# Rating Methodology

TRIS RATING
A Strategic Partner of S&P Global

## Hybrid Securities: Equity Content and Credit Rating Criteria

20 December 2024

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### OVERVIEW AND SCOPE OF THE CRITERIA

This paper provides further clarifications on the criteria TRIS Rating applies in assigning a rating as well as the level of equity content to hybrid securities. The paper also explains the treatment of hybrid securities in our calculation of key leverage ratios. The criteria apply to hybrid securities issued by corporates and non-bank financial institutions. We expect no change in the ratings and the level of equity content we have assigned to existing hybrid securities. The criteria supersede the "Hybrid Securities Rating Criteria" published by TRIS Rating on 28 June 2021.

Hybrid securities are securities that have the characteristics of both equity and debt. Key characteristics of hybrid securities are: 1) subordination, 2) permanence, and 3) coupon payment deferral. Generally, hybrid securities are ranked below all senior debt claims but before common shares in a liquidation scenario. Most hybrid securities are perpetual or have a very long maturity date. Unlike general subordinated debts, hybrid securities are allowed to defer the coupon payment without causing a default. Thus, the rating assigned to hybrid securities will be at least two notches below the issuer credit rating, reflecting the subordination risk and coupon payment deferral risk.

Hybrid securities that have certain characteristics will be qualified to receive equity credit. The level of equity credit assigned to the issue is classified into three levels: 1) "high", 2) "intermediate", and 3) "nil". In assigning "high" or "intermediate" equity credit to a hybrid securities issue, our key consideration will be on the features of the hybrid securities that are supportive of cash preservation or that absorb losses in a stress scenario.

The treatment of hybrid securities when calculating the key financial leverage ratios differs based on the equity content assigned to each issue. For hybrid securities issues assigned "high" equity credit, we will treat the whole issue amount as equity and the coupon payment will be treated as a dividend payment. For issues with "intermediate" equity credit, we will treat the issue as 50% debt and 50% equity. The coupon payment will be treated as 50% interest payment and 50% dividend payment. For issues assigned "nil" equity credit, we will treat the whole issue amount as debt and the coupon payment will be treated as interest expense. The maximum equity credit assigned to an entity will be limited to one-third of its existing equity (excluding the equity portion of hybrid securities).

## DEFINITION OF HYBRID SECURITIES

Hybrid securities are capital market instruments that have characteristics of both debt and equity. Below are the key characteristics of typical hybrid securities:

1) Subordination. The priority of claims of hybrid securities holders is lower than all senior and subordinated debt creditors but higher than common shareholders. This means that in a bankruptcy scenario, hybrid securities holders will be repaid after senior and subordinated debtholders but before common shareholders. In most cases, hybrid securities are ranked at the same level as preferred shares.

2) Permanence. Hybrid securities are usually perpetual or have a long maturity date. However, if these securities include a coupon step-up feature of 100 basis points (bps) or more, we consider the date that triggers the step-up as the effective maturity date. Consequently, we consider that the hybrid securities are deemed to have equity content only if they have a remaining life of more than 20 years until the effective maturity date or if they are mandatory convertible securities that must be converted into equity within the short term. In addition, in the case that the issue contains a call option that allows the issuer to redeem the instrument before the maturity date, we expect the issuer to redeem and replace that issue with new issues of securities that have the same or higher level of equity content. A failure to do so will affect the equity credit assigned to existing hybrid securities as well as future hybrid securities.

3) Deferral. One of the key characteristics of hybrid securities is the ability to defer coupon payment without triggering a default. The payment deferral could be cumulative or non-cumulative. However, the issue rating could be lowered to “C” once the issuer defers the coupon payment.

## RATING METHODOLOGY FRAMEWORK

We assign the same credit rating symbols to hybrid securities as those for ordinary bond issues; “AAA” to “C”, where “AAA” is the highest credit rating and “C” is the lowest. Credit ratings assigned to hybrid securities are typically at least two notches below the issuer rating (or the stand-alone credit rating of the issuer if we do not expect the support from its group members or the government to extend to the hybrid securities). The number of notches down reflects the legal subordination on the priority of claim, and the issuer’s right to defer coupon payments. A widening of the notching usually reflects heightened payment deferral risk which could be due to significant deterioration in the credit profile of the issuer or the existence of a mandatory payment deferral trigger (in addition to the optional deferral) that the issuer could breach in advance of a company-wide default. A mandatory trigger could require, for example, that the issuer defer the coupon payment if it records a net loss in any one year.

## EQUITY CONTENT

Because of the equity-like features of hybrid securities, the issue amount could be partially or wholly treated as equity in our calculation of financial ratios. The level of equity content depends on the equity-like features of the issue and the potential to defer the coupon payment. The key consideration is the availability and the ability of the hybrid securities to absorb losses or preserve cash when needed. The intention of the issuer to retain hybrid securities as part of its long-term capital structure will also be assessed as a key consideration. The equity credit assigned to hybrid securities can be categorized into three levels: “high”, “intermediate”, and “nil” equity credit.

