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Hybrid Securities Of Over 60 European Financial Institutions Downgraded Following S&P Review

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Hybrid Securities Of Over 60 European Financial Institutions Downgraded Following S&P Review

On March 31, 2009, Standard & Poor's Ratings Services lowered its issue ratings on the hybrid capital securities of over 60 European banking groups in several countries. For a complete list of the financial institutions affected, see "Hybrid Capital Issue Ratings Of Certain European Banks Lowered; Teleconference April 2, 4pm CET," published March 31, 2009, on RatingsDirect.

The rating actions came after our review of ratings on the hybrid securities of financial institutions in Europe. The downgrades reflect our assessment of the deteriorating financial prospects for the European banking industry in the worsening economic environment and our view that European governments and the European Commission (EC) over the medium term may be more willing than previously to encourage or force banks to suspend payments on hybrid securities to preserve cash and build capital. We did not change any of the issuer credit ratings (ICRs) on the banking groups that issue these hybrid securities.

Hybrid capital securities--preferred shares and long-term or perpetual subordinated notes with deferrable coupon payments-- are designed to absorb losses and preserve capital on a going-concern basis in times of stress, such as the present and projected recessionary environment in Europe. In contrast with the fixed payments of conventional debt, hybrid securities' interest and dividend payments may typically be deferred or cancelled at the issuer's discretion, upon the order of financial authorities, and/or when instrument-specific triggers occur. This characteristic, coupled with the typical deep subordination of hybrid capital issues, makes these instruments riskier, in our view, than senior debt for investors.

Under our ratings approach, the rating on a hybrid capital security reflects the potential for deferral or elimination of payments of interest and principal, as well as the security's typical subordinated ranking in liquidation. A missed payment according to terms on a deferrable hybrid security results in a 'C' rating on the security. The extension of the maturity of a hybrid security at the date on which the issuer has the option to call the security and repay the principal has no impact on the rating of the security.

From a rating perspective we generally widen the gap between the ICR and the rating on the hybrid instrument of the issuing entity to three or more notches when we consider the potential for payment deferral has increased (see our criteria articles in the Related Research section below). In our view, the potential for European banks, through their own initiative or under government order, to defer interest or dividend payments is greater over the medium term than it has been over the past two decades. We consequently have widened the gap between the ICR and the hybrid security rating to three notches for most European banking groups and to four or more notches in certain instances related to the elimination of ordinary dividends of the hybrid issuer, the existence of voting rights in several hybrid securities issued by certain banking group in the U.K. and Ireland, and features of certain hybrid securities that link deferral to financial performance.

Standard & Poor's recently took similar rating actions on the hybrid capital securities of U.S. financial institutions (see "Review Results In Changes To Certain U.S. Financial Institutions' Hybrid Capital Issue Ratings," published Feb. 24, 2009).

Hybrids Of Government-Supported Banks Are Increasingly Vulnerable

In our view, the hybrid capital securities of European and U.S. banking groups whose creditworthiness is supported by already-received and potential future government aid are more vulnerable to payment deferral than the hybrid securities of banking groups whose credit profiles reflect their stand-alone strengths. Earlier in 2009, Standard & Poor's took rating actions on several hybrid securities of European banking groups due to our assessment of this vulnerability (see "Issue Ratings Lowered On Hybrid Instruments Of Some European Banks On Heightened Deferral Risk," published Jan. 28, 2009).

We believe that governments in mature economies are not willing to support hybrid capital issues to the same extent as they would more senior obligations. When a bank incurs material net losses and needs to conserve cash and rebuild capital with government help (i.e. through public funds), deferring payments on hybrid securities may be one way to accomplish this. We recognize the broader negative market implications of a payment deferral on banks' future access to capital markets, but access to capital is in our view already seriously constrained for many European and U.S. institutions. Governments may use the deferral option more frequently due to the significant need to shore up the capital of certain banking groups damaged by the downturn. We consequently rate the hybrid securities of many European (and U.S.) government-supported financial institutions four or more notches lower than the ICR of the issuer, and often lower than 'BBB-'. The stand-alone credit profile of the issuer is a key element in our assessment of payment deferral risk of financial groups whose creditworthiness and ICRs benefit from potential future government support, if needed.

While we believe that the willingness of European governments to exercise the deferral option on the hybrid instruments of financial institutions that have received direct support has increased, we note that in the large majority of cases through the first quarter of 2009, European governments have permitted supported banks to service their hybrid capital securities.

Various Factors Heighten Risk Of Hybrid Payment Deferral

We believe that European financial institutions' current weak financial performances and eroding earnings prospects also heighten the risk of payment deferral on hybrid instruments of banking groups whose credit profile is not supported by anticipated direct government aid. We believe the leading indicators of heightened risk of hybrid payment deferral for issuing entities are:

- Recent incurrence of material net losses, coupled with poor near-term financial prospects;
- Weak capital ratios;
- Increased potential for breaching regulatory performance or capital tests;
- Creditworthiness in jeopardy of eroding to an extent that could materially affect its access to and cost of capital (for example, the short-term ICR on the issuer declines to 'A-2' from 'A-1');
- The cutting or elimination of dividends on ordinary shares. Many hybrid issues contain so-called 'dividend pushers,' under which the issuer must continue to make interest payments on hybrids as long as it is paying common dividends, or 'dividend stoppers,' where the issuer ceases common dividends if it has not paid interest on hybrids. Once the common dividend has been eliminated, the issuer has a freer hand to defer payments on its hybrids.

