The Hybrid Financial Instruments in Italy: A first attempt to define this category

FERDINANDO BRUNO & ANDREA ROZZI
UniCredit Bank AG, Milan Branch, (UniCredit Group), Italy

Introduction
In the Italian market – as well as in the European and international market – a new type of financial instrument has been often mentioned and used by financial and economic operators in recent years: the so-called “hybrid financial instrument”. This financial tool seems to have an open structure, enabling the financial engineers to create a financial solution different from equity and debt, collecting some features of both of them. As noted, in the last decade the international capital markets faced a trend much more than fast: the speed with which rules and actors of the international capital market are born, change and die makes really difficult the work of those who analyse this new financial structure which represents really an evolution, both for the financial actors and for the financial market, in terms of economic return and efficiency. The above is amplified by the so called “globalisation”, which – in the case of capital markets more than in other cases – clarifies the different approaches and interpretations among several jurisdictions regarding relevant matters and issues. Based on the above, there is a kind of natural attitude of the jurisdictions to follow foreign experiences in order to easily get the mentioned results, and specifically the experiences of those jurisdictions which – supported by high legal flexibility – represent an example for Italian doctrine and operators ready to copy new legal tools, often not available in Italy due to strict domestic rules.

The Hybrid Financial Instruments in the international market
In the international financial market, a hybrid financial instrument is defined as a type of security which combines some features of debt securities with some features of equity securities: “a hybrid financial instrument is a security containing two elements, equity and debt, that could be described as either a bond with equity features or a share with debt characteristics. The term may be used more loosely when referring to any financial instrument that combines features of two or more financial instruments”.

It is worth noting that the financial innovation proposed by several hybrid options related to instruments between equity and debt, is not easily recognisable in the financial market, as it has sometimes equity’s features and sometimes debt’s features.

---

1 Ferdinando Bruno, "La tassazione degli strumenti finanziari ibridi nell’ordinamento italiano", in Rivista ticinese di diritto (RtiD), I, 2008.
2 Ferdinando Bruno, "La tassazione degli strumenti finanziari ibridi nell’ordinamento italiano", in Rivista ticinese di diritto (RtiD), I, 2008.
3 Ferdinando Bruno, "La tassazione degli strumenti finanziari ibridi nell’ordinamento italiano", in Rivista ticinese di diritto (RtiD), I, 2008.
5 Brian Coyle, Hybrid Financial Instruments, The Chartered Institute of Bankers, 2002, pag. 2.
Starting analysing hybrid structures that we can find in the international markets, it must be noted that: “there is not one, single and final definition of hybrid products”⁶: therefore, that is the common view about the essence of the hybrid financial instrument. Despite having an agreement about common features of such kind of financial instrument, it does not exist – and it is not possible to arrange – an exhaustive list of the hybrid financial instruments used in the international capital markets.

