Rating Bank Subordinated and Hybrid Securities

Sector-Specific Rating Criteria

This criteria report is an updated version of the 1 December 2015 criteria report.

The criteria set out in this report supplement and are applied in conjunction with the Master Criteria for Financial Institutions and the criteria for 'Rating of Legacy Hybrids and Sub-debt'.

This sector-specific criteria report outlines India Ratings and Research's (Ind-Ra) methodology to assign ratings to bank and bank holding company's subordinated and hybrid securities issued in the domestic market under the Reserve Bank of India's (RBI) guidelines for the Basel III framework.

Key Drivers – Assigning Ratings

Non-Performance Definition: A coupon omission or deferral, write-down or conversion of the instrument into a more junior instrument are all considered to be non-performance from a rating's perspective, regardless of contractual treatment. Ind-Ra rates on a first loss principle.

Basis for Notching: Subordinated and hybrid securities are notched down from an anchor rating (see below). The number of notches reflects an assessment of incremental non-performance risk relative to that captured by the anchor rating, together with an assessment of loss severity. These two components are additive.

Anchor Rating for Tier 1 Instruments: If a bank's Long-Term Issuer Rating is driven by expectations of government or institutional support and is higher than its notional stand-alone or unsupported rating, the notching down of Tier 1 hybrids with going-concern loss-absorption features will usually start from this lower unsupported rating. This approach permits a consistent measure of the likelihood of the loss-absorption features being triggered and reflects the level of underlying risk in these instruments. It also recognises that government support may not be relied upon to extend to the holders of these securities during a crisis as it could be prioritised for depositors. In effect, the Tier 1 hybrid securities issued by a bank whose Long-Term Issuer Rating is support driven could be notched below the bank's Long-Term Issuer Rating. The notching could be wider for banks with low financial strength, reflecting their vulnerable profitability and capital ratios.

Anchor Rating for Tier 2 Instruments: Ind-Ra believes that the government's ownership of banks and the historically strong support environment reduce the risk of failure of government banks and improves prospects of bank securities with gone-concern loss-absorption features. The notching down of Tier 2 securities with gone-concern loss-absorption features will therefore usually be from a bank's Long-Term Issuer Rating.

Gone-Concern Loss Absorption: Loss absorption occurs as a principal write-down or as a conversion into equity when a bank is deemed non-viable by the regulator. For securities with gone-concern loss-absorption features, Ind-Ra regards the non-performance risk inherent in a pure non-viability trigger to be minimal for a bank with a high unsupported rating, and hence there may not be any notching from the Long-Term Issuer Rating. However, due to the higher risk of non-performance in subordinated securities than in senior obligations for banks with lower unsupported ratings, notching the ratings of such instruments from the Long Term Issuer Rating is appropriate.

Analysts

Prakash Agarwal
+91 22 4000 1753
prakash.agarwal@indiaratings.co.in

Jindal Haria
+91 22 4000 1750
jindal.haria@indiaratings.co.in

Going-Concern Loss Absorption: Loss absorption in the form of a coupon omission or deferral, principal write-down or conversion into equity may begin before the issuing bank is declared non-viable by the regulator. Such securities will typically be rated below an issuer's unsupported rating. The widest notching is assigned to deeply subordinated instruments with high incremental non-performance and loss severity risks relative to the risk captured by the bank's unsupported rating. Basel III compliant Additional Tier 1 securities can potentially fall into this category. Besides a mandatory notching owing to the discretionary component of coupon payment, these instruments would have notching component linked to their ability to manage the minimum capital requirement under Basel-III transition through capital raising and/or accruals and also a component linked to their ability to service coupons through their earnings and/or free reserves.

Scope

This report only covers the ratings of local currency issuances of Basel III subordinated and hybrid securities by banks and bank holding companies in India. The investors in these instruments are typically domestic insurance companies and pension funds, the largest among which are directly or indirectly owned by the government. Instrument guidelines are issued by RBI. Banks are permitted to issue these Basel III instruments to retail investors. However, retail investors are specifically required to sign-off on a statement articulating that they understand the risks and specific features of the instrument.

