November 2006

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Rating Preferred Stock and Hybrid Securities

Request for Comment

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This request for comment discusses the credit risk of preferred stock and so-called hybrid securities and suggests guidelines for rating these securities in light of their unique features. We propose to combine existing notching guidelines, which address severity of loss in the event of default, with incremental notching to reflect the fact that scheduled payments may be omitted without triggering a default by the issuer.

Hybrid securities – combining features of both debt and equity – have become an increasingly visible financing source for corporate and financial institution issuers around the world. Regulated entities, in particular, find hybrids to be a tax-efficient way to raise capital. Hybrid securities can take the form of preferred stock, subordinated debt, convertible bonds, or securities with mandatory conversion to equity.

Moreover, like their preferred stock counterparts, many hybrid securities contain special clauses which allow an issuer to omit payments, either at the issuer's option or because a pre-set "trigger" has been breached. While perhaps offering benefits to the issuer's overall credit profile these features can pose an additional risk for investors holding these securities. By factoring in this additional risk, Moody's rating for these securities would extend beyond the explicit promise of the contract. In essence, the ratings would reflect an expectation that payments would in fact not be omitted.

Specifically, we are proposing a two-step process for rating preferred stock and hybrid securities. The first step is to derive a loss-given-default (LGD) rating for the security, based on the issuing entity's rating and the security's position in the issuing firm's capital structure. The second step is to assess the risk that payments would be omitted, without triggering a default, and incorporate this into the hybrid security's rating. Moreover, we are proposing to extend this process to conventional non-cumulative preferred securities.

Market participants are invited to submit comments on this proposal to cpc@moodys.com on or before December 31, 2006.

Rating to Loss Given Default

In November 2000, Moody's introduced a conceptual framework for notching securities within an issuer's capital structure.[1] We defined rating notching as the general practice of making rating distinctions among the different liabilities of a single entity or of closely related entities. A September 2000 companion document provided guidelines for notching corporate securities based primarily on their priority of claim in the event of bankruptcy or resolution.[2]

The guidelines were developed by examining the relative recovery experience for obligations issued by firms with multiple classes of debt outstanding at default. Taking into account Moody's stated objective that ratings are designed to represent opinions of relative expected loss, observed differences in recovery rates were compared against historical default and loss experience in order to equate expected losses across instruments with the same rating.

For issuers with senior unsecured ratings (or Corporate Family Ratings, if applicable) at Ba2 or higher, the guidelines specify that both subordinated debt and junior subordinated debt be rated one notch below senior unsecured debt; preferred stock should be rated two notches below senior unsecured debt. For those issuers with senior ratings below Ba2, the guidelines specify two notches for subordinated, two or three notches for junior subordinated, and three or four notches for preferred stock.

In forming the guidelines, no distinction was made between cumulative and non-cumulative preferred stock. Although holders of the latter do not have a claim on any missed payments, we found no discernable differences in recovery rates on defaulted preferred securities, based on their cumulative versus non-cumulative status.

The fact that the proposed guidelines vary, depending on the senior rating of the issuer, arises from differences in category-to-category relative default (or loss) rates as one moves along the rating scale.

The August 2006 introduction of Moody's LGD Assessments represented a major innovation in rating securities across a firm's capital structure.[3] After specifying the anticipated capital structure at default, a rating committee can estimate the loss given default for each class of debt. Combining this assessment with an estimate of the firm-level probability of default produces an obligation rating in lieu of the traditional notching approach.

Whether using the notching guidelines or the more direct LGD-based approach, the result is a rating that hinges on the hybrid security's priority of claim. The LGD-based rating assessment forms the basis for further analysis.

Rating Omission Risk

Notching guidelines for priority of claim (or an explicit assessment of LGD) help establish ratings that reflect the loss given default associated with typical debt obligations. Yet certain preferred stock and hybrid securities pose another risk, namely that the obligor may omit interest or dividend payments without triggering bankruptcy or reorganization. Moreover, in the case of non-cumulative securities, any omitted payments may be forgiven altogether, while securities with cumulative features hold the promise that omitted payments will be resumed, typically before any common dividends can be paid. In addition, the newer generation of hybrids may settle through the issuance of common stock, warrants, or "benign" preferred securities.[4] Although this distinction may sound clear, in practice, there are many grey areas.