We can start from the fact that “A type of securities known as hybrid securities combines some of the characteristics of debt securities with some of the characteristics of equities”⁷. Now, the distinction between debt and equity is relatively easy to list the key factors which distinguish debt from equity investments. These factors would include the following (i) Contractual obligation: a company is under no obligation, whether contractual or otherwise, to pay dividends to shareholders; interest payments are paid pursuant to a contractual obligation. (ii) Consideration: a dividend is not a payment of consideration for anything provided by the shareholders to the company, but is instead a reflection of the shareholders’ ownership rights in the company; by contrast, interest payments are consideration for the use of the funds lent. (iii) Results dependent: the amount paid to the lender is not calculated by reference to the success of the company, whereas the amount of a dividend will reflect the underlying results of the company, perhaps simply because of the requirement that dividends are paid out of distributable reserves. (iv) Repayment date: Debt must usually be repaid by a specified date, whereas an equity holder may only be able to realise his investment by a sale or on the liquidation of the company. (v) Votes: An equity holder typically has voting rights that enable it to influence the management of the company, but such rights are not typically given to lenders. (vi) Subordination: Payments to equity holders are subordinated to payments to loan creditors, and therefore carry a greater credit risk. (vii) Risk and reward: As a shareholder is, in effect, the owner of a company, equity normally carries greater upside benefits than debt. This is because equity carries a higher risk, but also potentially may carry greater rewards⁸. As it has been correctly highlighted, the fundamental difference between a pure debt investment and a pure equity investment is that the relationship between a debtor and a creditor is based on a loan contract, whereas the shareholder-company relationship is based on company law. Another important difference between a typical debt investment and a typical equity investment is the requirement of repayment. A creditor has a right to repayment at the end of the fixed time period. A shareholder, on the other hand, is not entitled to any repayment during the company’s lifetime, i.e. before the winding up of the company. An equity investment is perpetual in its nature, whereas a debt investment is temporary. In company liquidation, the rights of equity investors are subordinated to the rights of the debt investors. All creditors must be satisfied before the equity investors may have a share of the proceeds. Another difference is that a creditor is entitled to a fixed return on the investment even if the debtor corporation has not earned profits, whereas a shareholder is entitled to a return on the investment only if the company makes a decision to distribute profits. The exact amount of interest may not be

---

⁶ Alexander Batchvarov, Hybrid Products (Instruments, Applications and Modelling), Risk Books, 2004, pag. xix, who also highlights that: “There is not one definitive definition of structured products either. Historically, hybrids where associated with a product that had both debt and equity characteristics (say preferred shares) and/or was the former, but under certain conditions “converted” into the latter (say convertible or exchangeable bonds”).

⁷ Joanna Benjamin, Interests In Securities (A Proprietary Law Analysis of the International Securities Market, Oxford, 2000, pag. 17. It has been also noted that: “Hybrid securities “are essentially bonds with an equity component””, Izzy Nelken, Handbook of Hybrid Instruments (Convertible Bonds, Preferred Shares, Lyons, ELKS, DECS and other Mandatory Convertible Notes), John Wiley & Sons LTD, 2000, pag. xv.

⁸ IFA Joint Meeting of USA and British Branches- Thursday 31st August 2000 Exotic Financing Structures: hybrid instruments, check the box and partnerships - Willard Taylor - Sara Luder.
known in advance, but at least the formula for calculating the return is known in advance. Interest is a fixed return agreed upon in the loan contract, whereas the amount of a dividend distribution is based on a decision of the shareholders’ meeting. The potential for interest is limited, whereas the potential for dividends is unlimited. A shareholder is also entitled to liquidation proceeds. Everything that is left after all the creditors have been satisfied is shared among the equity investors. The unlimited return potential compensates for the higher risk of equity as compared to debt. Unlike a creditor, a shareholder is generally also entitled to direct control of the company. Other doctrine noted that the ‘vital difference between the shareholder and the creditor,’ it was said in an early case is that the ‘shareholder is an adventurer in the corporate business; he takes the risk, and the profits of success, the creditor, in compensation for not sharing the profits, is to be paid independently of the risk of success, and gets a right to dip into capital when the payment date arrives.’ ‘The classic debt’ is said to be ‘an unqualified obligation to pay a sum certain at a reasonably close fixed maturity date along with a fixed percentage in interest payable regardless of the debtor’s income or the lack thereof. While some variation from this formula is not fatal to the taxpayer’s effort to have the advance treated as a debt for tax purposes... too great a variation will of course preclude such treatment.’

Historically, hybrids were associated with a product that had both debt and equity characteristics (say preferred shares) and/or was the former, but under certain conditions “converted” into the latter (say convertible or exchangeable bonds). The main categories of hybrid instruments are equity-linked bonds and the preferred stock (or preference shares). Equity-linked debt securities give the holder the right to subscribe to shares. They include convertible bonds, exchangeable bonds, and equity warrant bonds. The preferred stock (or preferred shares) are not equity shares.

