Rating Criteria for Capital Instruments issued by Banks and Financial Institutions

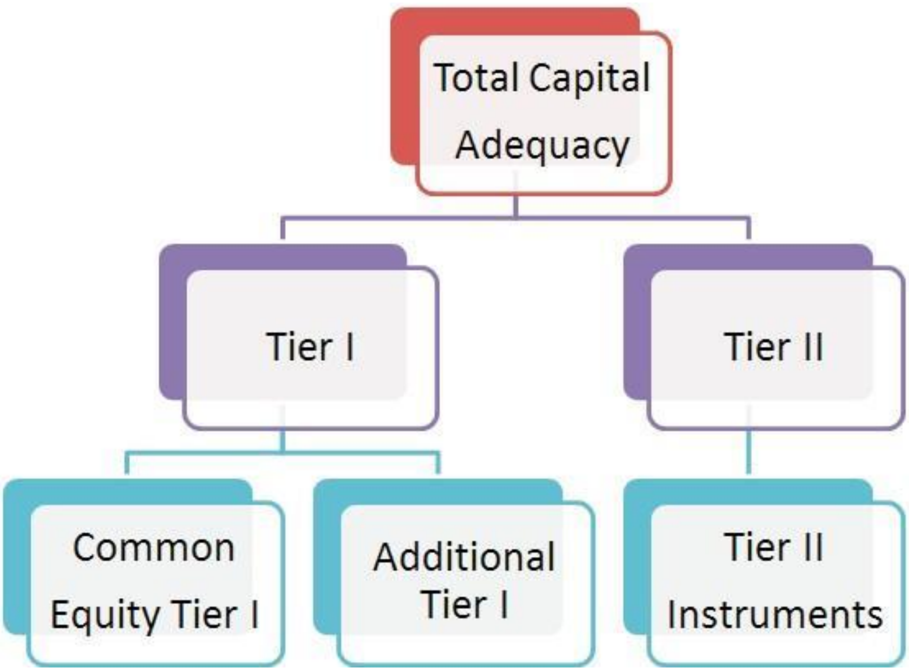
Reserve Bank of India (RBI) allowed banks to raise Tier I and Tier II capital under Basel II regulations till it issued Guidelines based on the Basel III reforms on capital regulation on 2 May 2012, applicable to banks operating in India.

Under the Basel II regime, banks could raise Lower Tier II, Upper Tier II, Innovative Tier I and Tier I preference shares as the various capital instruments. These instruments helped banks augment their equity capital and provided different levels of loss absorption capabilities. The criteria of Brickwork Ratings (BWR) for rating these Basel II instruments is discussed in this document.

The Basel III guidelines were aimed at improving the core capital of banks, imposing floor levels for the Common Equity Tier I (CET I) strengthen the financial strength of banks through the Capital Conservation Buffer and a Countercyclical Capital Buffer.

With the introduction of these in the Indian market, banks now have to keep a higher Tier I capital under Basel III as compared to Basel II.

The overall adequacy of a bank under Basel III is now assessed at the three levels shown in the figure below (figures in parentheses are minimum requirements):



Countercyclical Capital Buffer is bank-specific and should be maintained by each bank accordingly.
*Tier II Capital hence, can be recognised to the extent of 2.0%, provided the minimum Tier I and CET 1 capital requirements are met; additional Tier I and Tier II capital can be recognised in proportion to the equity capital available with the bank. BWR's criteria for rating these Basel III instruments is discussed in this document.

NBFCs and HFCs also issue capital instruments in the form of Lower Tier II bonds or subordinate debt and other hybrid instruments (perpetual debt or upper Tier II bonds). BWR's criteria for rating these hybrid instruments is discussed in this document.

Rating Capital Instruments Raised by Banks

The starting point for rating capital instruments is the Counterparty Credit Risk (CCR) rating of the bank/ the rating for the senior bonds issued by the bank. The CCR rating follows the CRAMEL model, and the detailed rating criteria for this can be accessed from the BWR website. The rating of capital instruments issued under the Basel II or Basel III guidelines is either equated or notched-down from the CCR rating. The criteria for the notch-down are highlighted below.

Under Basel II Guidelines:

1. Lower Tier II bonds

These instruments have a minimum tenor of 5 years with no put/call option. There are no regulatory restrictions on servicing the coupon and principal of these bonds, irrespective of the banks' capital adequacy or profitability situation. Hence, these bonds have no loss absorption capability and are rated at par with the bank's CCR rating.

2. Upper Tier II bonds

These instruments have a minimum tenor of 15 years with call options allowed after 10 years. Put options are not allowed on these bonds. A bank cannot make coupon or principal payments on these bonds if its CAR falls below 9%. Furthermore, if a bank makes losses or can be in loss if it makes the interest payment on these bonds, it will require the RBI's permission to service the interest/principal. Hence, these instruments have a significant loss absorption capability compared to Lower Tier II bonds, although these are cumulative in nature and can at a later date cure the default. Given the additional risk factors, these bonds could be rated at par or a notch below the Lower Tier II bonds. As long as the bank's capital adequacy remains comfortable, as has been seen in many instances in the past, we expect the RBI to not deny permission for the servicing of interest/principal by the bank. Thus, the key drivers for deciding the notch-down from Lower Tier II bonds will be the banks' CAR, cushion above the regulatory minimum and the ability to maintain the CAR during periods of stress.

