Hybrid Securities, a New Investment Choice

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In recent years, a new type of financial product called "Hybrid Securities" has grown into a booming market in the US and Europe. In Japan, issuance of hybrid securities has only been modest to date, but interest in these products is growing. In this report, from the viewpoint of an investor, I would like to explain what hybrid securities are and why they can be an attractive investment. I will also examine the risks involved with hybrid securities, and the challenges that issuers and investors will face as the market develops further.

What is a Hybrid Security?

Definition of a Hybrid Security: A hybrid security is, as its name suggests, an instrument with hybrid characteristics of debt and equity. There are many types of securities which fall into this area. In a broad sense, it includes securities other than senior bonds, such as subordinated bonds or preferred stock, and includes convertible bonds. In more general terms, it can be considered as a "non dilutive corporate bond-like security that is accepted by rating companies as a security that has an equity credit". (Figure 1)

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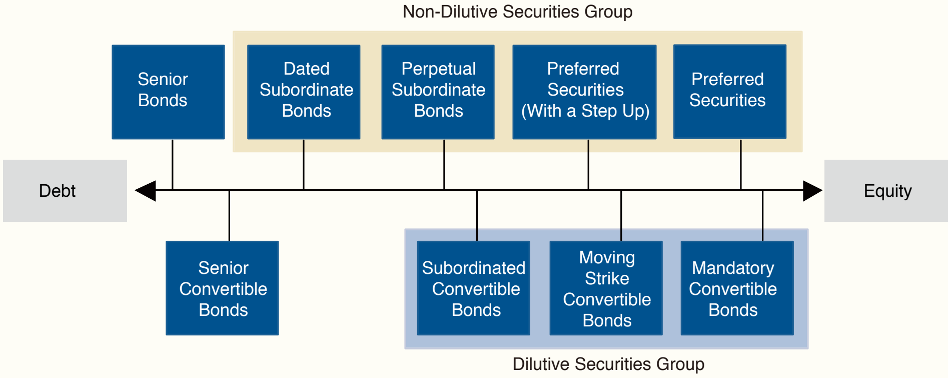


Source: PIMCO

Figure 1

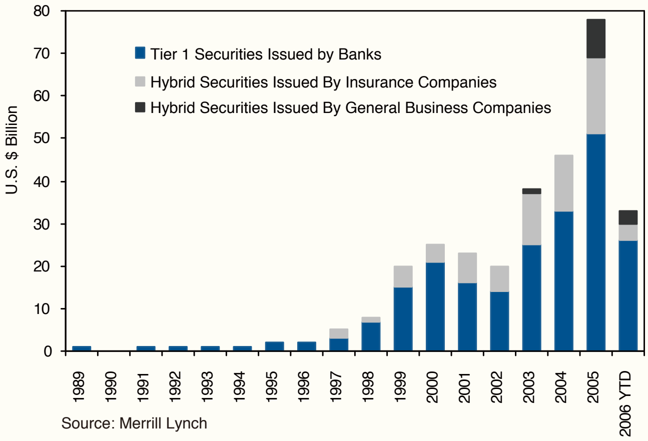
Bank Capital and Corporate Hybrids: In the banking sector, markets for subordinated bonds (so called Tier 2 capital securities) and senior securities (Tier 1 capital securities) have existed for more than a decade. These securities have collectively been referred to as bank capital and Japanese banks have issued many of these types of products. On the other hand, hybrid securities issued by companies other than banks are called corporate hybrids, and have only recently attracted attention in Japan.

We can elaborate further on the terms associated with hybrid securities. In the field of bank capital, in many cases, "hybrid" refers to Tier 1 capital, i.e. preferred securities (sometimes, excluding those with step-up conditions), and the term is used in a narrower sense than in "corporate hybrid," where it includes subordinated bonds and preferred securities. In addition, as I will explain later on, there is a significant difference between bank capital and corporate hybrids in terms of investment risk. Thus, we need to differentiate these two types of products.

Background of the Market's Expansion: In 2005, major credit ratings agencies launched scales that estimate the equity content of bonds, which led to the boom in corporate hybrid securities in the U.S. and Europe. The reason for the market's rapid expansion is that hybrid securities were a timely solution to the demands of both issuing companies and investors. For companies raising funds, hybrid securities offer several merits, including a reduction in capital costs, avoidance of capital dilution, prevention of an increase in unspecified shareholders at the time of new stock issuance, and a reduction in acquisition risk. For investors, it has become a popular instrument that provides high yield against a background of tightening credit spreads.

