



## HYBRID SECURITIES

*March, 2007*

In this current environment of tight spreads and low volatility, fixed income investors are challenged to seek out and identify less conventional securities that will deliver attractive risk-adjusted total returns. One group of such securities gaining favor among institutional investors in 2006 and early 2007 is Hybrid Securities (“Hybrids”).

**What are Hybrids?** According to Fitch Ratings, Hybrids refer to a wide range of capital market instruments that combines features of debt and equity and are neither common stock nor ordinary debt. Included are instruments such as preferred stock, preference shares, trust preferred securities, capital securities, bank tier 1 and upper and lower tier 2 securities, mandatory or optionally convertible debt and preferred securities, deferrable payment subordinated debt, and a changing list of other financial products.

**Why do companies issue Hybrids?** For issuers, Hybrids are attractive from both a tax and ratings perspective. Hybrids are accounted for as debt for tax purposes—meaning that coupon payments are tax deductible—while their subordination in the capital structure enhances the issuer’s equity capital base; this is favorable with both regulators and rating agencies. For highly rated companies in heavily regulated industries such as banking and insurance, this treatment is often quite advantageous from a weighted average cost of capital (WACC) perspective.

### Reasons to Issue Hybrids:

- Equity-like treatment from regulators and rating agencies
- Tax deductible treatment of coupon payments
- Improved weighted average cost of capital (WACC)
- Expanded investor base (liquidity)

**Why do investors buy Hybrids?** Given the structure and nature of Hybrid securities, additional risk is inherent relative to senior and subordinated debt securities. As such, Hybrids offer additional yield to investors to compensate for the added risk, which includes 1) subordination, 2) potentially longer than anticipated maturities, and 3) regulatory risks.

Hybrid securities usually feature very long stated maturities but have short call options. Investor expectations are that the issuer will call the securities due to onerous coupon adjustments if the securities are not called. The implied concept is that only firms experiencing difficulty will not call the securities. For financial firms, sending such a message would likely limit much needed access to the capital markets. These firms therefore have an added incentive to call and re-issue securities. As such, the market considers the term of these securities to be to the call date rather than to maturity.

### Reasons to Buy Hybrids:

- Higher yield relative to ratings and expected maturity
- High-beta nature of the securities allows investors to express views on direction of market spreads and volatility, as well as exploit issuer-specific fundamental trends

**2006 Recap.** After strong performance in late 2005, partly the result of a flight-to-quality trade away from potential LBO candidates, Hybrid performance hit a wall in March. The change in sentiment was precipitated by a series of surprising regulatory assessments by the National Association of Insurance Commissioners (NAIC) on both new and previously issued Hybrid instruments—more clarity on this follows below. Fallout from the NAIC’s review process extended into September. On September 10th, the NAIC adopted a classification approach that was judged sufficiently benign by the market and propelled a powerful rally in Hybrids generating strong relative performance (Hybrid ScoreCard Group) for the entire year (see Figure 1). For the first two months of 2007, the Hybrid ScoreCard Group outperformed the US Credit Finance Index while trailing the US Credit Index and Capital Security Index.

**Figure 1. Excess Returns (basis point returns over US Treasuries) for Hybrids Relative to Credit Index and Sub-indices\***

<u>Index</u>	<u>2006</u>	<u>YTD</u>
US Credit Index	119	31
Capital Security Index	161	20
US Credit Finance	146	6
Hybrid ScoreCard Group	346	13

\***Source:** Lehman Brothers POINT analytics. Hybrid ScoreCard group consists of a set of 27 new generation Hybrids.

**What implications could the NAIC decision have had?**

The major issue for Hybrids regarding the NAIC was how insurance companies, as investors in these securities, not as issuers, classify these investments. The NAIC requires insurance companies to allocate part of their capital base against investments. The amount of capital is determined by the risk classification of the security. Higher risk securities require additional capital allocation, thus reducing the return on investment. As insurance companies are major investors in these securities, the proposed classification changes could have had a significant impact on the demand side of the equation for these securities. As such, prices fell and effective yields rose when the NAIC questioned the classification of these securities.

**2007 Outlook.** Hybrid issuance in 2007 is expected to at least match levels seen in 2006 (in the \$65 billion range), fueled both by ongoing refinancing of the 1996/1997 trust preferred issuance bulge and by pressure on bank issuers to optimize their capital structures. Banks and insurance companies, which accounted for more than three-quarters of 2006 supply, are expected to remain the dominant source of issuance. Thus far in 2007, some banks have exhibited signs of asset quality erosion, declining net interest margins, and pressures on funding costs, and the combination of the above is likely to prompt a heightened emphasis on capital structure maximization. This could readily translate into more aggressive use of low-cost capital alternatives—including Hybrids—to fund share repurchase programs.

Inasmuch as Hybrids, by their nature, are designed to satisfy multiple constituencies, structural complexity can be high. Continued structural innovation is a given, but the bias is to a streamlining of structures. As investors become more familiar with the various Hybrid structures, the market is likely to benefit from increased liquidity. In 2007, as the new Hybrid issuance activity takes hold, investors who can effectively value these securities will be well positioned to utilize Hybrids for the benefit of client portfolios.

**Sources:**

Barclays Capital, JPMorgan, Lehman Brothers