Israel Securities Authority

Public Issuance of Hybrid Bonds

May 2020

A. Background

The term "hybrid financial instrument" refers to a broad set of financial instruments that combine elements of debt securities and equity securities. The following types of hybrid financial instruments are traded in global capital markets:

a. Preferred shares;

b. Convertible bonds;

c. Mandatory convertible bonds (MCB) - convertible bonds whose conversion is subject to the issuer's discretion;

d. Convertible bonds - convertible bonds, and specifically CoCo bonds, can be converted into common equity if specific conditions arise, and are typically issued by financial institutions;

e. Hybrid bonds - non-convertible bonds issued by non-financial companies, in which the issuer has flexibility regarding the payment of interest and/or principal.

Within these categories, the specific elements of each instrument may vary.

The Israel Securities Authority ("ISA") recognizes the importance of developing the Israeli capital market and is taking steps to diversify the range of financial products available to investors. At this time, convertible bonds, CoCo bonds, preferred shares, as well similar financial instruments can be issued on the Tel Aviv Stock Exchange ("TASE").[1]

Over the years, ISA has received inquiries related to the potential issuance of additional types of hybrid financial instruments, which recently have included non-convertible hybrid bonds that offer issuers flexibility regarding their maturity dates.

Against this background, in September 2019, the ISA published a Consultation Paper on Hybrid Bonds for Public Comments. The Consultation Paper was designed to increase market players' familiarity with and understanding of the key features of hybrid bonds, and to obtain public comments on the terms and elements that might be included in hybrid bond issuances. The Consultation Paper presented the features of hybrid bonds that challenge pricing and possible ways to mitigate address them, as well features that are likely to trigger specific scrutiny by ISA staff. Following the publication of the Consultation Paper, the ISA received comments from various capital market actors. After the ISA studied these comments, and after the TASE Listing Rules were amended to permit hybrid bond issuances in the manner outlined in the Consultation Paper, ISA's insights from this process were incorporated into this policy document.

- We would like to express our thanks to CPA Yevgeny Ostrovsky and CPA Ravit Aliyahu-Dory, formerly of the ISA, who made a significant contribution to this document.

[1] Debt certificates or convertible debt certificates whose principal and/or interest is payable in shares, at the issuer's discretion, subject to predefined conditions, where the strike price is a function of the stock exchange price, according to a mechanism defined in the offer. Note that in contrast to several mandatory convertible bonds (MCBs) currently traded across the globe, the conversion mechanism in this case is a function of the market price rather than a fixed price.

Hybrid bonds

In this policy paper, "hybrid bonds" are defined as subordinated debt instruments that confer a contractual right to the issuer to defer payments of interest. Hybrid bonds are not convertible or subject to mandatory conversion. They are typically issued with very long maturities, and provide the issuer with some financial flexibility. Their terms grant issuers the right to defer the payment of interest for up to a maximum predetermined period, at their discretion or if predetermined objective conditions are met. The right to defer interest generally expires when the issuer performs specific capital actions. Additionally, the issuer often has an option to exercise an early call on the hybrid bond on fixed dates, at a fixed price, which also offers flexibility to the issuer in terms of call dates.

Clearly, due to issuers' financial flexibility, and the bonds' subordinated status and long maturities, hybrid bonds may offer more attractive yields compared to ordinary bonds of the same issuer. Occasionally, bonds may include various mechanisms that limit issuers' flexibility in order to control the higher yield. For example, a step-up mechanism is sometimes used to curb the yields in respect of a bond's long duration. A step-up clause states that if the issuer does not redeem the bond by an agreed date, the interest rate on the bond increases by a fixed step-up percentage. A step-up clause further incentivizes the issuer to exercise an early call of the bonds, even though the issuer may defer redemption at the cost of higher interest. As a result, this mechanism may shorten the bond's average economic life relative to its maximum contractual life, and reduce the interest paid on the bond, especially in an upward yield curve environment.

The hybrid bond market is a "young" market, created in the mid-2000s. Since then, the hybrid market in Europe has developed and has been recently estimated as accounting for app. 3%-4.5% of the total European debt market.[1]

Main Incentives for Issuing Hybrid Bonds

As mentioned above, hybrid bonds generally carry higher interest rates than ordinary corporate bonds, and offer greater financial flexibility that may assist issuers, especially support them during temporary liquidity stress. The current COVID-19 crisis illustrates situations in which hybrid bond issuers benefit from the instrument's advantages.

Furthermore, hybrid bonds offer issuers a credit-rating advantage over ordinary bonds because credit rating agencies may assign equity content to a certain proportion of the instrument, depending on their rating methodologies.[2] This option may even be relevant when the rated bond in entirety is defined as a financial liability according to IFRS.

