Hybrid Bonds & Not for Profits

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Hybrid bonds may have a useful role to play in the capital structures of not for profit entities that have exposure to commercial risk. Not for profit entities, such as housing associations, are non-distributing and therefore traditional hybrid products such as convertible bonds (where debt is converted into equity) are not suitable. It is possible, however, to issue bonds that have equity like features such as the ability to miss payments for periods of time, but which do not convert into equity. There needs to be a sufficient degree of "equity like" features, however, for such a hybrid bond to be considered as a "non-debt" instrument.

A number of regulated not for profits in other sectors, such as mutual insurers, have these instruments but they have not been used in the social housing sector. A hybrid bond would need to be structured to meet specific rating agency criteria in order for it to be considered "equity-like" and therefore not increasing the level of indebtedness of the borrower.

Hybrid bonds would help provide a cushion for on balance sheet risk. This should help support the credit ratings on existing debt and could be considered as an alternative to some off balance sheet financing arrangements where risks, rewards, and controlling interests are typically shared with a commercial partner.

Hybrid Bonds – an Introduction

Hybrid bonds are issued by the borrower (or via a borrower owned vehicle) and can be structured in various ways. Similar to equity, hybrid bonds may have no fixed maturity date but there can be predetermined dates agreed between lender and borrower for call options in order to redeem the bonds.

A key feature of the bonds is the ability to miss interest payments that would normally be expected to be received by bondholders. The trigger events that allow for missed repayments on a hybrid bond can include an income cover test that is set above the existing income cover triggers for debt obligations. If the income cover test is met, then a borrower is not obliged to make a payment on a hybrid bond. This will allow a borrower some additional time to address cash flow issues in order to avoid defaulting on other obligations.

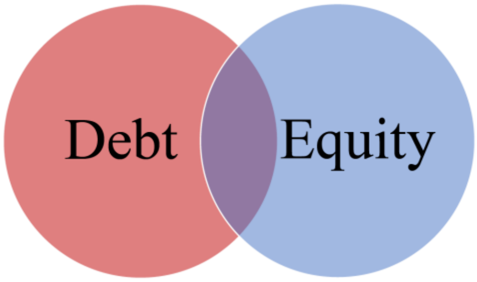
The design of the trigger mechanism that allows for missed interest payments, limitations on the number of missed payments after any trigger event, and the mechanism for repaying any missed payments are all factored into the analytical assessment of the overall level of "equity like" characteristics that can be attributed to a particular hybrid bond.

Hybrid bonds are a form of subordinated capital but are not the same as sub-ordinated debt. Hybrid bondholders would be sub-ordinated to other creditors including junior noteholders in in a similar way to traditional equity.

Hybrid bonds would not be secured on collateral. It is also unlikely that there would be any security covenants, such as asset disposal restrictions or unencumbered asset tests, which can be a feature of traditional "unsecured" bond issues.

Hybrid Bonds have Debt-like and Equity-like Features. Whether a particular Hybrid Bond is more Debt-Like or Equity-like will Depend on an Analytical Assessment of its Key Characteristics

Hybrid bonds have debt-like and equity-like features



Key Benefits

A key credit consideration that underpins the analysis of housing associations is the significant level of asset strength but compared to other highly rated entities there is a relatively low level of cash flow cover. Cash flow cover has increased in recent years, helped by profits from building housing for sale. This source of income is, however, more volatile than traditional income from regulated rents.

A default may therefore occur because of a short term cash flow interruption, for example in the event of an unexpected delay to commercial asset sales. Responding to short term cash flow volatility by missing some hybrid bond interest payments can act to absorb losses and may forestall a default on existing debt obligations. A missed interest payment (or payments), as per the terms and conditions of the hybrid bond, would not cause a default of the hybrid bond and would not cross default debt obligations.

By providing a cushion for on balance sheet risk, hybrid bonds can help support the credit ratings on existing debt obligations. Furthermore, hybrids could be considered as an alternative to some off balance sheet structures, such as joint ventures. These arrangements are set up to help reduce the risk associated with commercial investments, but they also share the rewards and control over development.

A commercial development can be a key factor in the success of a wider mixed tenure redevelopment project, where a housing association may have other social and financial investment commitments. In this instance a housing association may consider providing some form of additional support in the event of unexpected poor performance of its commercial investment with a joint venture partner. This support could be considered a form of contingent liability whereby the housing association does not have a legal obligation to support a commercial investment but may support it for other reasons.

If a housing association is providing some form of contingent support, then this should raise questions as to what level of risk sharing benefit a housing association is getting in return for it sharing the rewards and control with a joint venture partner. An equity investor in a joint venture arrangement can be compared with a hybrid bond investor lending directly to a housing association. A hybrid bond investor would be taking a clearly defined element of risk but would not be seeking the same level of return as a commercial equity investor and would not want the same level of control.

Depending on the issue size and analytical assessment of the hybrid bonds, they should act in a way to support the group ratings of a housing association and help reduce the risk of downgrades to group ratings. Hybrid bonds will be more expensive than traditional secured bonds, but it is expected that a relatively modest issuance of hybrid bonds would help support existing ratings. Maintaining (or improving) group ratings in the face of income volatility is likely to maintain attractive pricing of traditional debt instruments for housing association borrowers.

Considerations

The introduction of the new Rent Standard may give some housing associations more flexibility to develop affordable housing without relying on cross-subsidisation from commercial sales. However, having now developed skills and the capacity to deliver housing for sale, many housing associations will continue to cross-subsidise their affordable housing development programme and will continue to manage the risks associated with market volatility.

The analytical assessment of whether a hybrid bond is more equity-like or more debt-like will be undertaken by a rating agency (or rating agencies) based on the structure and terms and conditions of the bond. There may need to be an iterative process to balance on the one hand the benefits of being more equity-like which would provide more support to existing debt ratings, and on the other hand the higher price associated with a more equity-like hybrid bond compared to a more debt-like hybrid bond.

Hybrid bond credit ratings are likely to be “notched off” existing group ratings. The more equity-like a hybrid bond is assessed to be, the more notching should be expected. This may mean that for some housing associations a more equity-like hybrid bond would be rated as non-investment grade.

A hybrid bond issue which is assessed by a particular rating agency may help support the ratings of existing issues that are rated by the same agency. Ratings agencies may come to different conclusions in their assessment of hybrid bonds and it should not be assumed that a hybrid bond rated by a particular agency would support the group ratings provided by other agencies.

While a hybrid bond may be considered to have equity-like features by a rating agency, it does not necessarily follow that bank lenders would consider hybrid bonds to provide a level of equity-like support that could be considered in the calculation of existing gearing covenants. It may, however, be possible to seek to include hybrid bonds in future gearing covenant arrangements.

Conclusion

The group ratings of housing associations have been under pressure recently in part due to increasing commercial exposure. Housing associations are also often constrained by existing lending covenants that can restrict the flexibility to increase traditional borrowing on a secured basis. Nevertheless, many continue with ambitious affordable housing development programmes that are core to their social purpose.

Hybrid bonds may provide a new source of risk finance for housing associations with mixed development programmes that could be used alongside (or instead of) joint venture arrangements with commercial equity partners.