Rating of Financial Institutions Legacy Hybrids and Sub-Debt

Sector-Specific Rating Criteria

This criteria updates the December 2015 criteria titled 'Rating of Bank Legacy Hybrids and Sub-Debt'.

The criteria set out in this report supplement and are applied in conjunction with Master criteria for Financial Institutions

Graded Approach Maintained: India Ratings and Research's (Ind-Ra) approach to ratings of legacy hybrids of Financial Institutions (both banks and non-banks) in India reflects the loss absorbing features of these instruments in the event of an annual loss or capital shortfall in the entity. Hybrids (both Tier 1 and Tier 2 capital) are therefore rated lower than senior debt - the difference in the ratings (the number of notches) depends on the likelihood of coupon or principal deferral (the loss absorbing feature) being triggered.

'Annual Loss' is Key: The 'annual loss' test would likely be triggered first in a crisis, earlier than the capital test of whether the capital ratio is below the regulatory minimum, and so serves as the guiding benchmark. Deferral under annual loss is optional for perpetual tier 1 and upper tier 2 instruments and these are usually notched down at least once. Preference shares have compulsory deferral under annual loss and these are usually notched down at least twice.

Notched from Unsupported Rating: If a bank's long-term rating is driven by expectations of government support and is higher than its notional 'standalone' or 'unsupported' rating, the notching down of hybrids will usually start from this lower 'unsupported' rating. This recognises that government support during a crisis could be prioritised for depositors, leaving hybrid capital investors exposed to the bank's own stand-alone capacity to cover the deferral triggers.

In effect, the rating of a hybrid instrument issued by a bank whose long-term rating is support driven could be multiple notches lower than the long-term rating.

The notching could be wider for banks with lower financial strength, reflecting their vulnerable profitability and capital ratios. Typically, the number of notches could start widening from the lower end of the 'IND AA' rating category and continue to widen for lower categories.

Event of Deferral: In the event of an actual or imminent deferral of coupon or principal under the terms of the hybrid issuance, the rating of the instrument will move to the 'IND BB' or 'IND B' category or lower, depending on loss expectations. Loss expectation will depend on the cumulative versus non-cumulative nature of the instrument, and also on the expected duration of the coupon deferral.

Treatment of junior subordinated: Lower tier 2 capital instruments (junior subordinated debt) with no deferral clause are not notched from the bank's long-term rating under the current rating approach in India. This reflects the present time-consuming legal environment in India that does not demonstrably put a senior creditor in a superior recovery position compared to subordinated debt holders in the event of liquidation.

It is however possible that in future Ind-Ra may start to differentiate between senior and lower tier 2 debt as creditor rights are progressively strengthened and there is stronger evidence of different recovery expectations between various creditor classes.

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Scope

This report only covers ratings of local currency issuances of legacy hybrid debt capital and lower tier 2 subordinated debt by banks and non-bank financial institutions in India. The investors in these instruments are typically domestic insurance companies and pension funds,

some of whom have widely different risk perceptions about hybrid debt capital. Instrument guidelines are issued by the Reserve Bank of India (RBI). The Basel III hybrid instruments are not covered in this report and will be addressed separately.

The report identifies the minimum number of notches that ratings of hybrid debt capital will usually be rated below the long-term rating of the issuing bank. The methodology for assigning long-term ratings to issuers is consistent with Ind-Ra's financial institutions rating criteria and is outside the scope of this report.

The approach to rating of hybrid debt capital and lower tier 2 instruments in India apply consistently to banks, non-bank finance companies and other financial institutions that operate in the domestic market, subject to regulatory guidelines for various categories of institutions to issue these instruments.

Limitations

The general limitations discussed in Ind-Ra's master criteria for financial institutions, "Financial Institutions Rating Criteria", dated December 2018, apply to this report as well.

Ratings provide relative measure of creditworthiness only within India. Comparisons between ratings in different countries are therefore not meaningful.

Bank ratings are subject to the limitations that are outlined in www.indiaratings.co.in

Nature of Legacy Instruments

Indian banks are permitted to issue lower tier 2 subordinated debt, upper tier 2 and perpetual tier 1 debt capital, and preference shares. Hybrid tier 1 instruments can form up to 40% of a bank's total tier 1 capital. Tier 2 capital of a bank can amount up to 100% of its tier 1 capital.