In 2005, there were more than 10 trillion yen of hybrid securities issued in Europe and the U.S., respectively, and more than 20 trillion yen issued in the world. The high level of issuance continued during 2006. (Figure 2) At present the market size is estimated to be about 50 trillion yen in the world.

The Amount of Hybrid Security Issuance in Europe

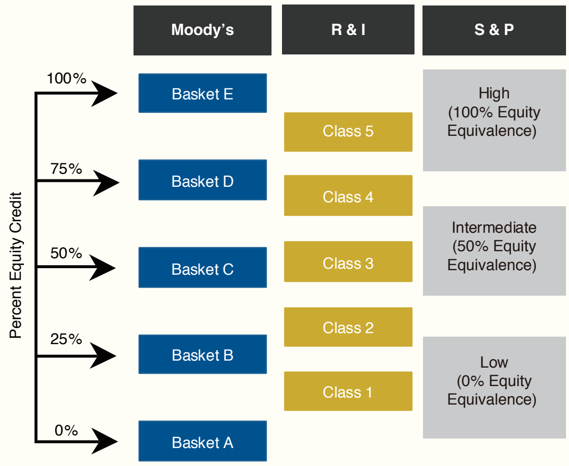


Source: Merrill Lynch

Figure 2

The Accreditation Criteria for "Equity Credit": In general, the "equity credit" of a hybrid security is formed from (1) the degree of permanency of the fund raising period or limitations on redemption (2) potential limitations on interest and dividend payments, including an optional payment postponement clause or

Classification of "Equity Credit" by Respective Rating Companies



Source: Merrill Lynch

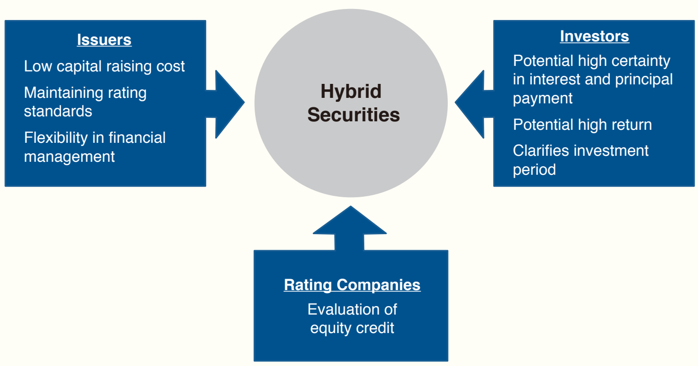
Figure 3

mandatory payment postponement clause, (3) a loss absorption measure (the subordinated nature of the repayment order) and other factors. The equity credit is estimated according to the respective constituting factors' strength. The accreditation criteria of the equity credit by Moody's, S&P, R&I are given in Figure 3. The estimation of equity credit varies greatly according to the characteristics of the security, but in many cases the issuer considers the equity credit to be effective in its capital policy when it is 50% or more.

The Significance of Hybrid Securities

From the Issuers' Point of View: Investors and issuers are interested in hybrid securities for quite different reasons (Figure 4). For the issuer, there are aspects of hybrid securities that allow increased flexibility for

Interests Surrounding Hybrid Securities



Source: PIMCO

Figure 4

corporate financing while reducing capital costs. Issuance of hybrids can help (1) reduce capital dilution, (2) improve capital structure, and (3) offer tax benefits (on balance sheets, hybrid securities are regarded as a liability, allowing them to be reported as a loss). For U.S. and European corporations, the purpose for issuing hybrid securities can vary greatly. The funds that are raised might be used for mergers and acquisitions (Porsche's recent acquisition of a stake of Volkswagen in Germany), fund raising for pension liability (German household goods and chemical firm Henkel) or share repurchase (US railway company BNSF).

For Japanese companies, against the backdrop of slowing economic growth in the secular horizon, issuance of hybrid securities has the potential to grow because it can be an effective way to reduce the risks associated with leveraged expansion. Additionally, hybrids might help alleviate mounting pressure on corporate management to conduct "shareholder friendly" policies such as share repurchases or growth through financed acquisitions.