1) **High equity content.** We may assign “high” equity content or 100% equity credit to certain types of hybrid securities, such as mandatory convertible securities which have all of the following elements:
   a) The issue is ranked below all senior and subordinated debts but before common shares in the event of debt restructuring and/or liquidation.
   b) The coupon payment is deferrable at the issuer’s discretion.
   c) The securities are mandatorily converted into common shares within two years of the issuance.
   d) The conversion price should be specified in advance. In addition, the conversion price floor should be equal to or higher than the issuer’s share price at the time of issuance.
   e) There are no signs of any attempt by the issuer to undermine the conversion benefit through subsequent stock repurchase.

2) **Intermediate equity content.** We may assign "intermediate" equity content or 50% equity credit to hybrid securities which have the following elements:

   a) Subordinated to all senior and subordinated debts but before common shares in the event of debt restructuring and/or liquidation.
   b) Have remaining life until the effective maturity exceeding 20 years.
   c) The issuer has the discretion to defer interest payments, whether they are cumulative or non-cumulative. For cumulative payments, the issuer should be able to postpone the payments for more than five years from the original due date.
   d) In the case that hybrid securities have a call option, the first call date must be at least five years from the issuance date. In addition, we expect the issuer to replace the redeemed hybrid securities with new issues of securities that have the same or higher level of equity content (Replacement Capital Covenant or RCC) in case the call option is exercised, and publicly state its intention to do so.

3) **Nil equity content.** We assign "nil" or 0% equity credit to hybrid securities that do not meet the requirements for "intermediate" or "high" equity content as mentioned above.

## TREATMENT OF HYBRID SECURITIES IN FINANCIAL RATIO ADJUSTMENTS

Based on accounting standards, hybrid securities that meet the requirements of Thai accounting standards are regarded as equity. However, from our perspective, hybrid securities have characteristics of both debt and common equity. Thus, the treatment of hybrid securities in our calculation of financial ratios is based on the equity content we assign to the securities as mentioned above.

**High equity content.** For hybrid securities with "high" equity content, 100% of the issue or outstanding amount is treated as equity, with coupon payments treated as dividends.

**Intermediate equity content.** For hybrid securities with "intermediate" equity content, 50% of the issue or outstanding amount is treated as equity and the other 50% as debt. Therefore, 50% of the coupon payment is treated as dividends and the other 50% as interest expense.

**Nil equity content.** For hybrid securities with "nil" equity content, 100% of the issue or outstanding amount is treated as debt, and the coupon payments are treated as interest expense.

## OTHER CONSIDERATIONS

- We assign a 0% equity credit to hybrid securities issued to one or two investors unless the securities are held by a government or investors as a form of support during a financial stress period. The financial stress period is defined as the time during which the issuer has a significant decline in creditworthiness and has difficulty accessing other sources of funding.

- The maximum equity credit given to all outstanding hybrid securities is limited to one-third of the issuer's total equity before including the equity content from any outstanding hybrid securities. Thus, all hybrid amounts exceeding one-third of the original equity capital are classified as having no equity content and are counted as debt.

  - We may continue to recognize the equity content of hybrid securities even if their equity credit exceeds the maximum equity credit after a decline in total equity due to operational weakness or asset impairment. This is permissible provided that the initial equity content of those hybrid securities did not exceed the maximum equity credit as determined at the time of issuance.

- In the case the issuer issues new securities with the same or higher equity content and earmarks those securities to replace the existing hybrid securities which contain "intermediate" or "high" equity credit, those securities are considered as having been replaced with the new securities and no longer receive any equity credit. This would not change the equity content of the remaining outstanding hybrid securities. However, if the new hybrid securities issue is not intended to replace the existing hybrid securities, we assign the respective equity credit to both new and existing hybrid securities. In this case, at the time of redemption of the existing hybrid securities, we would expect the issuer to replace the redeemed hybrid securities with a new issue of equal or higher equity content.

- In the case that the issuer redeems its hybrid securities without a replacement issue of the same or higher equity content, we may deem that the issuer does not intend to retain hybrid securities as part of its long-term capital structure. As such, we may no longer assign equity credit to the issuer's remaining hybrid securities or its future hybrid securities. However, notwithstanding the absence of replacement issues, we may maintain the equity credit to the remaining hybrid securities and future issues of hybrid securities if the redemption was due to any of the following reasons:
    - Changes in accounting practices such that the hybrid securities are no longer treated as equity.
    - Changes in tax treatment which no longer treat the hybrid's coupon as a tax-deductible expense.
    - Changes in rating methodology which lower the equity credit assigned to the outstanding hybrid securities.

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