

RATING APPROACH - HYBRID INSTRUMENTS ISSUED BY CORPORATE SECTOR ENTITIES

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ANALYST CONTACTS

Mr. K. Ravichandran
Executive Vice-President and Chief
Rating Officer
+91 22 6114 3408
ravichandran@icraindia.com

Mr. Jitin Makkar
Senior Vice President
+91 124 4545 368
jitinm@icraindia.com

Mr. Pratik Singhania
Vice President
+91 124 4545 801
pratik.singhania@icraindia.com

Mr. Balaji Murali
Vice President
+91 44 4596 4300
balaji.murali@icraindia.com

This rating methodology updates and supersedes ICRA's earlier methodology document on this subject, published in November 2021. This methodology applies to the hybrid instruments issued by corporate sector entities and does not apply to the hybrid instruments issued by regulated financial institutions such as banks, non-banking finance companies and insurance companies. The analytical treatment of hybrid instruments issued by such regulated financial institutions is covered in their respective sectoral methodologies, available at www.icra.in.

Definitions

What is a hybrid instrument?

A hybrid instrument combines the features of both debt and equity and could take various forms, including non-convertible instruments like preference securities, subordinate debt, or convertible instruments like optionally or mandatorily convertible debt or preference securities. The equity-like features in the hybrid instruments have the effect of reducing default risk on the conventional debt instruments through mechanisms such as payment deferral, conversion to equity or principal write-down.

What is not a hybrid instrument?

In case payment deferral in an instrument is considered an 'Event of Default', as per the transaction documents, which may lead to acceleration of payment on the purported hybrid instrument or initiation of bankruptcy proceedings, such instruments are treated as pure (conventional) debt instruments and no equity credit is ascribed to such instruments.

Default recognition

The rating assigned by ICRA to hybrid instruments reflects the risk of deferment of payments. A missed or a deferred payment on the hybrid instrument is treated as a default by ICRA, even if the terms and conditions of the hybrid instrument allow for a payment deferral or skipping under certain conditions. Therefore, to account for the relatively high risk of payment deferral (and hence default), the rating of hybrid instruments is typically notched-down from the rating of the conventional/ senior debt instruments.

Assessment of a hybrid's equity content

The principles underlying the assessment of how much equity credit should be ascribed to a hybrid instrument are underpinned by determining how closely the features of the hybrid instrument resemble equity capital. This approach involves an assessment of the features of the hybrid instrument in terms of their availability and ability to reduce default risk on conventional debt on a going concern basis, a benefit that pure equity provides fully. ICRA's approach towards assessing the efficacy of a hybrid instrument in reducing the default probability of conventional debt is premised entirely on the hybrid's cash flow subordination vis-à-vis the pay-outs scheduled on conventional debt—while the entity is a going-concern. The aspect of the hybrid instrument being junior or subordinated to various other creditors' claims at the time of insolvency and a possible liquidation, is not a rating consideration. This is because ICRA's ratings are based on the probability of default approach, rather than the expected loss approach.

The parameters assessed by ICRA to determine how much equity credit is to be assigned to a hybrid instrument are given below:

- Trigger strength for payment deferral
- Permanence of payment deferral (cumulative / non-cumulative)
- Residual tenor of the instrument

Hybrid instruments that have (a) steeper trigger thresholds to defer payments on a non-cumulative basis or require principal write-downs or equity conversion under certain conditions much before the entity defaults on its conventional debt instruments, and/ or (b) ability to absorb losses for a longer period, are assigned a higher equity credit compared with others.

Trigger strength for payment deferral

Optional versus mandatory payment deferral mechanisms: No comfort is taken by ICRA from the payment deferral mechanisms that are optional in nature, regardless of the trigger reference being weak or strong. This is because in such cases, the discretion whether to prioritise payments to conventional debt holders over the hybrid instruments' investors rests with the borrower. This is especially prevalent in the higher rating categories where the issuers are generally reluctant to defer payments on hybrid instruments as it could be perceived to be a signal of weakening of the financial profile and thus constrain the entity's ability to raise fresh capital in the future. In addition to concerns related to the capital market perceptions, the hybrid instruments may have features such as step-up in the coupon rates upon a payment deferral that may discourage the deferral of payments on hybrid instruments.