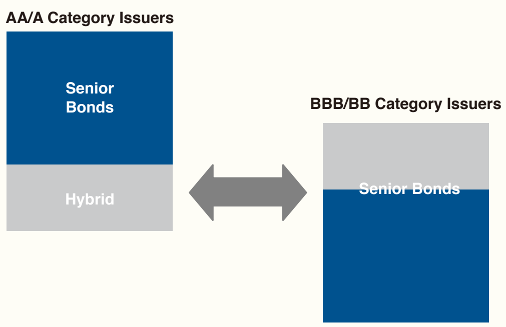
Significance from the Investors' Point of View: For investors, hybrid securities have several merits. Investors can benefit from growth of a market sector that has more attractive credit spreads. Also, hybrid securities can open up a larger array of investment choices. For example, an investor can be faced with the choice of investing in a hybrid security issued by a high credit company or a senior bond issued by a low credit company. (Figure 5) An increase in diversity of products can allow investors a more multi-dimensional array of diversification tools for a portfolio.

Investment Risk for Hybrid Securities

Interests of Issuers and Investors: As explained earlier, issuers and investors seek very different things from hybrid securities. On the issuer side, the incentive for issuing hybrid securities centres on the ability to raise funds with high flexibility in dividends and redemption schedule. On the investor side, hybrid securities add a wide selection of creditable investment choices for portfolio allocations that seek improved returns in exchange for higher risk securities. Because of this dual-benefit, it can be said that the conflict of interests between the issuers and investors is more salient for hybrid securities than it is for senior bonds. Furthermore, there are increasingly significant risks due to external factors such as changes in regulation. It is still fresh in our memories that from May to July of 2006, the whole hybrid securities market was affected significantly by the National Association of Insurance Commissioners' decision to change the rule on the measure of risk that is applied to hybrid securities held by insurance companies. (That event had a large impact on the hybrid securities market, though it has since recovered after the NAIC decided to re-examine its decision.)

Factors for Investment Risk: Next, we turn to the constituent factors for investment risk (Figure 6). The primary risk factors in hybrid securities are (1) the subordination risk that arises at time of default and liquidation, (2) coupon or dividend omission risk, (3) non-call risk, or the chance that the securities will not be called on the expiry date. If we break down the risk premiums in hybrid security spreads, the largest components are (2) and (3), and we consider that (1) is not as important as

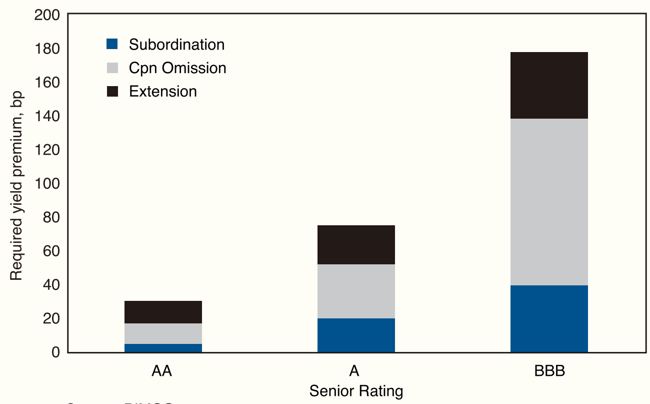
Merits for Investors



Source: PIMCO

Figure 5

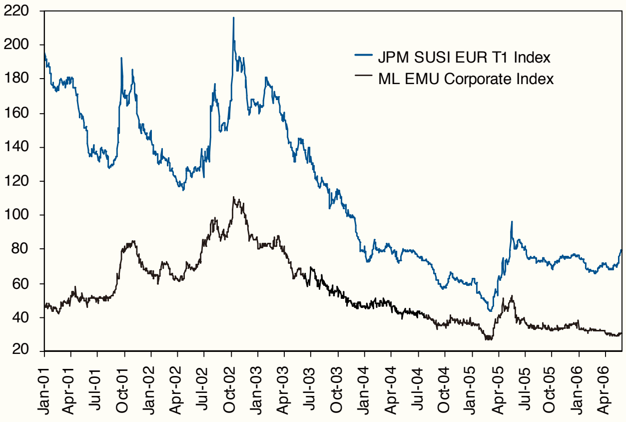
Constituent Factors for Investment Risk (Theoretical Value), Bank Capital, (Tier 1 Capital Securities)



Source: PIMCO

Figure 6

Index Spread Development Between Bank Capital and General Corporate Bonds (Europe)



Source: JP Morgan、Merrill Lynch

Figure 7

other two risks. As the issuer's creditworthiness declines, the risk of (2) is likely to become larger. In fact, if we look at the history of bank capital in Japan, there have been no cases of default but several cases in which dividends of preferred securities have been skipped or cases where perpetual subordinated debt was not called on the expiry date. For investors, an additional risk factor is the fact that price volatility of hybrid securities is larger than that of senior bonds due to their higher risk premiums (Figure 7).

