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Spectrum Asset Management

Principal Asset Management℠

Guide to capital and hybrid securities

What are European capital and hybrid securities?

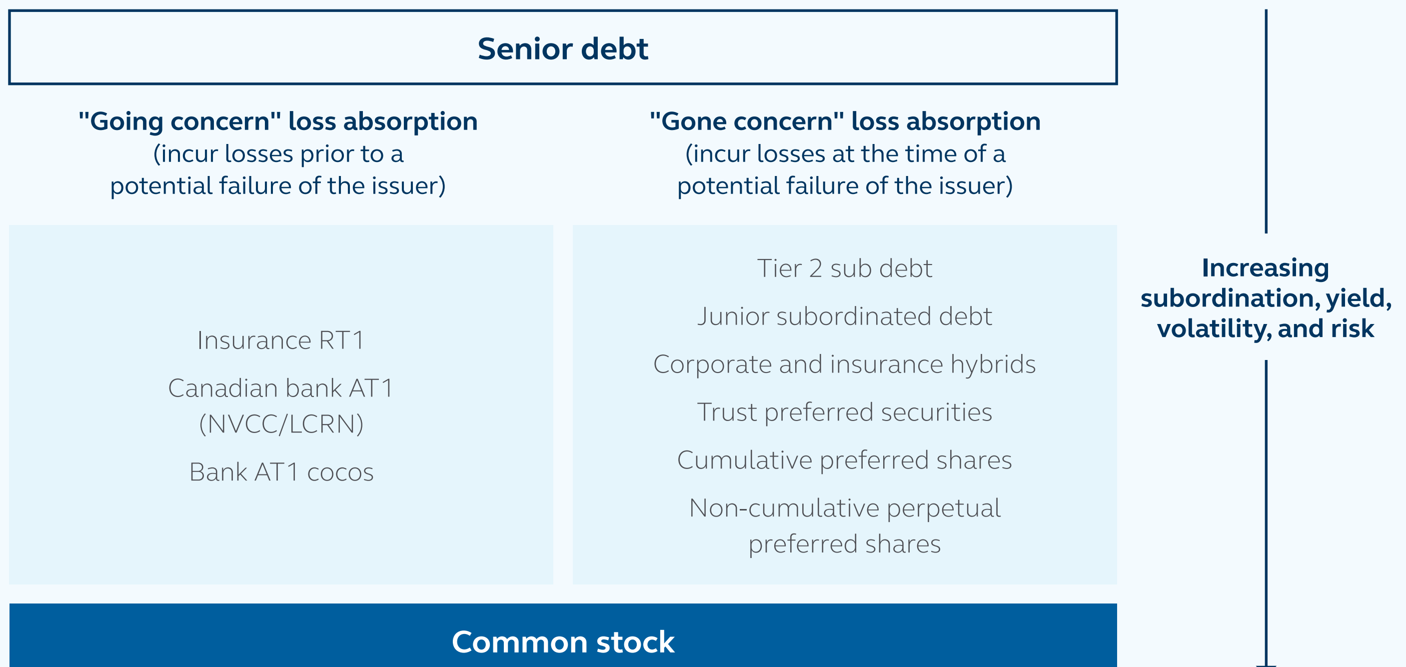
Capital and hybrid securities have been an attractive fixed income sector for investors around the world for many years, but they are still not widely understood. The purpose of this guide is to provide a better understanding of these instruments and their market, as well as why capital and hybrid securities may be a compelling investment choice for some investors.

Capital and hybrid securities are deeply subordinated in the capital structure and can typically defer or skip payments without creating an event of default. Capital and hybrid securities are issued mainly by large banks and insurance companies, as well as industrial and other corporate issuers, for regulatory and/or rating agency capital purposes. Similar to other fixed income investments, the performance of capital and hybrid securities can be affected by interest rates and credit risks.

