Treatment of hybrid securities[1]

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The purpose of this paper is to describe different types of hybrid securities and to discuss the issues that affect how data on hybrid securities are collected. Hybrid securities are securities that have a combination of debt and equity characteristics. The original hybrid security was preferred stock, representing ownership in a company (like equity) but having fixed payments (like bonds). Since then, companies have structured securities in many different ways. Many are structured in ways similar to debt, allowing the owner to receive a cash flow (floating or fixed) with a periodic rate of return, but also have options for conversion to equity.

Hybrid securities are beneficial to investors because they provide investors with protection during bankruptcy as compared to common stock. That is, hybrid investors are eligible to be paid before common stockholders in bankruptcy. Additionally, hybrid securities generally provide a higher rate of return then the typical debt instruments. Hybrids can also be tailored to meet their individual investor's needs. The complexity of some of these new structures can cause reporting institutions to be inconsistent in reporting data on hybrid securities, which is a significant issue for data compilers.

Types of hybrid securities

Preferred stock was the first type of a hybrid security offered in the market place.

Investors who wanted to own stock of a company without assuming some of the risks of owning common stock would purchase preferred stock. Preferred stock gives the investor a higher dividend then the company's common stock (closer to the rate of the company's bonds) and places the investor before the common shareholder in bankruptcy. However, owning preferred stock typically does not give the holder voting rights in the company. In addition, preferred stock can be callable, giving the company the option to repurchase the shares back from the preferred shareholder.

A type of hybrid security that has significantly grown is convertible securities. These are issued as bonds with the option to be converted into shares. Typically, these securities have a set interest payment until the conversion. (Some companies have even allowed loans to be converted into shares.) The convertible security holder determines if and when to convert the bond to equity based on that company's common stock price. In other cases, the company retains the right to determine when the conversion occurs. Convertible bonds are popular especially when there is a volatile equity market.

Recently, companies have issued different types of hybrid securities that are similar to preference shares and convertible debt securities, but are structured slightly differently to meet the needs of investors. The characteristics that change from security to security are the type of interest/dividend payments, a fixed or variable maturity date, and its price. However,

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all are similar in that they have a combination of debt and equity characteristics, which are set up to meet the specific needs of investors.

Data collection of hybrid securities

The United States' security-by-security annual reports, ask reporting institutions to code each security with a security type (for list of reportable security types see Appendix A). There are several codes under the broad headings of equity and debt. As part of those codes, there are individual security types for the most common types of hybrid securities. All preferred stock are coded with a unique security type code under the broad classification of equity. The quantity held of the preferred security is the number shares, similar to the way ownership of common stock is reported. All convertible debt is coded with a unique code under the broad classification of debt. The quantity held of the convertible security is the face value held, similar to "straight" debt. Once the security is converted to equity, the reporting institution reports the new security type and reports the quantity as the number of shares instead of the face value.

In order to collect data on newer versions of hybrid securities, there are several steps taken to ensure that the securities are coded with the proper security type. First, data compilers determine if reporting guidance was provided for similar instruments and if those reporting criteria can be applied to this instrument. Then, each security in analyzed on an individually to understand its characteristics. Some of the key characteristics that indicate that the security is equity are a) if the owner has a claim on the residual value of the company; b) the owner has voting rights; and c) there is no finite maturity date. Indications that the security is a debt security include a) the owner has unconditional rights to the payments and principal, and b) a finite maturity date. Based on the characteristics, a decision is made on the appropriate security type and how the reporters should report the amount held.

Additionally, data compilers investigate how institutions code these securities in their internal systems. At times, because of complex accounting rules, securities may be coded in their internal system as a particular security type even though the characteristic of the security indicates a different one. Compilers work with the reporting institution to ensure that the data reported are consistent with our needs.

Issues in collecting data on hybrid securities

One key issue is how the reporters report the quantity held of a hybrid security. The United States collects the market value and quantity held for each security, and based on those fields calculates the security's implicit price. The actual price is not reported. Occasionally, the quantity for a particular security is represented in both shares and face value. This may lead to reporting inconsistencies between reporting institutions. Ultimately this may cause market value errors, especially if the reporting institution reports the face value of the security but calculates the market value based on the share price.

Other reporting issues occur while collecting data on hybrid securities, including when non-US preferred stock is sold in the United States as American depository receipts (ADRs). The United States require the security type of an ADR's underlying security to be reported, which in this case would be preferred stock. Frequently, it is incorrectly reported as common stock. Another significant issue is when mutual funds have hybrid securities within their portfolio. The custodian of the fund needs to look carefully at all the different types of securities the fund has in its portfolio and properly code them as equity or debt. A fund may be called an "equity fund" but contain some hybrid securities that need to be classified as debt.

Conclusion

There is a considerable challenge for data compilers to keep track of different types of hybrid securities issued in the market and to determine how they should be captured on various reports. In addition, data compilers need to understand that at times our classification of hybrid securities may not be compatible with some of the accounting rules of either US GAAP or IFRS.

Appendix A

Security types from the TIC SHC(A) report of US ownership of foreign securities

Equity	Debt
1 = Common stock	5 = Commercial paper
2 = Preferred stock	6 = Negotiable CD
3 = Fund shares	7 = Convertible debt security
4 = All other equity	8 = Zero coupon and stripped security
	9 = Unstripped note or bond & all other nonasset-backed debt
	10 = Asset-backed security

Security types from the TIC SHL(A) report of foreign ownership of US securities

Equity	Debt
1 = Common stock	5 = Commercial paper
2 = Preferred stock	6 = Negotiable CD
3 = Fund shares	7 = Convertible debt security
4 = All other equity	8 = Zero coupon bond or note
	9 = Bond or note, unstripped
	10 = Bond or note, stripped
	11 = All other nonasset-backed debt
	12 = Asset-backed security