The last indicator is increasingly important in the current environment. We consequently have increased the gap between the ICR and the hybrid security rating to four or more notches for several European banking groups that have eliminated their ordinary dividends.

Issue Characteristics Contribute To The Gap Between ICRs And Ratings On Hybrid Securities

Hybrid securities that include terms that link the suspension or elimination of payments to financial performance, notably earnings, distributable income, or specified capital levels, in our view increase the potential of payment deferral for issuers whose future financial performance may come under pressure. The worsening economic conditions in Europe and the hurdles ahead for the banking sector, we believe, increase the potential for future losses and broadly heighten the payment deferral risk for most hybrid securities with payments linked to performance measures. This factor is behind our current downgrade of the hybrid securities of Spanish banks; we widened the gap to four notches between the ICRs and the ratings on hybrid instruments of all Spanish banking groups. Under the Spanish regulatory framework, hybrid capital securities link nonpayment with the distributable profits of the previous year.

Many hybrid capital instruments of German financial institutions have clauses that link payments to earnings performance measures. Some are unrated issues of "Genusscheine" and "Stille Einlagen," two types of hybrid capital instruments specific to the German market. The performance link is typically a broad earnings measure that allows for the issuing institution to use capital and earnings reserves to offset an annual loss. One case in which we have reflected in our ratings the incremental risk of a performance link is for several hybrid securities of DZ BANK AG Deutsche Zentral-Genossenschaftsbank (DZ Bank), which we rate four notches lower than the ICR on DZ Bank due to a clause that links the payments on the securities to the group consolidated net earnings. In a stress scenario of heavy losses for the banking industry, we believe that hybrid securities with links to financial performance could be relatively more vulnerable than those with terms that allow for more flexibility in payment.

In the U.K. and Ireland, perpetual preferred shares that grant voting rights to the holders in certain circumstances may be included in a nationalization of a troubled financial institution to ensure that the government gains full control. This happened to Northern Rock PLC and Anglo Irish Bank Corp. Ltd. The U.K. and Irish governments, respectively, included the preferred shares with voting rights of these two institutions in their nationalizations, and payments to the original holders ceased. Since March 24, 2009, we have rated preference shares with voting rights issued by Lloyds Banking Group PLC and Royal Bank of Scotland Group PLC one notch below their other perpetual deferrable instruments to reflect what we view as this incremental "nationalization risk" of the preference shares of these two government-supported banking groups. We have currently not made a similar distinction in the cases of other U.K. and Irish issuers of preference shares with voting rights, but may do so if the issuing entities received material government capital support and we believed that the potential for nationalization has increased.

European Regulators May Take A More Active Stance On Hybrid Securities

In periods of normal market conditions, we have observed that banking groups are reluctant to defer payments on hybrid securities. We believe this is because their heavy ongoing funding appetite heightens the importance of preserving access to capital markets. Regulators also have an interest, in our opinion, in assuring market access for

banks and overall market stability. But market conditions are now far from normal. Our ratings on hybrid securities of European and U.S. banks broadly reflect our view that financial regulators and banking groups themselves will be selective in their approach to payment deferral over the medium term. Still, we do not rule out the possibility that regulators or other government officials in Europe and in the U.S. could adopt a more sweeping approach to the use of hybrid securities to absorb losses.

A capital injection from a European Union (EU) government into a financial (or other) institution typically requires an application to the EC under EU state aid rules. Over the past several months, the EC has granted conditional approval to a number of national support schemes for banks. As part of its assessment of an application, we understand that the EC determines whether a bank or other entity is distressed or fundamentally sound at the time the entity receives support. We believe that as a policy matter the EC may aim to ensure that state aid granted to banks in difficulty is preserved and used to strengthen capitalization and not paid out to shareholders or holders of other capital instruments, including hybrid securities. As a consequence, potential EC intervention in certain cases of state aid to banks is a further consideration in our assessment of payment deferral risk.

The hybrid capital securities of several European banking groups remain on CreditWatch with negative or developing implications due to uncertainties on the degree of earnings deterioration of these groups, potential groupwide restructuring that could impact hybrid securities, and questions regarding the application of EU state aid rules. The institutions with hybrid ratings remaining on CreditWatch are: Commerzbank group, including Dresdner Bank AG and Eurohypo AG; the Dexia S.A. Group, including Dexia Crédit Local, Dexia Banque Internationale à Luxembourg, and Dexia Bank S.A.; Fortis Bank SA/NV; Northern Rock PLC; Allied Irish Banks PLC; and Bank of Ireland. National governments already have provided substantial support to these banking groups in the form of capital and guarantees; future government decisions, we believe, will be crucial to the creditworthiness of these entities. We expect to remove the issue ratings on the hybrid instruments of these entities from CreditWatch following review of several factors: projected earnings; potential national government actions, including decisions on restructuring; and EC rulings on state aid.

In terms of the long-term credit profiles of hybrid capital securities, to the extent that we believe that the financial performance of banking groups durably recovers to more normal levels over time, we would consider raising the issue ratings and narrow the gap between the ICRs and the hybrid instrument ratings for many financial institutions. Ratings on hybrid capital securities are potentially more volatile than ratings on conventional debt issues.

Related Research

This article is based in part on the following criteria articles:

- "Franchise Stability, Confidence Sensitivity, And The Treatment Of Hybrid Securities In A Downturn," published Dec. 1, 2008;
- "Hybrid Capital Handbook," published Sept. 15, 2008.

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