Capital and hybrid securities have several characteristics that investors find attractive:

- Fixed income diversification
- Yield enhancement
- Stable credit quality
- Low default and deferral history

CAPITAL STRUCTURE



Hybrid features

Capital and hybrid securities are sometimes referred to as "hybrids" due to their combined debt and equity attributes. Debt-like features may include stated coupon payments, a definitive maturity date, and a stated par value. Equity-like features typically include a long-dated maturity or a perpetuity, capital credit from regulators and credit rating agencies, and payment deferral options. In a distressed situation, distributions of cumulative issues can be deferred for up to 10 years, and those of non-cumulative issues can be passed indefinitely, without the threat of investors being able to force the issuer into bankruptcy. This is in stark contrast to a standard corporate bond, where a bondholder can force an issuer into bankruptcy after one missed coupon payment. Capital and hybrid security investors generally have preference over common equity investors, whereby all payments must be made before any dividend payments are distributed on common equity. While there are companies that have failed to pay on their capital and hybrid securities, most have done so only when they have filed for bankruptcy and also defaulted on their senior bonds and loans.

> "Capital and hybrid securities rank junior to senior debt, but are senior to common equity."

Junior ranking in capital structure

Capital and hybrid securities rank junior to senior debt, but are senior to common equity. For example, if a company has filed for bankruptcy and the assets of the company are liquidated to pay off creditors, the most senior investors would expect to receive more than those lower (e.g., capital and hybrid security investors) in the capital structure. This "recovery rate" is expressed as the amount recovered as a percentage of the par amount of the investment.

Distributions

Capital and hybrid securities pay distributions to their holders in the form of interest payments, either on a quarterly, semi-annual, or annual basis. The tax characteristics of capital and hybrid securities can vary depending on the jurisdiction of the issuer and investor, and specific security structure. Interest payments are tax deductible to the issuer and potentially fully taxable to the investor.

Callable

Most capital and hybrid securities are callable or redeemable prior to maturity by the issuer. This right allows the issuing company the option to buy back the securities from the investor at the stated par value before the maturity date. This is valuable to the issuer because, if interest rates decline after the securities have been issued, the issuer can "call back" the securities and re-issue new securities at a lower interest rate, thereby locking in a cheaper cost of capital. To make the securities more attractive to investors, the issuer provides some guarantee that it will not call the security for a specific period of time. This "call protection" is generally five years or 10 years. This embedded call option feature in the security has value to the issuer and creates reinvestment risk[1] for the investor. The value of this option will change as the probability of the security being called increases or declines. For example, a security that is trading at a significant premium to par, implying that interest rates have fallen since issuance, is likely to get called at the first available call date. Alternatively, a security trading at a deep discount to par implies that interest rates have risen since issuance, meaning the security is unlikely to be called soon.

[1] Reinvestment risk is the risk that future coupon payments will not be reinvested at the interest rate from the initial purchase of the bond.

Structures

There are several types of capital and hybrid securities in the market.

> "Most of the capital and hybrid securities market comprises large global financial services issuers."

Subordinated debt

Junior to senior debt, and frequently plays some role in meeting regulatory capital requirements for insurance companies and banks. Subordinated debt usually has a specific, stated maturity, and coupons are typically not deferrable. In the banking sector, older style subordinated debt structures are sometimes referred to a "Tier 2" paper.

Cumulative junior-subordinated debt and non-cumulative preferred securities, capital securities, and hybrids

Comprising a majority of the capital securities and hybrids market, these rank junior to senior debt and subordinated debt, and have coupons that can be deferred. The most senior of these securities are junior- subordinated debt instruments (typically bonds with long-dated maturities) having cumulative coupons. These are generally issued by insurers, utilities, and industrial companies. "Cumulative" means that any deferred coupons continue to accrue as a liability to the issuer.