In contrast, when upon the breach of a pre-defined trigger, the payment skip/deferral is mandatory as per the contractual terms of the hybrid instrument, the instrument would qualify to be allocated a relatively higher equity credit. Mandatory triggers by themselves do not necessarily merit a high equity credit, if the triggers for the payment deferral are weak in nature (discussed in detail in the next section).

Example of optional payment deferral mechanism:

An example of an optional payment deferral mechanism would be a hybrid instrument where the coupon/ dividend payment could be deferred based on a prior approval from the lenders/ investors in that instrument. Here, the deferral would be at the lenders'/investors' discretion rather than being an unqualified imperative for the issuer to skip/defer the payment.

Strong versus weak triggers for payment deferral: The strength of a trigger indicates the adequacy of conditions/ thresholds which trigger the payment deferral, so that these triggers are initiated sufficiently before the entity defaults on the conventional debt instruments. Ceteris Paribus, a higher equity content is ascribed to hybrid instruments which absorb losses via coupon deferral or principal write-down/conversion much before the point of default on conventional debt instruments.

Examples of weak payment deferral mechanism:

- Trigger for payment deferral is set at a level which is breached only when the financial position of the entity has significantly deteriorated, and the entity is likely to default even on conventional debt. For example, payment is deferred when the debt service coverage ratio (DSCR) falls below 1.0 time.
- Covenants which restrict the ability to timely react to a worsening financial position through deferral or foregoing of payments on hybrid instruments. For example, covenants that specify some minimum period which must lapse from the last common dividend paid, before the payments on the hybrid instruments could be skipped or deferred. As another example, consider preference shares where the distribution of dividends is allowed from the current year profits or cumulative prior year profits, regardless of the sufficiency of cash flows to service the obligations relating to conventional debt. Such hybrid instruments are weak in terms of their ability to enhance the likelihood of servicing the conventional debt.

Examples of strong payment skip/ deferral mechanism:

The trigger for skipping/deferring payment on a hybrid instrument comes reasonably early in relation to the point at which the financial position of the entity deteriorates considerably. For example, payment deferral happens when the DSCR falls below 1.5 times, or there is a P&L loss, or the rating gets downgraded by more than two notches etc.

Permanence of payment deferral

Cumulative versus non-cumulative: When coupon payments are deferred in the case of cumulative instruments, these accumulate for payment later. This results in a relatively low capacity to provide financial protection to conventional debt instruments compared to non-cumulative instruments, where the payment once deferred is permanently suspended.

Residual tenor of the instrument

If the residual tenor of a hybrid instrument is less than ten years, then regardless of the strength of the trigger or the permanence/non-permanence of payment deferral, no equity credit is ascribed to such an instrument. However, a reasonably high equity credit (of over 50%) could be assigned to a hybrid instrument, having a mandatory and strong payment deferral trigger, if the residual tenor is more than 10 years.

Table 1: Indicative equity credit assigned to hybrid instruments

Parameters	Attributes [For illustration]		
Strength of payment deferral	25% equity credit could be ascribed to instruments when the payment deferral is mandatory albeit weak, with a residual maturity of over 10 years	50% equity credit could be ascribed to instruments when the payment deferral is mandatory, strong, and cumulative, with a residual maturity of over 10 years	Upto 100% equity credit could be ascribed in cases when the payment deferral is mandatory, strong, and non-cumulative, and the instrument is a mandatorily convertible instrument or a perpetual instrument
<i>Optional</i>			
<i>Mandatory but weak</i>			
<i>Mandatory and strong</i>			
Permanence of payment deferral			
<i>Cumulative (Temporary deferral)</i>			
<i>Non-cumulative (Permanent deferral)</i>			
Residual Tenor[#]			
<i>Up to 10 years</i>			
<i>>=10 years</i>			
<i>Perpetual instruments/ Mandatorily convertible instruments</i>			
Category	Low	Medium	High
% Equity Credit	0%-25%	25%-50%	50%-100%

Residual tenor is the remaining time period during which there is no scheduled principal repayment on the hybrid instrument. This is assessed in conjunction with the evaluation of put/call option (if any) on the instrument, as discussed in the section below.