3. Innovative Perpetual Debt Instruments (IPDIs) or Innovative Tier I bonds

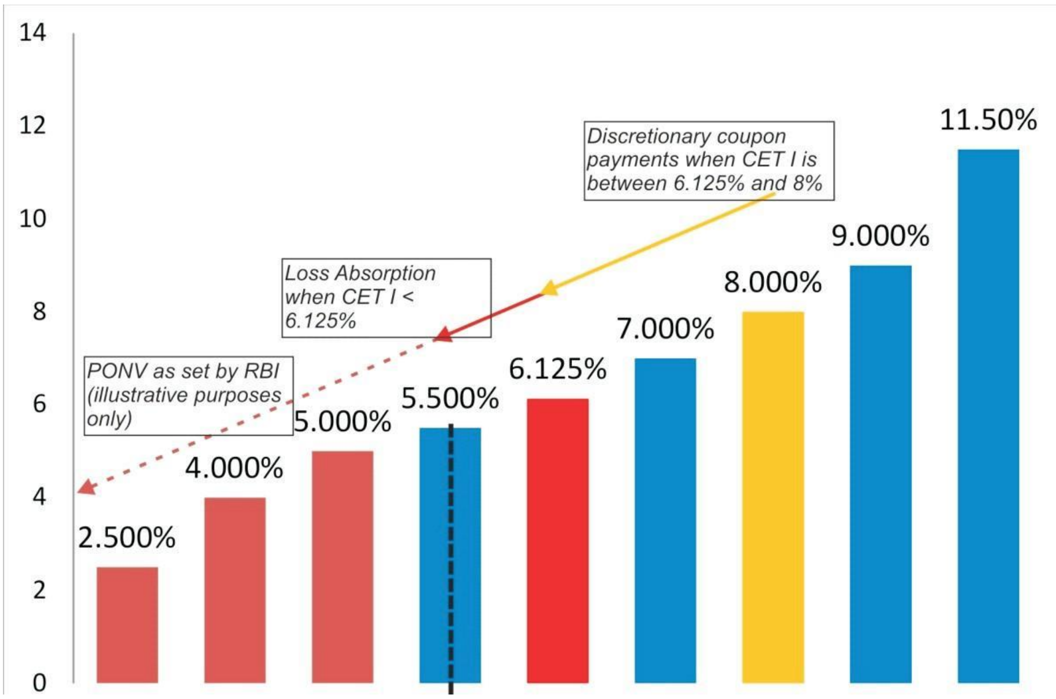
These instruments are perpetual, with call options allowed after 10 years. Put options are not allowed on these bonds. A bank cannot make coupon or principal payments on these bonds if its CAR falls below 9%. Furthermore, if a bank makes losses or can be in loss if it makes the interest payment on these bonds, it will require the RBI's permission to service the interest/principal. Hence, these instruments have high loss absorption capability compared to Lower Tier II bonds and similar to Upper Tier II bonds. However, unlike Upper Tier II bonds, IPDIs are non-cumulative, and hence, any default cannot be cured subsequently. The rating criteria for IPDIs is similar to that for Upper Tier II bonds.

4. Tier I preference shares

These are perpetual instruments with call options allowed after 10 years. Put options are not allowed on these instruments. A bank cannot make dividend payments on these bonds if its CAR falls below 9%. Furthermore, if a bank makes losses, it will require the RBI's permission to pay dividend. Preference shares are non-cumulative, and hence, any default cannot be cured subsequently. These instruments have the best loss absorption capability since the preference dividend can be paid only from allocable profits, unlike interest. The rating criteria for IPDIs is similar to that for Upper Tier II bonds.

Under Basel III Guidelines:

Basel III instruments have higher loss absorption capability as compared to Basel II instruments.



Note: The Countercyclical Capital Buffer has not been considered while defining the triggers above. In some cases, the triggers may be set at higher levels for SIBs, and the above does not show such higher triggers.

1. Tier II bonds

Basel III Tier II bonds have some additional features that distinguish them from Lower Tier II bonds under Basel II. The key difference is the presence of a Point of Non-Viability (PONV) trigger, at which the instrument principal will be written-down, leading to a default.

When the PONV trigger is breached, the amount that needs to be converted/written-off will be determined by the RBI and not the bank.

The PONV trigger event is the earlier of

a) A decision that a conversion or temporary/permanent write-off, without which the bank would become non-viable, is necessary, as determined by the RBI, and

b) The decision to make a public sector injection of capital, or equivalent support, without which the bank would have become non-viable, as determined by the regulator. Such a decision would invariably imply that the write-off or issuance of any new shares as a result of conversion consequent upon the trigger event must occur prior to any public sector injection of capital, so that the capital provided by the public sector is not diluted. The AT1 instruments with the write-off clause will be permanently written-off when there is a public sector injection of capital.