Consequently, hybrid bonds are frequently issued as a flexible means of financing a significant acquisition or transaction, without increasing the issuer's leverage or downgrading their financial profile for credit rating purposes (which would be the case if the issuer assumed loans or issued

[1] See "Hybrid bond issuance bounces back in Europe, helped by M&A, low interest rates" Scope, May 16, 2018.
[2] For example, between 25% and 50% of the instrument's nominal value.

ordinary bonds), and without diluting existing shareholders and increases the issuer's financing costs (which would be case in an equity issue). In other cases, issuers issue hybrid bonds to raise financing without downgrading their credit rating or are, for various reasons, unable to issue common equity or regular debt. Therefore, like other complex financial instruments, the issuance of hybrid bonds is not suitable for all corporations.

Although preferred shares and hybrid bonds share some similarities, the hybrid bonds described in this document (which have a final maturity date) differ from preferred shares (which have no such liability element) in several significant respects, including taxation (for example, because hybrid bonds bear interest and are not eligible for dividend participation), dividend distributions (due to bonds' fixed maturity dates, principal and interest payments, among other reasons), the rules that apply to institutional investors (for example, compliance with the investment policy and legal requirements applicable to mutual fund managers, and pricing (investors may price hybrid bonds in comparison to the issuer's ordinary securities). As a result of these differences, issuance of the hybrid bonds does serve as a substitute for the issuance of preferred shares.

Main Incentives for Investing in Hybrid Bonds

Ordinarily, hybrid bonds have a greater risk than ordinary bonds issued by the same issuer (and a lower risk compared to the issuer's ordinary shares or preferred equity shares). Therefore, hybrid bonds are usually traded at higher yields compared to ordinary bonds, and the extra yield provided by hybrids is the main investment inventive. However, hybrid bonds also are associated with unique risks, including:

a. Deferral of interest payments;

b. Extension risk - A risk that the issuer will not exercise an early call, especially when the investment decision assumed an early call;

c. Subordination risk - This risk stems from the fact that hybrid bonds are subordinated to other more senior debt of the issuer, and the rate of recovery is low either before or at liquidation.

Additionally, similarly to ordinary corporate bonds, hybrid bonds also involve credit risks, market risks, interest rates, and sometimes currency risks. Therefore, an informed decision to invest in hybrid bonds should be based on a specific assessment of the relationship between the higher spread and the added risk.

B. Preconditions for Listing

The novelty of hybrid bonds in the Israeli market and their lower priority of bondholders' rights compared to those of ordinary bonds underscore the need to define more stringent preconditions for listing hybrid bonds for trading on the stock exchange, compared to the preconditions defined for ordinary bonds, in order to support efficient trading and proper pricing of hybrid bonds. The preconditions are defined in the recent amendment to the TASE listing rules.

According to the new rules, a hybrid bond may be listed for trading by a corporation that meets the following conditions on the issuance date:

1. At least one of the following conditions obtains:

(a) Its shares are listed for trading and are included in the Tel Aviv 125 index, and at least one series of non-hybrid bonds is listed for trading;

(b) The value of the public holdings in the issued hybrid bonds will be at least NIS 200 million, provided that one of the following conditions obtain:

- According to the most recent financial statements included in the prospectus, the issuer's share capital is at least NIS 500 million;
- The issued bonds have a dual rating.[1]

2. The terms of the bonds define a single maturity date.
3. The terms of the bonds permit deferral of interest payments up to a maximal period of six years.
4. The terms of the bonds define that in the event that the issuer decides to defer interest payments, the issuer must give notice of their decision at least four days in advance of the determined interest payment date.

To remove all doubt, the definition of hybrid bonds in the TASE listing rules differs from the definition of CoCo debt Instruments and therefore the above conditions for listing hybrid bonds do not apply to CoCo bonds, which are subject to specific provisions in the TASE listing rules and relevant regulatory rules.

It should also be noted that the satisfaction of the above preconditions is assessed at the issue date. Nonetheless, within their commercial negotiations, investors and issuers may define in the bond trust deeds that the issuer must continue to meet these preconditions or other conditions, not only on the issue date but also over the entire life of the instrument.

[1] In view of the unique features of the instrument, issuers who wish to issue hybrid bonds must include a dual rating in the issuance prospectus —ratings by two rating agencies. In the absence of a dual rating initiated by the issuer, the ISA will be required to conduct a further receive of the due disclosure in the prospectus.

