In the Moody's for Subordinated Debt Securities: Methodology Changes for Awarding Equity Credit

August 5, 2024

Moody's New Criteria for Investment-Grade Entities

Earlier this year, Moody's Investors Service ("Moody's") simplified its methodology and updated its criteria for awarding equity credit to subordinated debt securities of investment-grade issuers. Previously, Moody's assigned five possible tiers of equity credit to subordinated debt securities: 0%, 25%, 50%, 75% and 100%. Moody's replaced this five-tier system with a three-tier system: 0%, 50% and 100% equity credit, also referred to as basket L, basket M and basket H, respectively (*i.e.*, "low," "medium" and "high"). Under the new methodology, the subordinated debt of investment grade companies that is mandatorily convertible to equity is now assigned 100% equity credit, and subordinated debt that has an "unrestricted optional skip of coupons" and a maturity of at least 30 years, with at least 10 years left until maturity, is assigned 50% equity credit. Securities that do not fall into one of these two buckets are assigned 0% equity credit.[1]

Moody's shift to a three-tier system aligns with the existing systems of its counterparts, S&P and Fitch, which both use similar three-tier rating systems. S&P assigns subordinated debt securities high, intermediate, or no equity content, while Fitch uses 0%, 50% and 100% tiers of equity credit.

Heightened interest in subordinated debt securities is expected to follow Moody's adoption of its new methodology. For example, subordinated debt securities may become a more attractive source of capital for insurance companies as a result of the simplified criteria and their lower cost as compared to other hybrid securities, such as preferred stock. Ultimately, the most appropriate and optimal means of raising capital

---

1 Moody's takes a different approach to ascribing equity credit to hybrid securities issued by speculative-grade issuers. These hybrid securities are assigned either 0% or 100% equity credit, depending on certain rights such as (1) whether, upon the occurrence of certain events, the terms of the security include the ability to trigger bankruptcy or (2) whether the security offers the securityholders creditor rights in bankruptcy. If a subordinated debt security provides neither (1) nor (2), 100% equity credit is given. If a subordinated debt security provides either or both of (1) or (2), 0% equity credit is given.

will depend on a range of factors, including the composition of the company's capital structure, the intended use of proceeds, and regulatory and rating agency considerations.

Refresher on Subordinated Debt Securities

For issuers considering issuing subordinated debt securities, there are a number of benefits. To learn more about the key features of subordinated debt securities, please refer to our article "*Thoughts on Financing and Capital Solutions for Insurance Companies*," which discusses the interest rate, interest deferral, optional redemption, offering document/marketing, and tax aspects of subordinated debt securities in depth. A refresher on certain key features of subordinated debt securities, and how they relate to Moody's new methodology, follows.

Rating Agency and Financial Covenant Treatment

Subordinated debt securities typically receive equity credit from rating agencies up to a specified percentage of the principal amount (as described above), which credit will depend upon the specific terms of the securities and the particular rating agency's criteria. This benefit can help issuers manage their debt-to-capital ratio as calculated by rating agencies.

To the extent that an issuer is subject to a restrictive covenant limiting its ability to incur senior indebtedness (*e.g.*, a consolidated indebtedness to total capitalization financial covenant), subordinated debt securities are often not included in the calculation of consolidated indebtedness to the extent of the equity credit afforded to such notes by the rating agencies. As a result, subordinated debt securities may provide an issuer with additional flexibility to finance its business without incurring the full impact on its ratings or financial covenants that senior debt would have.

The extent of equity credit afforded to an issuer by a rating agency in connection with the issuance of subordinated debt securities is dependent upon the exact terms of the notes. In general terms, the extent of equity credit granted to any particular security is a function of the following:

- "Permanence" of the security

Moody's will first assess the mandatory conversion characteristics of a security. A subordinated debt security that mandatorily converts to a fixed number of common equity shares within three years is assigned 100% equity credit. If the security does not mandatorily convert within three years, it is assigned either 50% or 0% depending on the security's coupon skip provisions and the extent of the security's subordination.

A security would also be assigned 100% equity credit if, in the event of a breach of a regulatory solvency threshold at any time, the security is subject to a write-down or converted to equity.

- Provisions governing interest and principal payments

Moody's examines whether a security's terms include an unrestricted option to skip coupon or dividend payments. If there is no optional payment deferral, the security receives no equity credit. If a security does have an optional payment deferral mechanism, depending on the extent of its subordination, it is assigned 50% or 0% equity credit.

Subordinated debt securities are assigned 0% equity credit if the coupons "must be paid upon payment on junior or parity securities." If the payments on the more junior or parity securities can be made at the discretion of the issuer, however, the security is considered to have an unrestricted optional coupon skip and can be assigned 50% equity credit.

An "unrestricted optional coupon skip" was formerly interpreted to mean that there could be no time limit on the deferral. Now, Moody's says that the deferral right "should be available to the issuer for a length of time sufficient, typically at least several years, for the issuer to return to a stronger credit profile." Though Moody's methodology does not provide further guidance as to how many years would be sufficient, recent subordinated debt issues have settled at five years.