NOTE: A zero-coupon or a near-zero-coupon hybrid instrument is typically considered akin to an instrument that has a 'mandatory and strong' payment deferral mechanism.

Treatment of select hybrid instruments/ features

Equity credit for loans/ preference shares from shareholders: Loans and preference shares from promoters/ shareholders are generally assessed on the same lines as described in the section above i.e. in terms of their ability to provide financial protection to conventional debt on a going concern basis.

Convertible instruments: Optionally convertible instruments are analysed on the same parameters as non-convertible instruments without assuming conversion to equity, given the market uncertainty or the uncertainty around an entity's or the investors' perception when the milestone of conversion arrives. For mandatorily convertible instruments, however, equity credit could range between 25% and 100%, depending on the strength of the payment deferral features and the permanence of the coupon/ dividend deferral. The equity credit could also be nil for mandatorily convertible instruments if in the period until conversion, there is no coupon skip/ deferral provision such that the pay-outs are non-discretionary. However, if the conversion is to happen within three years for the mandatorily convertible instruments issued by investment grade entities, and the coupon rate on these instruments is not above the general market borrowing rate for the entity, then 100% equity credit could be ascribed even if the payment deferral is optional.

Instruments with call option: For hybrids with a call option, the maturity date is assessed depending on the likelihood or the incentive to call the instrument. As an example, for instruments where the coupon steps-up significantly in case the call option is not exercised by the entity, the incentive for the entity to call the instrument on the call date would be high, given the increased cost upon not exercising the call option, and thus the call date is considered as the maturity date for such an instrument. In cases where the likelihood of the call option being exercised cannot be ascertained, the maturity date is considered as the forthcoming date for exercising the call option. In case it could be assessed with reasonable certainty that the entity would not exercise the call option on the upcoming call option date, a longer maturity could be assumed depending on when the entity could be reasonably expected to exercise the call option. To infer the likelihood of the call option being exercised, ICRA considers factors including, but not limited to, the entity's past behaviour towards exercising call options/ redeeming hybrid instruments before due dates, or the cost of replacement of the hybrid capital.

Instruments with put option: In case the instrument has a put option, the exercise date for the put option, as defined in the contractual terms, is considered as the maturity date of the instrument. This is because it is difficult to ascertain the behaviour of the lender/ investor as to whether the put option will be exercised.

Instruments with capital replacement feature: Hybrid instruments which have features that restrict any repayment of the associated principal amount unless the hybrid instrument is replaced with a similar amount of a new hybrid instrument and with similar or better hybrid features, are considered as perpetual in nature. This is because on each maturity date, such a hybrid instrument is contractually bound to be rolled over. Equity credit for such an instrument could range between 25% and 100%, depending on the strength of the payment deferral features and the permanence of the coupon/ dividend deferral.

Cap on equity credit

Common equity is a more predictable source of credit support under financial stress, as opposed to hybrid instruments. While payments related to hybrid instruments could be deferred or entirely cancelled, an entity, particularly in the higher rating categories, will generally try to pay hybrid coupons as long as possible and only defer these if it is in severe financial distress.

This is because suspending a hybrid coupon could negatively impact the capital market’s perception of the entity which may restrict its access to the capital market in the future. Moreover, beyond a point, an entity’s non-standard, complex, or over-engineered balance sheet begins to put its financial policies in a negative light. Therefore, ICRA imposes a cap of 30% on the extent of the equity credit that it accords to a hybrid instrument issued by non-financial sector entities. The cap is applied on the entity’s adjusted equity, which is defined as conventional equity plus the hybrid equity credit.