In some cases, a hybrid security will contain a mandatory deferral feature whereby payments must be omitted if a pre-specified threshold is met. Often, this threshold will be linked to a particular financial measure. For example, hybrid payments must be omitted if the entity reports three consecutive years of losses. For other hybrids, the issuing entity may omit payments, without consequences, at management's option.

By incorporating omission risk into credit ratings, we are taking an expanded view of the concept of credit risk. Although an indenture may specifically allow the issuer to omit payments without triggering bankruptcy or reorganization, we assume that investors expect to receive payments as scheduled.

In order to gauge the potential ratings impact associated with omitted payments, we modeled the risk profile of a hypothetical non-cumulative preferred stock. We linked the probability that payments would be omitted to the issuer's default risk. Next, the expected loss attributable to omission risk was added to the expected loss implied from the LGD-based rating and this sum was converted back into a rating. The conclusions from this exercise are depicted below in terms of incremental notching to be applied beyond the LGD-based rating.

1. *"Notching for Differences in Priority of Claims and Integration of the Preferred Stock Rating Scale," Moody's Special Comment, November 2000.*
2. *"Summary Guidance for Notching Secured Bonds, Subordinated Bonds, and Preferred Stocks of Corporate Issuers," Moody's Special Comment, September 2001.*
3. *Please see Moody's Rating Methodology "Probability of Default Ratings and Loss Given Default Assessments for Non-Financial Speculative-Grade Corporate Obligors in the United States and Canada," August 2006.*
4. *So-called "benign" preferred securities are non-cumulative, perpetual and callable with binding replacement language or have mandatory deferral triggers and intent-based replacement language.*

Modeled Notching Results for Non-cumulative Preferred Stock	
LGD-Based Rating	**Incremental Notching for Omission Risk**
Aaa	None
Aa1 and below	One notch lower

We discuss below the circumstances under which these guidelines may be applied.

Straight Non-Cumulative Preferred Stock

We propose applying the incremental "omission risk" notching guidelines shown above to straight non-cumulative preferred stock. When an issuer omits dividends on its non-cumulative preferred stock, there is no requirement to repay the omitted payments. Nor is there an expectation that omitted payments will be repaid. Such securities pose an incremental risk to investors – however well understood and contractually clear. We are not claiming that the omission of dividend payments constitutes a default, per se. We are saying that there is an implicit promise to pay dividends at the contractual rate of the notes.

Issuers of cumulative preferred stock must pay any omitted dividends before resuming common stock dividends. And there is a higher expectation that any omitted payments will be repaid. Consequently, cumulative preferred stock would not be subject to the incremental notching described above.

As noted previously, Moody's current LGD-based notching guidelines call for no distinction between cumulative and non-cumulative preferred stock. Yet, we feel that rating cumulative and non-cumulative preferred stock at the same level understates the true risk differential between these two security types.

Hybrids and the No Ongoing Payments Classification

In February 2005, Moody's New Instruments Committee refined its approach to assessing a hybrid security's "equity content" as communicated through an A (debt-like) to E (equity-like) basket ranking.[5] The basket ranking is an assessment of the degree to which a hybrid security resembles equity and thereby provides support to more senior, traditional debt instruments. Such equity treatment can result in adjustments to various financial ratios used to assess the issuer's overall credit profile.

As part of the basket assessment process, the New Instruments Committee considers three major features characteristic of plain-vanilla equity: No Maturity, Loss Absorption and No Ongoing Payments. The first of these, No Maturity, is generally not a factor in determining expected loss, and therefore has little or no ratings implications. The second, Loss Absorption features prominently in our notching for priority of claim and should already be reflected in the LGD-based rating.

The No Ongoing Payments dimension, however, is directly pertinent to the assessment of omission risk. The New Instruments Committee uses four classifications in assessing this equity-like dimension: Strong, Moderate, Weak and None. The classifications, along with examples, are shown in the table below. The examples are illustrative only, as each hybrid type is evaluated on a case-by-case basis.