C. Efficient pricing of hybrid bonds

Under the assumption that hybrid bonds are inherently more complex and not necessarily suitable for all types of issuers or investors, it is important to ensure that the bonds can be efficiently priced. The following features are designed to facilitate efficient pricing of hybrid bonds. These features are based on cumulative global experience and the feature's prevalence in issues, and have been adjusted to the lack of experience in the Israeli market and the necessary caution it requires. Additional considerations, such as credit rating methodologies for such instruments, were also taken into account.

It should be emphasized that other designs of hybrid bonds may require a specific assessment by ISA staff.

Instrument type and payment dates

The principal of the bond will have a single final maturity date that is no later than 60 years from the date of issuance. The instrument will be defined as a bond, that is, upon issuance it will be subject to the legal and other requirements that apply to bond issues, including but not limited to the appointment of a trustee, a bond trust deed, and listing requirements. Periodic interest will be paid at a frequency to be determined. However, the terms of the bond may state that the issuer may defer the payment date at their discretion by providing advance notice. Among other things, subject to the following terms, the bond trust deed may stipulate that deferral of payment is at the issuer's absolute discretion and/or if some objective predefined conditions are met. The issuer may also note their intention to exercise the option of deferring interest payments to hybrid bondholders in the event that payment may impair its ability to repay its liabilities to senior creditors.

However, the maximum deferral period will not exceed six years, and deferred interest will accrue interest, compounded at a specified rate until the effective payment date. The deferral period will be calculated from the due date of the interest payment to the payment in full of all deferred interest (including any accumulated compounded interest). In other words, if the issuer defers interest payments several times, and these amounts (including the compounded interest) are outstanding, the deferral period is counted from the first date on which interest payment was deferred. A deferral period exceeding six years constitutes a violation of the terms of the hybrid bonds, which would be grounds for an immediate demand to repay the hybrid bonds, similarly to a violation of the terms of ordinary bonds.

Moreover, the terms of the bonds may include a mechanism for interest rates adjustments at fixed dates (step-up) or adjustments to a benchmark rate plus a margin.

Seniority

Hybrid bonds are subordinated to other bonds of the issuer (including, but not limited to, ordinary bonds, convertible bonds, and bank loans). However, they have priority upon liquidation to the issuer’s equity instruments, such as ordinary shares, equity-like preferred stock, or capital notes.

<u>Conditions</u>

Additional conventional clauses used in hybrid bond trust deeds:

Dividend Stopper clause - Deferral of interest payments on the hybrid bond stops any payment to its equity holders. Deferral of interest on the hybrid bonds halts dividend payments or share buybacks on common equity, redemption of capital notes of equity-like preferred shares, and similar actions ("**equity payments**"), until full repayment of the accrued and unpaid interest on the hybrid bonds, including compound interest. It should be clarification, the prohibition of making equity payments before the bonds are redeemed is a broad prohibition that applies to all equity payments and other distributions defined in the Companies Law 5759-1999.

Dividend Pusher clause - Equity payments terminate the issuer’s right to defer interest payments for a period of six months from the date the equity payments. During this period, the issuer may not defer interest payments, and non-payment constitutes grounds for immediate redemption.

Specific TASE marking

It should be noted that hybrid bonds issued according to this policy paper will be marked by the TASE in order to allow investors to identify hybrid bonds whose features differ from those of ordinary bonds. The aim of the marking is to indicate the unique nature of the instrument in question, which requires special understanding and knowledge.

D. <u>Early redemption</u>

ISA staff believe that, despite the difficulty to price an early call, an early redemption option is justified by hybrid bonds’ unique features and the need to provide issuers with an option to determine limited exit points in scenarios in which the higher yield is no longer relevant. Such an option may use mechanisms such as the liability value plus accrued interest (pari passu), or other mechanisms, at predetermined time points ("repayment points"), subject to the following conditions:

a. Early repayment points will be set in intervals of at least five years, and may stipulate that the instrument’ interest rate will be adjusted thereafter (interest rate adjustment mechanism).

b. In repayments that are not executed at the predefined repayment points, the redemption value will be calculated according to the conventional mechanism for early calls on bonds - the higher of (i) the liability value (pari passu) of the outstanding bonds (principal plus interest accrued and unpaid) and (ii) the market value of the bonds subject to a demand of immediate repayment, based on its average closing price in the 30 trading days prior to the date in which the issuer's board of directors decided to exercise a call.

In addition to the predetermined repayment points, the parties may determine that in extraordinary predetermined events, the issuer may exercise a call on the bonds for the liability value (pari passu) plus a penalty (to be determined independently of the average market price). Such an option, if included, will define the objective changes in the purpose of the instrument (e.g., a material and objective change in credit rating methodologies, as a result of which the hybrid bonds no longer possess equity content, or a material change in tax law that disallows the issuer's interest expenses).