict legal sense; it is actually more akin to common in the economic sense.

The investor has no voting rights which is typically associated with debt but in the absence of debt like protections must be viewed as more closely associated with lower common. The investor has no opportunity for profit participation a feature associated with the debt or preferred profile. The promise to make scheduled payments is non-cumulative which can be associated with either preferred or common. However, when placed in context, that the exchange which creates the non cumulative feature would take place when the holding company was in financial distress; this feature is deemed closer to the common profile.

Periodic payment is scheduled but only prior to the exchange. After the exchange, non payment is not an event of default. Dividends which are not paid are permanently lost since they are non-cumulative. While these characteristics can be associated with the preferred profile, as before, in the context of the financial distress of the holding company that triggered the exchange; the feature is more common like.

As to maturity, the security is perpetual previous to and after the exchange, subject to redemption at the issuer's option prior to the exchange. After the exchange, the security is subject to redemption only in bankruptcy or with permission of the regulator. The conclusion is that this is more consistent with the common profile.

The claim in involuntary insolvency is stated to be senior to common equity for full liquidation value, subject to

availability of funds after payment of all debt and traditional preferred obligations, a feature that can be associated either with the preferred or common profiles.

In light of all the preceding circumstances, this issue was determined to be common-like.

### *c. Case C*

**Security Characteristics:** This perpetual subordinated security was issued by an indirect subsidiary of a non-US financial institution. Ideally, the investor will receive a semiannual distribution for ten years, after which the issuer will redeem the securities at face value. However, the contract does not require these payment streams, which may be stopped by the issuer at its discretion, or when ordered to do so by its regulator. The cessation of cash outflow to these securities would provide relief to the institution in times of financial distress.

The contract allows for principal repayment to be funded only with proceeds from the sale of similar equity-like securities, or upon the institution's bankruptcy/liquidation. Distributions may be suspended indefinitely without interest; the obligation to repay them expires after two years; repayment may not be funded from operating cash flows; no voting rights are bestowed regardless of the length of payment suspension. Dividends to the institution's common shareholders may continue to be paid during this suspension.

**Classification Analysis:** Under the guidelines:

The contractual promise is junior to all debt (including dated and undated subordinated debt) and policyholder obligations; senior only to junior securities (i.e., the institution's common stock): this is a feature associated with preferred stock.

The investor has no voting rights which can be viewed as a characteristic of debt. However, without conventional debt-holder protections, or the contingent voting rights associated with preferred stock, the lack of any voting rights may be viewed as lower-than-common. The investor does not have a right to profit participation, a feature associated with debt or preferred securities. Payments made are cumulative for 2 years only and then viewed as non-cumulative, a feature associated with the most common-like version of a preferred security.

The payment promise is scheduled with the potential for deferral and subject to the additional requirement that the regulator may order non-payment. This feature is associated with the preferred profile. Deferral is not an

## Case Studies of the Application of Synergistic Analysis (Continued)

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event of default, a feature associated with preferred stock. However, the contract provides that common stock dividends may continue to be paid during the deferral period, thereby ranking the distribution to the hybrid securities junior to common stock.

With respect to maturity and redemption, the security is perpetual although it is redeemable at the issuer's option for full liquidation value, a feature associated with the most common-like version of a preferred security.

In an involuntary redemption, the investor's claim is senior to common equity for full liquidation value, subject to availability of funds after payment of all debt and policyholder obligations, a feature associated with a preferred security.

Prominent features include that the security is perpetual, deeply subordinated in the capital structure (senior only to share capital), lacks any events of default, permits unlimited deferral of periodic distributions, the obligation to pay deferrals is cancelled after 2 years and repayment of deferrals must be funded from the issuance of like or junior securities. The transaction lacks protective elements associated with preferred stock. Although the investor enjoys a claim for full liquidation value, the protracted period of financial decline anticipated in the structure implies asset depletion (e.g., assets are sold or pledged to secured lenders, the market value reflect "distress" pricing for assets of a troubled company). This undermines the normal expectation associated with the realization of principal repayment.

In aggregate, the features of this security led to a determination of common-like.

### *d. Case D*

**Security Characteristics:** This Trust Preferred Security ("TPS") was issued by a SPV-type subsidiary of a holding company ("Holdco") of non-financial operating entities. The SPV used proceeds from the TPS issuance to buy Holdco junior subordinated notes. The TPS are structured to be a pass-through/mirror of the notes. Ideally, the investor will receive semiannual fixed rate distributions for 20 years after which the TPS will be redeemed at face value.

However, the contract allows the issuer much flexibility in the payment stream. Periodic distributions may be [optionally] deferred with accrued interest for up to five years. An additional five years of deferrals is allowed as long as Holdco tries to issue capital stock to raise the funds for payment. Also, another seven years of payments could

be suspended if Holdco fails to meet certain financial strength measures. This last deferral is mandatory for as long as the financial levels are breached, and these deferred obligations expire after two years (i.e., five years are non-cumulative). During a deferral period, no dividends will be paid to parity and junior securities. Rights in bankruptcy are senior only to a specified common of Holdco.