No Ongoing Payments Classification	Examples
Strong	Mandatory deferral of payments must be tied to the breach of pre-specified triggers. They may be non-cumulative or settled through the issuance of common stock, warrants, or "benign" preferred securities, all subject to certain limits. The timing of settlement after a trigger breach varies. The focus is also on the claim of any unsettled distributions in bankruptcy.
Moderate	Issuer may optionally defer payments. These may also be non-cumulative securities or offer settlements similar to mandatory deferral securities.
Weak	Issuer may optionally defer payments. These are cumulative securities.
None	Straight corporate bonds.

5. *Please see Moody's Rating Methodology "Refinements to Moody's Tool Kit: Evolutionary, not Revolutionary!," February 2005.*

We propose extending the incremental notching detailed above for non-cumulative preferred stock to hybrid securities with No Ongoing Payments classifications of either "Strong" or "Moderate." Generally speaking, these classifications are typically applied to securities with non-cumulative (or non-cumulative-like) features, although the materiality and the likelihood of any triggers being breached are incorporated into the classification process. This proposal does not involve changes to the New Instruments Committee's methodology for assigning baskets to hybrids.

An Exception for Certain Alternative Coupon Satisfaction Mechanisms

Because the focus of the New Instruments Committee is on a hybrid's benefits to issuing firms, we propose an exception be made for hybrid securities with a mandatory or optional deferral feature where omitted payments cumulate on a non-cash basis, but must be settled immediately or within one year. Often classified as "Moderate" (in the case of optional deferral) and "Strong" (in the case of mandatory deferral) for No Ongoing Payments, such hybrids contain an Alternative Coupon Satisfaction Mechanism (or similar structure) whereby omitted payments must be settled with additional securities or through the issuance of preferred or common shares. The proceeds of this issuance can be used to make the hybrid holders whole. Where settlement is immediate (or within one year), these mechanisms have the effect of turning a non-cumulative security into a more cumulative-like security and thereby reduce the risk of investor losses.

Rating Securities That Omit Payments

The guidelines described above are intended to apply to preferred stock and hybrid securities which are current on payments to holders. This section provides guidance for securities that are omitting payments. In some cases, the rating on an omitting security will be negatively affected by a coincident downgrade of the issuer's rating. The guidelines proposed here are specific to non-cumulative securities and those that settle with equity, warrants, or "benign" preferred securities.

Moody's ratings are designed to be forward-looking opinions of relative expected loss. All else equal, once a non-cumulative preferred stock or similarly classified hybrid security has omitted a payment, the probability that future payments will be omitted is higher. This higher probability may be reflected in further notching for omission risk.

Using the framework described above for assessing omission risk, we further raised the probability that payments would be omitted. The results suggest that a non-cumulative (or equivalent) security currently omitting payments should be rated at least two notches below the LGD-based rating.

Impact on Current Ratings

If implemented as proposed, the refined methodology would lead to rating downgrades for most non-cumulative preferred stock issues and a for a number of hybrid securities. The large majority of rated preferred stock is cumulative and these securities would not be impacted by the proposal. Without examining every security in detail, it is difficult to determine the exact number of expected rating changes, but an initial survey indicates that ratings could change for roughly 300 securities if the proposal is adopted.

Related Research

Special Comment:

Notching for Differences in Priority of Claims and Integration of the Preferred Stock Rating Scale, November 2000 (61860)

Summary Guidance for Notching Secured Bonds, Subordinated Bonds, and Preferred Stocks of Corporate Issuers, September 2001 (70456)

Rating Methodologies

Refinements to Moody's Toll Kit: Evolutionary, not Revolutionary!, February 2005 (91696)

Probability of Default Ratings and Loss Given Default Assessments for Non-Financial Speculative-Grade Corporate Obligors in the United States and Canada, August 2006 (98771)

To access any of these reports, click on the entry above. Note that these references are current as of the date of publication of this report and that more recent reports may be available. All research may not be available to all clients.

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Report Number: 100692

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