Table 2: Illustration of hybrid equity capping

		Hybrid Equity Credit	
Hybrid Instrument Amount	a	100	100
Equity Credit (based on Table 1)	b	50%	75%
Hybrid Equity	$c=a*b$	50	75
Hybrid Debt	$d=a-c$	50	25
Conventional Equity	e	100	100
Adjusted Equity	$f=c+e$	150	175
Hybrid Equity as % of Adjusted Equity	$g=c/f$	33%	43%
Capped Hybrid Equity as % of Adjusted Equity	h	30%	30%
Capped Hybrid Equity	$i= (h*e)/ (1-h)$	43	43
Implied Equity Credit	$j=i/a$	43%	43%

The above table indicates that if hybrid equity as a proportion of the adjusted equity is greater than 30%, then even if the hybrid instrument is assessed to be eligible to be ascribed an equity credit of 50% or 75% or 100% (as the case may be), the effective equity credit would be capped (in the above example at 43%) so that the hybrid equity as a proportion of the adjusted equity is restricted to 30%.

Consider entities or special purpose vehicles (SPVs), where there exists an escrow mechanism or a trust and retention account (TRA), which involves a payment priority order defined for various end-uses. An example of a payment priority order is given below:

- a. Statutory dues
- b. Operational creditors
- c. Debt service payment
- d. Funding of debt service reserve account (DSRA)
- e. Funding of other reserves, if any
- f. **Payments in the distribution sub-account (referred to as ‘surplus’)**

If only the surplus after servicing the senior/conventional debt can be transferred to a distribution sub-account, it does not matter whether the allowed outflow is on account of equity dividends or coupons/ dividends on a hybrid instrument or any other capital instrument which ranks junior in the payment priority. These payouts are junior to the other defined payouts, both relating to the operational creditors as well as the financial creditors. Hence, in such cases, the aspect of allocating equity credit to such instruments will not apply.

Financial adjustments with respect to the hybrid instruments

Adjustments in the balance sheet: Amount of equity credit with respect to the hybrid instruments is added to the net worth and the balance amount is added to the debt.

Adjustments in the profit and loss statement: The payment towards hybrid instruments is allocated between fixed financial expenses (such as interest) and optional financial expenses (such as dividends) in the same proportion as the equity credit given (i.e. optional financial expense = total payment on hybrid instrument * equity credit).

On any given balance sheet date, the equity credit is ascribed based on the residual tenor of the hybrid instrument. The debt and the equity components are reviewed and, if required, re-allocated on every subsequent balance sheet date, as the maturity date approaches. In other words, the attribution of equity credit is not a one-time analytical exercise but is factored-in over the projected time horizon. Moreover, for entities that report their financials as per the IND AS, the reported equity credit is adjusted as per the approach described in this methodology.

Rating notching of hybrid instruments

The rating of hybrid instruments is typically notched down from the rating of conventional debt, because of the higher probability of default associated with hybrid instruments in relation to conventional debt. As a general principle, higher the equity credit ascribed to a hybrid instrument, which corresponds to a higher level of protection provided to the senior/conventional debt, higher is the notch-down of its rating from that of conventional debt. Further, for two entities—one rated much higher than the other—the notch-down in the rating of the hybrid instrument vis-à-vis the conventional debt could be much higher for the lower rated entity, even when the same equity credit (in % terms) is applicable to the hybrid instruments issued by both the entities, given the higher probability of financial deterioration and thereby default on the hybrid instruments issued by a lower-rated entity.

Summing Up

In the credit analysis of an entity, a hybrid instrument is considered within the context of the entity's overall credit fundamentals. In assigning equity credit to hybrid instruments, ICRA categorises them on a debt-equity spectrum, with instruments classified as 'Low' being closest to debt and those classified as 'High' being the closest to equity (see Table 1). There is a specific equity credit that ICRA ascribes to a hybrid instrument corresponding to its specific attributes pertaining to the strength of the payment deferral, the permanence of the deferral and the residual tenor. Accordingly, the reported financial statements are adjusted for computing the leverage and the coverage ratios. These adjustments form the basis of determining the rating of the conventional debt. The rating of the hybrid instrument is typically notched down in reference to this anchor, depending on the hybrid's equity content.