There are restrictions, too, on prepaying the TPS: any repurchases within the first 35 years must be funded from sales of like or junior securities. After 20 years, however, the coupon changes from a fixed rate to a floating rate. The latter "step-up" rate is considered, at this time, to be a rich spread.

The step up would only provide an incentive to redeem if (A) there is a favorable market acceptance of similar securities, in general and for the issuer at that time; (B) the spread is still considered "rich," i.e., the issuer's credit spread in twenty years is not wider (due to higher credit risk); and (C) material credit events which prompt optional or mandatory deferrals do not occur.

The TPS contract does not limit corporate financing or operating activity in any way. Investors are fully exposed to event risks such as asset sales, share repurchases, LBO, share distributions, or voluntary restructuring. The contract does not bestow voting rights to holders to compensate for missed distributions.

**Classification Analysis:** Under the guidelines:

The contractual promise is preferred-like in its general specifications: it is subordinated to all Holdco indebtedness, and no dividends may be paid to common stock during a TPS deferral period. However, the 35-year restriction on TPS redemption (it must be replaced with a similar or junior security) is more severe than that for common stock (no ongoing TPS deferral). This imbues the TPS with a more permanent, or common-like, status.

The investor has no voting rights which can be viewed as a characteristic of debt. However, without conventional debt-holder protections, or the contingent voting rights associated with preferred stock, the lack of any voting rights may be viewed as lower-than-common. The investor does not have a right to profit participation, a feature associated with debt or preferred securities. Payments made are cumulative for 2 years only and then viewed as non-cumulative, a feature associated with the most common-like version of a preferred security.

It is the absence of rights on the upside that makes the TPS appear more debt-like, while the absence of rights on the

## Case Studies of the Application of Synergistic Analysis (Continued)

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downside makes it appear more common-like. In theory equity holders enjoy rights on the upside, while debt holders enjoy rights on the downside; it is the absence of both that leads to a lack of classification clarity. An important point to consider is that TPS investors have less leverage in a voluntary restructuring than do the common shareholders, which infers subordination to common.

The payment promise is scheduled with the potential for deferral, and deferrals are not events of default. In some situations, the deferrals may continue for up to 17 years, and may be non-cumulative. These features are associated with the most common-like version of a preferred security.

With respect to maturity and redemption, the TPS has a contractually established maturity date in fifty years, a feature suggesting sufficient permanence as to require careful consideration whether it should be considered suggestive of common instead of debt or preferred equity. However, the 35-year effective prohibition on redemption (limited to the issuance of like or junior securities) creates a more common-like status for the TPS.

In an involuntary redemption, the investor's claim is senior to common equity for full liquidation value, subject to availability of funds after payment of all debt and policyholder obligations, a feature associated with a preferred security. However, the TPS investor has no such claim in a voluntary restructuring: as long as the distribution payments are up-to-date, Holdco may add unlimited creditors ahead of TPS and buy out an unlimited amount of the common stock cushion below TPS.

In many ways, this TPS is a more permanent part of the issuer's capital structure than common shares:

- TPS can only be redeemed through 2040 via the proceeds of an equity issuance; Common shares may be repurchased through free cash flow or debt issuance at any time
- Given that the TPS functions to absorb losses without voting or acceleration rights, there is no incentive for the company to issue equity to repay the TPS on the downside

- Given that the TPS has no right to participate in the upside, there is no incentive for the company to dilute common equity on the upside in order to redeem the TPS

In view of the preceding attributes, this issue was determined to be common-like.

### Conclusion

Classification analysis makes a number of important assumptions about securities, many of which are identified above. There are some other assumptions that may not be as clear. First and foremost classification is not about probability. The SVO has three profiles and is required to conduct an analysis whose objective is to match the hybrid up to the profile it most resembles. It is assumed that carefully drafted legal provisions drafted on behalf of sophisticated market participants and institutional investors will be enforced as written. Issuers and the regulators whose charge they are will exercise any right they have to defer if the conditions for deferral are triggered under the contract. Hybrid securities are designed to prop up the issuer by providing a cushion for bank lenders and traditional bondholders. Accordingly issuer default is not considered to be the pertinent risk to trigger deferral and other loss absorption. The trigger will be some degree of financial deterioration accelerated by how markets interpret that deterioration for the specific issuer in a given investment environment. Quantifying when deterioration will be sufficient to cause the issuer to defer is not measured by a rating. And is not also something classification requires. The insight provided by classification is revealed in the five articles in this series. Hybrid securities undoubtedly may represent a good investment opportunity and may add any number of benefits to the portfolio. But they contain and reflect a different kind of promise than is contained in bonds and increasingly in preferred stock and the circumstances that will trigger the "equity content" risk in them is unlikely to correlate with traditional ratings.



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