Moody's no longer considers it decisive if the coupon is skipped on a cumulative or non-cumulative basis.

- Extent of the security's "subordination"

For securities that do not mandatorily convert to a fixed number of common equity shares within three years, but do allow for unrestricted optional coupon skips, Moody's will assess the security's maturity.

A security is assigned 50% equity credit if it has a maturity of at least 30 years (or has no stated maturity) and has at least 10 years remaining until maturity. A security without these characteristics is assigned 0% equity credit.

If a security has meaningful interest or dividend-rate step-ups, Moody's will use the time to the first call date of the security as the effective maturity, rather than using the stated maturity. If there are no meaningful step-ups, the first call date is not considered in the assessment of the security's maturity.

A step-up in any amount prior to 10 years following the issuance of the security is considered "meaningful." However, a step-up for change-in-control events is only considered meaningful if the step-up is more than 500 basis points. After 10 years, a step-up is considered meaningful if it exceeds 100 basis points. If the coupon or dividend of a security resets from a fixed rate to a fixed rate or from a fixed rate to a floating rate, Moody's will assess the nature of the step-up based on "whether the contractual interest rate spread over the risk-free rate at the time that the rate resets exceeds 100 basis points from the initial contractual interest rate spread."

The former view from Moody's was that, to be assigned 50% equity credit, a debt security had to be junior to all obligations except common stock. Under Moody's new regime, the security no longer has to be the most junior in the capital structure—it need only be junior to specified more senior securities. This change could make subordinated debt more attractive than preferred shares in light of the former's tax-deductibility advantage.

Planning Ahead: Dusting Off the Shelf

It is common (though not required) for investment grade securities, including subordinated debt securities, to be issued in transactions registered with the SEC. Issuers with an effective "omnibus" shelf registration statement will likely have sufficient flexibility to issue securities meeting the new criteria using a prospectus supplement, but should review existing disclosure and indentures with legal counsel to confirm. Issuers without an effective shelf registration statement that permits SEC-registered sales of subordinated debt securities (or those with a shelf registration statement expiring in the near term or which does not register subordinated debt securities with terms enabling a more favorable Moody's methodology) should consider taking action. This could include filing a new shelf registration statement or a post-effective amendment to an existing shelf registration statement. When doing so, issuers should review the description of debt securities and the form of base indenture (if any) to facilitate flexible terms for the issuance of subordinated debt securities.

Redeeming and Repurchasing Existing Preferred Stock

Moody's changes in methodology could make certain types of liability management activity more attractive, as a result of the potentially higher equity credit attainable for subordinated debt securities, increasing their relative attractiveness vis-a-vis preferred equity. Prior to the new methodology, U.S. companies could receive a 50% equity credit for preferred stock issues, but because preferred stock is treated as equity for tax purposes in the United States, dividend payments are not tax-deductible. Tax-deductible subordinated debt was generally given only 25% equity credit by Moody's under the old methodology, but that equity credit is potentially raised to 50% with the new methodology.

Accordingly, issuers may consider replacing their outstanding preferred stock with subordinated debt securities, either by (i) redeeming the preferred stock or (ii) offering to repurchase outstanding preferred stock. From a planning perspective, issuers should assess whether and when their outstanding securities are redeemable. If existing preferred stock is not readily redeemable, or if trading prices make repurchases a more economic approach, issuers will need to assess whether the SEC's tender offer rules apply. Whether or not an offer to purchase securities may be deemed a tender offer is a facts-and-circumstances analysis that should be considered with legal counsel. Generally speaking, in connection with any offer to repurchase outstanding securities from a large number of holders, the minimum requirements of Regulation 14E—including the requirement to keep the offer open for at least 20 business days—will apply. With respect to preferred stock listed on a U.S. securities exchange, which is commonly the case for certain types of preferred stock issued by financial institutions, the more stringent requirements of Regulation 14D will also apply. This includes, for example, the requirement to file a Schedule TO with the SEC, the so-called "all-holders, best-price" rule, and extended withdrawal rights.

* * *

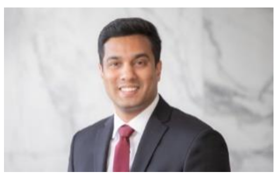
Please do not hesitate to contact us with any questions.

Follow Debevoise & Plimpton on [LinkedIn]() and [Twitter]().

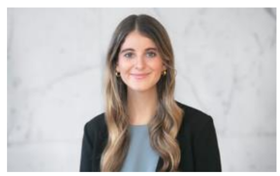
Eric T. Juergens
Partner, New York
+1 212 909 6301
etjuergens@debevoise.com

Benjamin R. Pedersen
Partner, New York
+1 212 909 6121
brpedersen@debevoise.com

Paul M. Rodel
Partner, New York
+1 212 909 6478
pmrodel@debevoise.com



John Jacob
International Associate, New York
+1 212 909 6795
jjacob@debevoise.com



Julia Glazer
Associate, New York
+1 212 909 6236
jglazer@debevoise.com