(i) **Lower tier 2:** subordinated debt: no deferral features, minimum tenure of five years

(ii) **Upper tier 2:** mandatory deferral of coupon and principal if the total capital adequacy ratio is below the regulatory minimum (currently 9%). Optional deferral in the event of annual loss, regulatory permission required to pay coupon and principal. Tenure of 15 years with call after 10 years, no step-up option. Coupon is cumulative

(iii) **Perpetual tier 1:** similar deferral terms as upper tier 2 capital, coupon is non-cumulative. Call option available after 10 years with no step-up

(iv) **Preference shares:** classified as either tier 1 or tier 2 capital depending on tenure, level of subordination, whether the dividend is cumulative or non-cumulative and redeemable or irredeemable nature of the shares. Deferral is mandatory under both capital and profit tests for all varieties of preference shares

Perpetual tier 1 and upper tier 2 instruments have typically been issued to insurance companies and pension funds in the domestic market. Lower tier 2 debt has also been issued to retail investors through the debt capital market. Preference shares have so far mostly been issued to the government. There has only been one reported instance of an optional deferral trigger being tested for an Indian bank that issued hybrid debt.

Ind-Ra's approach to rating of hybrids primarily focuses on the risk of deferral and therefore does not distinguish between cumulative and non-cumulative instruments. However, this may become relevant in the event of imminent or actual deferral to determine the loss to investors, when the notching may become wider for non-cumulative instruments.

The Basel III instruments incorporate greater loss absorbing features compared to the legacy hybrid instruments. The notching for the Basel III hybrid debt capital is addressed in a separate criteria report "Rating bank subordinated and hybrid securities".
Ind-Ra's rating of lower tier 2 subordinated debts is currently at the same level as the long-term rating of the issuing entity on grounds of inadequate data to differentiate between recoveries in various debt classes in India. Ind-Ra may phase out this special treatment with improved creditor rights and better track record of timely resolution of bad debt. Once lower tier 2 capital

Applicable Criteria

Financial Institutions Rating Criteria, April 2019

is rated a notch below senior debt, it would mean a corresponding wider notching of the existing hybrid instruments. For example, perpetual tier 1 and upper tier 2 hybrid debt will then be rated at least two notches lower than the long-term debt of the issuing entity, wider than the current one notch.

Deferral Terms

In the event of an annual loss but total capital adequacy ratio remaining above the regulatory minimum, coupon payment on the perpetual tier 1 and upper tier 2 debt capital will have to be referred to RBI, this being the optional trigger under the terms of the instruments. Term sheets typically declare a deferral as not being a default, unless the bank was to pay out coupon on a more junior instrument, for example if it paid dividend on equity shares.

The regulator's decision on whether to allow the coupon payment or force a deferral may take into consideration the period over which the concerned bank's operating problems are likely to be resolved, and the extent of protection that the bank's depositors and other senior creditors may need. Some market participants argue that allowing a deferral might disrupt the refinancing ability of the bank, which the RBI would consider carefully if a bank's losses are expected to be short-lived. However, Ind-Ra notes that cancellation of equity dividend is automatic for Indian banks if they make an annual loss, suggesting that RBI may well choose a similar automatic deferral treatment at least for tier 1 hybrid instruments in the event of an annual loss. For the moment, Ind-Ra continues to differentiate between instruments with optional deferral triggers and those where deferral is automatic if the bank makes a loss.

Indian banks and non-banks whose standalone credit profile justify an unsupported rating at the top end of the long-term scale ('IND AAA', 'and IND AA category) typically have a history of large franchise, strong core capitalisation and steady above average performance. Various stress tests also show these banks are less impacted during a credit crisis. The ratings of hybrid instruments for these banks are notched down least from their unsupported rating level; the minimum notching is currently at least one notch for instruments with optional deferral triggers and at least two notches for instruments with compulsory deferrals.

Lower rated banks with unsupported rating in the 'IND A' category have historically shown greater volatility in profits, which could stem from regional and sector concentrations, together with a more limited funding and equity franchise, smaller franchise and lower expectations of ordinary support especially in case of state-owned banks. The hybrid ratings of these banks are therefore notched wider than those issued by the better rated banks. The notching will further widen for banks whose standalone financial profiles are even lower on the long-term rating scale.

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