Hybrid instruments hold much promise to investors, issuers and financial institutions alike. For the investor these instruments hold the promise of participation in future equity market rallies. For the issuer, the hybrid may be a cheap source of financing. For the financial institutions, the instruments may be used to create huge returns via specialised hedge funds. Alternatively, the institution may invest its clients’ money via an investment management regime or the institution may invest their own capital in such an investment fund. In addition, since these instruments are generally quite complicated to analyse, they may offer arbitrage opportunities.

Some of the better known hybrid instruments include certain classes of preference shares, convertible notes, capital protected equity loans, profit participating loans, perpetual debt, endowment warrants, equity swaps and so on.

9 56 BULLETIN FEBRUARY 2004 © 2004 International Bureau of Fiscal Documentation * © Marjaana Helminen, 2004. E-mail: marjaana.helminen@helsinki.fi. Classification of Cross-Border Payments on Hybrid Instruments Prof. Marjaana Helminen* University of Helsinki
10 539 Plumb (1970-1) at 404.
The recent rapid growth in hybrid capital issuance by banks and insurance companies highlights the important role played by hybrid instruments in capital and balance-sheet management. U.S. banking regulators effectively launched the hybrid capital market in the early 1980s, when they were seeking a way to encourage the then-overleveraged U.S. financial sector, and particularly the so-called money center banks, to build capital. Since then, the issuance of hybrid capital by financial institutions has spread globally and has followed an uninterrupted upward path of development. Hybrid capital's usually tax-deductible coupon payments, lack of dilution of common shareholders, wide access to fixed-income investors, regulatory capital credit, and benefits for reported ROE (“Return on Equity”), have made it an unbeatable capital markets product for banks and insurers, particularly in the past decade of low interest rates and recent very low credit spreads.

The global markets have also experienced a proliferation of innovative hybrid capital structures in recent years. Several trends are behind this. The dynamic growth of risk assets and the high amount of mergers and acquisitions in the financial services sector have fuelled a need for capital, often in a short timeframe. In addition, the global acceptance of hybrids as regulatory capital, and the convergence of banking and insurance regulation, has led national authorities to allow more variations in hybrid structures over time. Moreover, many financial institutions have reached regulatory limits for "traditional" types of hybrids. Lastly, market participants and financial regulators have worked with unlisted cooperative and mutual banking and insurance groups unable to issue common equity to develop innovative hybrid instruments that allow them to raise regulatory capital like their listed counterparts.

The Hybrid Financial Instruments in the Italian market
The understanding and the analysis of a hybrid can’t avoid starting from the definition of the referent case, such case being the matrix from which the hybrid instrument substantially differs, “stealing” one or more typical features of the reference case (and this is the so called hybridity). It is worth noting that an hybrid can have as reference only one matrix (and in this case we can talk about “hybrid with a single matrix” or, in the case of a financial instrument, “hybrid financial instrument with a single matrix”) or 2 or more matrices (and in this case we can talk about “stricto sensu hybrid” or, in the case of a financial instrument, “a stricto sensu hybrid financial instrument”). In the case of a hybrid with a single matrix, the hybridity of the relevant hybrid will be in the presence of one or more features belonging to such matrix. In case of stricto sensu hybrid the hybridity of the relevant hybrid will be in the presence of one or more features belonging to two or more matrices, which will become poles between which the relevant hybrid is found, each pole being the matrix of at least one feature of the relevant hybrid. The absence of any link with any matrix will entail the absence of the essence of the hybridity (and therefore we could not say it is a hybrid financial instrument), and that being the case, it is an autonomous case, for sure already qualified or able to be differently qualified, or a new instrument to qualify.