However, the PONV is expected to be at very low CAR levels and is a very remote possibility in the Indian context, with robust regulatory supervision and the expectation of regulatory intervention well before a bank reaches the PONV. Given this, the rating of Basel III bonds is the same as or a notch below the banks' CCR.

2. Additional Tier I Instruments:

Instruments that are eligible to be considered as Tier I Capital Instruments reflect more equity characteristics than under Basel II.

The main features of these instruments include

a) The perpetual nature of the instruments, such that they may have a call option that can be exercised after a minimum of 10 years. Exercising the same requires prior approval of the RBI, and the capital has to be compulsorily replaced by capital of the same or better quality.

b) The discretionary payment of coupons on Tier I instruments by the bank; interest payments are not cumulative.

c) The capital conservation clause is applicable when the CET I drops below 8%. The capital conservation range is specifically defined in line with the range of CET 1 when it is below 8%. If a bank wishes to make payments in excess of the amount that the norm on capital conservation allows, it would have the option of raising capital for such excess amount.

d) Loss Absorption Features: On reaching a pre-specified trigger point (as indicated in the chart above), there can either be a write-down mechanism or a mechanism to convert some of the liabilities to common equity.

e) If a bank does not have sufficient earnings, payments on coupon can be made from the revenue reserves, subject to the issuing bank meeting the minimum regulatory requirements for the CET1, Tier 1 and Total Capital ratios at all times.

BWR considers the features of AT1 instruments (as detailed above) while assigning ratings to these. The key features that impact the ratings are as follows:

a) **Coupon Discretion:** The payment of the coupon on the instrument is discretionary.

b) **Trigger for CET I and PONV:** The trigger levels set allow for the conversion or write-down/write-off of the principal amount in the case of a breach of these triggers. BWR considers the probability of the breach of the higher trigger, i.e., CET I level, while assigning the rating.

c) **Insufficient Profits and Reserves:** The coupon payment can be paid from current year profits or revenue reserves. Insufficient profits for the year and revenue reserves would lead to coupon non-payment.

Considering **the loss absorption features** and discretionary payments for Basel III Tier I instruments, BWR considers these riskier than Tier II instruments (for which loss absorption kicks in only when the PONV trigger is breached). Hence, the ratings of AT1 instruments are notched-down from the Tier II ratings. The features of Basel III Tier 1 instruments also make them riskier than the Basel II Tier 1 instruments, and hence, the notch-down for these could be sharper than that for the Basel II Tier 1 instruments.

BWR assesses the following while deciding the number of notch-downs in the AT1 ratings:

a) The bank's overall credit worthiness (CCR rating of the bank)

b) The current cushion maintained by the bank over the regulatory minimum of 8% CET1 and the cushion projected to be maintained.

c) The strength of the bank's promoters in terms of their financial flexibility. The ease of raising equity capital in the case of private sector banks and any commitment for the same, and for public sector banks, the current government shareholding and the government's policy on infusing the required capital amounts.

d) The bank's strategy for raising and maintaining capital

e) Profitability over the last 3 years and projected profitability

f) The coverage of revenue reserves to interest to be paid under a stress scenario

Thus, the ratings for Additional Tier I Basel III instruments may be notched-down from the bank's standalone credit rating. The notch difference may vary from '1' to '4'. The notch-down would be lower for stronger banks as compared to weaker banks and would increase sharply as a bank's credit profile weakens.

Rating Capital Instruments Raised by NBFCs and HFCs

The starting point for rating the capital instruments is the CCR rating of the NBFC/HFC or the rating for the senior bonds issued by the NBFC/HFC. The CCR rating follows the CRAMEL model, and the detailed rating criteria for this can be accessed from the BWR website. The rating of capital instruments is either equated to or notched-down from the CCR rating. The criteria for the notch-down are highlighted below.

1. Sub-ordinated debt or Lower Tier II instruments

Subordinated debt instruments issued by NBFCs/HFCs have no covenants linked to their CAR or profitability and have no loss absorption capability. Hence, the rating of these instruments is equated to the CCR rating of the NBFC/HFC.

2. Perpetual debt or Upper Tier II or hybrid instruments

NBFCs/HFCs are restricted from servicing interest/principal on hybrid instruments if the CAR falls below the regulatory minimum (15% for NBFCs and 12% currently for HFCs). Furthermore, the RBI/NHB permission will be required if the NBFC/HFC makes a loss in any given year. Hence, these instruments have a good loss absorption capability. These features are similar to those of the Upper Tier II bonds issued by banks. Hence, the rating criteria is also similar to that followed for banks.

Given the additional risk factors as compared to Lower Tier II instruments, these bonds could be rated at par or a notch below the Lower Tier II bonds. As long as the capital adequacy of the NBFC/HFC remains comfortable, as has been seen in many instances in the past, we expect the RBI/NHB to not deny permission for the servicing of interest/principal by the NBFC/HFC in the event of the NBFC/HFC making a loss. Thus, the key drivers for deciding the notch-down from Lower Tier II bonds will be the CAR, cushion above the regulatory minimum and the ability to maintain the CAR during periods of stress.

The previous version of this document can be found in
https://www.brickworkratings.com/download/Criteria-Basel3CompliantInstruments.pdf

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