Difference between Bank Capital and Corporate Hybrid

At present, there is a significant difference in investment risks between corporate hybrid and bank capital (Figure 8). For bank capital, issues are limited by the capital regulations that affect banks. On the other hand, corporate hybrids are more flexible in their design. Additionally, for banks, there is a need for constant financing, spurring discipline and restraint. Management at a bank would be likely to say, "even if the market environment causes a temporarily high refinance cost, from a broader point of view, it will be beneficial to call on the expiry date in order to maintain credibility with investors." In the case of general business corporations, however, such incentives might be weaker than they are for banks. Also, bank capital has a track record of more than a decade, but the corporate hybrid market is still in its infancy, and thus the liquidity and depth of the market is also very different. Generally speaking, the investment risk in corporate hybrid is higher than that of bank capital, and thus requires higher risk premiums.

Differences in Risks Between Bank Capital and Corporate Hybrid

	Bank Capital	Corporate Hybrid
Investor class	Common	
Product design	Certain degree of standardisation (Framework within the capital adequacy regulation)	Flexible: Strong individuality (Places an emphasis on the equity credit assessment given by ratings)
Incentive to call on the expiry date	Strong (Need for constant refinancing)	Weak?
Liquidity	High	Low
Depth of the market	Yes	No

Source: PIMCO

Figure 8

Points to be Noted when Investing in Hybrid Securities, and Challenges in the Course of Developing the Market

Hybrid securities are a very interesting investment choice, and have the potential to generate alpha in corporate bond investment. However, investors should fully analyse and understand risks involved with hybrids, which are different from ordinary corporate bonds. Compared to the relatively mature bank capital market, the corporate hybrid market is in the early stages of development, and is potentially exposed to more unknown risks. For the further development of the corporate hybrid market in Japan, we need to overcome the following three challenges:

Product design that meets investors' needs

Unlike the U.S. and Europe, the high yield bond market in Japan is not mature yet. Thus, in principle, hybrid securities need to be acceptable to an investment community whose experience is largely limited to investment-grade securities. Highly complex products or low quality credits are not acceptable to the bulk of Japanese investors. Also, there should be sufficient efforts to add adequate step-up conditions and thereby increase the probability of the execution of the call, which would clarify the investment period. So far, much of the issuance has included a step up range of 100 basis points or less due to rating standards.

Second, shortening of the period until the expiry date

In Japan, liquidity in the corporate bond market is relatively low, making it difficult to sell securities in the secondary market. For senior bonds, interest payments and principal redemptions will be carried out as long as the issuer does not default, and if investors buy and hold the security until the expiry date, the security will be redeemed at par with no loss. However, for hybrid securities, there are uncertainties with dividend payment and call redemption. Due to rating standards, it is common to issue securities with a repayment grace period of more than ten years until the call is exercised. It is certainly difficult to forecast ten years in advance the probability that a call will be executed or profits will be available for dividends, and that uncertainty can be a significant restraining factor for investors. It will be important that issuers compensate for this drawback by shortening the period allowed for the execution of the call and to thereby secure a framework that allows investors to exit. Generally, investors' needs are geared toward product that can be called at 3 to 5 years.

Third, standardisation of product design

Although it is important to acknowledge the needs of issuers, liquidity in the hybrid securities market can only be achieved by standardising hybrid securities to allow easy comparisons of their risk and relative value, as is the case with bank capital.

Unfortunately, at present, the rating methods in place at credit ratings agencies seem rather inflexible and the rationale for their rating standards is not necessarily clear. For example, why does the call date have to be 10 years after the issuance? Why does the range of step-up need to be 100 basis points or less? These questions suggest that some standards were set just by simply following the example of standards for Tier 1 bank capital. But applied to corporate hybrids, these points can be a restrictive factor in designing the products, and improvement of ratings standards should be addressed immediately. These problems need to be solved and the depth of the market needs to be improved in order to achieve proper long-term development of the corporate hybrid market in Japan.

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