Now, as seen regarding the international capital market, also in the Italian market the analysis of hybrid financial instruments refers to two main poles, the shares and the bonds. In the current Italian legal framework, the share seems to have as a specific feature the one of being a capital instrument, so bringing a certain level of risk regarding the repayment and the consideration received by the investor (i.e. the shareholder): based

15 Standard & Poor's Financial Services Criteria: Equity Credit For Bank And Insurance Hybrid Capital, A Global Perspective date: 16-Feb-06,
16 Standard & Poor's Financial Services Criteria: Equity Credit For Bank And Insurance Hybrid Capital, A Global Perspective date: 16-Feb-06,
on that, several hybrid financial instruments could be issued starting from the typical share. Pursuant to the qualification provided above, these kind of hybrid financial instruments are hybrid financial instruments with a single matrix, where the single matrix is represented by the mentioned typical share. An example of this hybrid financial instrument with a single matrix based on the typical share are the privileged shares (azioni di risparmio), providing their shareholders (privileged shareholders) different rights compared to the rights of the typical shareholders.

Another recent type of hybrid financial instrument created by the Italian law is the Azione Sviluppo (which can be translated as Sviluppo Share) a new kind of share, different from the typical one as it: 17, (i) is issued by listed or unlisted companies where the majority of the shares are held indirectly through a company controlled by only one person, or by a group of persons linked by family relationships; (ii) is automatically converted into an ordinary share in the case that the Controlling Person (s) loses, for any reason, such status; (iii) has voting rights in the shareholding meeting which authorise defensive actions against a takeover (Italian OPA), and which decide about taking legal action against a member of the board of administrators and board of auditors; (iv) provides its shareholder with an economic privilege represented by an percentage increase – to be fixed at the time of the issue – of the dividend provided to the ordinary shares; (v) must not be of an amount less than 25 per cent of the share capital after the issue from the Company and – being limited voting shares, cannot – together with any other limited voting shares – exceed 50 per cent of the share capital18.

In relation to our analysis, it must be noted19 that the Azione Sviluppo is without any doubts a hybrid financial instrument, as it is a special class of share with rights different from the rights provided by ordinary shares20.

Now, if – as we have seen before - the privileged share is – as it is - a hybrid financial instrument, there is no doubt that also the Azione Sviluppo is an hybrid financial instrument, having rights specific and not present in the ordinary share, which is its matrix. It must be highlighted that the Azioni Sviluppo has a hybridity different from that of privileged shares, which, for example, don’t have voting rights. Therefore, the Azione Sviluppo could be qualified as a hybrid financial instrument with a single matrix. But the point requires further reasoning. We think that the Azioni Sviluppo should be considered hybrid also regarding the debt matrix, and in particular the convertible bonds, which are the only financial instrument considered in the Italia Civil code – art. 2420-bis – having the feature of the conversion into ordinary shares which – as seen above – characterizes also– with its economic privileges and limited voting rights – without any doubt the Azioni Sviluppo, which can therefore be considered also a financial instrument between ordinary shares and convertible bonds, namely a stricto sensu hybrid. The Azione Sviluppo it is therefore a convertible share.

***

**Ferdinando Bruno** is a dual qualified lawyer, as *Avvocato* in Italy and as Solicitor in England and Wales; he gained several years of experience in international capital markets, commercial and corporate law, insolvency, banking and finance. He is currently Managing Director and Head of Italian Restructuring of UniCredit Bank AG, Milan Branch, (UniCredit Group).

**Andrea Rozzi** is Managing Director and Head of Legal & Documentation Milan. UniCredit Markets & Investment Banking, UniCredit Bank AG, Milan Branch, (UniCredit Group). He is one of the best derivatives experts in Italy.

**UniCredit Bank AG, Milan Branch, (UniCredit Group)**, formerly Bayerische Hypo-und Vereinsbank AG, Milan Branch, and Unicredit Banca Mobiliare (UBM) S.p.A., is the investment bank of UniCredit Group, covering Debt Capital Markets, Equity Capital Markets, Corporate Finance, and Investment Banking.