Contact us for any feedback or comments at: methodologies@icraindia.com

RELATIONSHIP CONTACT

L Shivakumar

+91 22 6114 3406

shivakumar@icraindia.com

MEDIA AND PUBLIC RELATIONS CONTACT

Ms. Naznin Prodhani

+91 124 4545 860

communications@icraindia.com

Helpline for business queries

+91-9354738909 (open Monday to Friday, from 9:30 am to 6 pm)

info@icraindia.com

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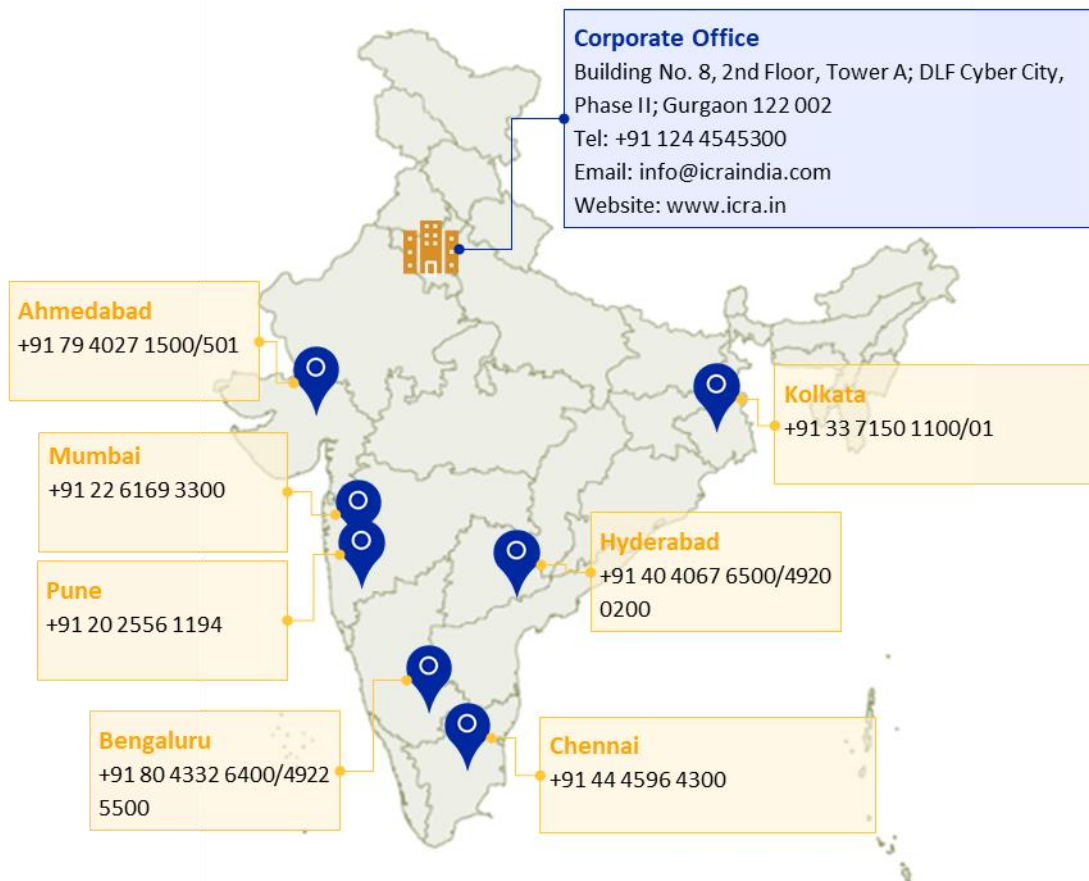
Registered Office

B-710, Statesman House 148, Barakhamba Road New Delhi-110001

Tel: +91 11 23357940-45



Branches



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