AT1 contingent convertible (CoCos) capital securities

A form of capital issued by non-U.S. (mostly European) banks as part of regulations following the global financial crisis, CoCos are structured as junior, non-cumulative perpetual securities whose coupons can be skipped at any time. In addition, if the issuer's regulatory common equity capital drops below certain pre-set levels, the CoCo will be either written down in par value (sometimes with the ability to be written back up later if the issuer's capital improves), written off completely, or converted into common stock, depending on the terms of the structure. U.S. banks do not currently issue CoCos due to different tax laws in the United States. Depending on the particular form of capital, CoCos can be referred to as "AT1", "Tier 1", or "Tier 2" paper.

Restricted tier 1 (RT1) capital securities

RT1 securities are the most subordinated form of hybrid bonds issued by European insurance companies, similar to bank AT1 bonds. The EU Solvency II Directive defines the classification criteria for these bonds, specifically, that they have no maturity date (with a first call date after 5 years), have discretionary coupons, and the capital can be written down or converted into equity capital if the issuer's regulatory capital requirements are not met (a Solvency II ratio of less than 100% for 3 months or 75% once). As a "going concern" capital instrument, such conversion or write-down is solely dependent on the Solvency II ratio.

The European capital and hybrid securities market

The European capital and hybrid securities market emerged as an outgrowth from the U.S. preferred and capital market, which began in the early 1900s, largely driven by regulatory rules for financial institutions. At first, small and thinly traded, the European capital and hybrid securities market began to expand in 2010 as Basel III provoked the creation and issuance of CoCos by European banks and realigned the regulatory framework for banks. By 2023, the European capital and hybrid securities market totaled more than EUR 340 billion[2] in face amount and trades with very efficient liquidity.

Credit quality of capital and hybrid securities

The stable credit quality of capital and hybrid securities reflects the resiliency of large banks and insurers, which represent the major issuers. Post global financial crisis, the banking and insurance industries have evolved into two of the most attractive industry sectors due to strengthened credit fundamentals. This improvement has been driven by regulatory changes globally, through the Basel III agreement for banks and in Europe through Solvency II for insurers. Unlike before the global financial crisis, banks are now more "utility-like," characterized by steadier profits, higher capital levels, lower leverage, tighter regulation, and simplified, better managed business models. Today, the insurance industry exhibits even stronger capital and liquidity, supported by sound risk management and enhanced regulatory initiatives. Following the global financial crisis, the fundamental health of the financial industry has resulted in a reduction in global systemic risk.

Most capital and hybrid securities are rated by the large credit rating agencies such as Standard & Poor's, Moody's and/or Fitch. It has become an industry standard that capital and hybrid securities are formulaically rated several notches below the rating of the senior debt of the same issuer. Nearly 90% of the senior debt of capital and hybrid issuers is investment grade, making capital and hybrid securities reasonably comparable to high grade rather than below investment-grade fixed income due to better underlying credit fundamentals. Historically, the default characteristics of capital and hybrid securities have been markedly lower than those of below investment-grade bonds. Moreover, similar to investment-grade debt, capital and hybrid securities have experienced little to no defaults over the past several years.

[2] Source: EBSU+ENSU+EUR component of CoCos, as of December 31, 2023.

Companies issue capital and hybrid securities for a variety of reasons

Most of the capital and hybrid securities market comprises large global financial services issuers. Among the many benefits are:

Regulatory capital credit

Global banking regulation categorizes certain capital and hybrid securities as AT1 capital. Notably, capital and hybrid securities serve as an important source of regulatory capital providing support for bondholders, depositors, policy holders, and other senior creditors.

Structural benefits

Due to deferrable income features, non-payment of interest does not create an event of default for the issuer. Embedded call options can also add value.

Rating agency equity credit

The major credit rating agencies can award some equity credit to capital and hybrid securities when analyzing a company's enterprise credit rating. Consequently, the issuance of a capital or hybrid security could have less of an impact on an issuer's financial leverage (compared with that of a straight bond), while supporting the issuer's senior debt rating.

Lower capital cost

Due to greater risks in common stock ownership, equity investors require a higher return than that demanded from capital or hybrid security investors. As a result, capital and hybrid securities can present a lower cost option to the issuer and provide some equity credit. Importantly, capital or hybrid securities issuance is non-dilutive to shareholders.

Tax advantages

The tax characteristics of capital and hybrid securities can vary by jurisdiction, and can be attractive to both the issuer and the investor. Interest payments are generally tax deductible to the issuer and may be fully taxable to the investor. Dividend payments are not tax deductible to the issuer and may be tax beneficial to the investor.

What makes capital and hybrid securities attractive to investors?

Yield

Historically, capital and hybrid securities are one of the highest yielding sectors of the high-quality income market. Capital and hybrid securities typically trade at an attractive spread over the same issuer's senior debt. As such, when the enterprise rating of a particular issuer is stable to improving, investment in capital or hybrid securities gives the potential for a greater yield and return than debt issued higher in the capital structure. This is known as investing "down the capital structure."

Regular income frequency

Most pay quarterly, semi-annual, or annual coupons, similar to corporate bond frequencies. Coupon payments are dependent upon an issuer's ability to service their debts.

Quality

The majority of capital and hybrid securities are issued by well-known and widely-researched companies which generally have investment-grade-rated senior debt. Historically, most of the additional return generated by capital and hybrid securities is attributable to the junior-subordination premium and the value of the call option. Defaults in the capital and hybrid securities market are somewhat greater than those found in the investment grade corporate bond market, yet significantly below those found in the below-investment-grade (or high yield) corporate bond market.

Diversification

Historically, capital and hybrid securities (or high yield) have moderately positive correlations with the general bond market. Capital and hybrid securities, therefore, have the potential to offer an attractive diversification tool for fixed income investors by helping to rebalance expected risk-adjusted returns of a broad fixed income portfolio.

Liquidity

Most capital and hybrid securities markets can be categorized as "liquid," whereby individual constituents can be expected to be sold within seven calendar days or fewer.

Yields and spreads

Capital and hybrid securities, like other fixed income securities, are typically valued on a yield basis, and spread basis versus European government bonds. Spread relationships to senior debt are a key value consideration as well.

Current yield
This is calculated by dividing the annual coupon payment by the current market price of the security.

Yield to maturity
This is the yield if the bond is held to final maturity and dividends are reinvested at the yield-to-maturity rate, taking into account the income earned and any capital gain or loss that will be made. For example, an investor has to consider redemption at a lower price if a bond is bought at a premium and held to maturity, as the holder will only receive the par or nominal value at maturity.

Yield to call
This is the realized yield if a security is held until the first call date, assuming all dividends are reinvested at the call rate and taking into account any income and capital gains or losses.

Yield to worst
This is the lower of the yield to maturity and the yield to call. Generally, if the bond is trading at a premium to par, the yield to call will be lower and the bond is more likely to be called. However, if it is trading at or below par, the yield to maturity will be lower and it is more likely not to be called.

Interest rates can change during any holding period. Importantly, an investor should monitor reinvestment rates, and the risk that a fixed coupon may switch to a floating rate (or variable re-fixed rate) over the life of the issue.

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Over 1,950 employees with 700 investment professionals

The scope of our investor base spans over 85 markets

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Spectrum Asset Management

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*As of December 31, 2023. See full disclaimer on the back page.

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Risk considerations

Investing involves risk, including possible loss of principal. Past performance is no guarantee of future results. Fixed-income investment options are subject to interest rate risk; as interest rates rise their values will decline. Risks of preferred securities differ from risks inherent in other investments. In a bankruptcy, preferred securities are senior to common stock but subordinate to other corporate debt. Asset allocation and diversification do not ensure a profit or protect against a loss. Yields and yield related characteristics shown are only one component of performance or expected performance and are not guaranteed. Contingent Capital Securities carry greater risk compared to other securities in times of credit stress. An issuer or regulator's decision to write down, write off or convert a CoCo may result in complete loss on an investment. An issuer or regulator's decision to write down, write off or convert a CoCo may result in complete loss on an investment.

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