This report identifies the minimum number of notches at which Tier I and Tier II instruments will be rated below the Long-Term Issuer Rating of the issuing bank. The methodology for assigning the Long-Term Issuer Rating to issuers is consistent with Ind-Ra's financial institutions rating criteria and is outside the scope of this report.

The approach to rating Tier I and Tier II instruments in India applies 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', 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 Basel III Instruments

Gone-concern loss absorption arises where instruments are only designed to absorb losses if the issuing bank becomes non-viable and then, for example, either enters into some form of insolvency or resolution process or receives extraordinary support that prevents a default. Going-concern loss absorption, on the other hand, is achieved where loss-absorption is triggered to maintain the minimum mandatory capital ratios under Basel-III to avoid intervention and remedial action by the regulator. While loss absorption would be most commonly achieved through coupon deferral or omission, it may also include write-down or conversion features.

Post the global financial crisis, with a view to improving the quality and quantity of regulatory capital, RBI's guidelines require that the predominant form of Tier 1 capital must be common equity; since it is critical that banks' risk exposures are backed by high quality capital. Indian banks are permitted to issue non-equity Tier 1 and Tier 2 capital, subject to eligibility criteria as laid down in the RBI's Basel III capital regulations.

1. Tier II debt capital (gone-concern capital): minimum maturity of 10 years with no step-ups or other incentives to redeem; no put option but callable at the initiative of the issuer after a minimum of five years subject to RBI approval and regulations, however the bank must not do anything which creates an expectation that the call will be exercised; subjected to a

progressive discount for capital adequacy purposes; no rights to accelerate the repayment of future scheduled payments except in bankruptcy and liquidation and seniority of claim subordinate to the claims of all depositors and general creditors of the bank. The instruments must have a contractual non-viability principal loss absorption trigger (explained further in 4 below).

2. Tier I debt capital (going-concern capital): no maturity date and no step-ups or other incentives to redeem; no put option but callable at the initiative of the issuer after a minimum of five years subject to RBI approval and regulations; however, the bank must not do anything that creates an expectation that the call will be exercised or the bank can call the bonds if they are being replaced by better quality capital; coupons to be paid out of distributable items and free reserves (current year profits, profits brought forward from previous years, or from reserves representing appropriation of net profits less accumulated losses and deferred revenue expenditure) and interest shall not be cumulative; full discretion to issuing bank over coupon payments at any time; dividend pushers not permitted; loss absorption features through conversion/ write-down/ write-off on breach of pre-specified trigger (if the common equity Tier 1 ratio (including the capital conservation buffer) falls below 5.5% till Mar'19 or below 6.125% beyond Mar'19) and at the point of non-viability and seniority of claim superior to only the claims of investors in equity shares and perpetual non-cumulative preference shares.
3. Preference Shares: classified as Tier 1 capital in case of perpetual non-cumulative preference shares with similar characteristics and loss absorption features as Tier 1 debt capital; perpetual cumulative preference shares, redeemable non-cumulative preference shares and redeemable cumulative preference shares with characteristics similar to Tier II debt capital to be classified as Tier II capital.
4. Point of Non-Viability Loss Trigger: Both Tier 1 and Tier 2 capital instruments issued by banks in India must have a provision that requires such instruments, at the option of the RBI, to either be written off or converted into common equity upon the occurrence of a trigger event, called the point of non-viability (PONV) trigger. The PONV trigger is the earlier of (a) a decision that equity conversion or temporary/ permanent write-off of capital instruments - without which the firm would become non-viable - is necessary, as determined by RBI or (b) a decision to make a public sector injection of funds, without which the bank would become non-viable, as determined by RBI.

Rating Capital Securities: Notching and Anchor Rating

Notching down a bank's subordinated and hybrid ratings from its anchor rating allows Ind-Ra to express differing levels of investment risk for different classes of obligations from the same borrower. The extent of downward notching for any given instrument reflects primarily the probability of non-performance relative to the anchor rating plus an assessment of the relative loss severity given non-performance. The two components are additive.

Non-performance risk is essentially 'first loss', and for Ind-Ra's rating purposes, is defined as any one of the following events:

- an omission or a deferral of a coupon or similar distribution
- a contingent conversion into a more junior instrument to the detriment of the investor (other than at the investor's option)
- a write-down (either temporary or permanent) resulting in partial or full non-payment of principal

Although potential for extraordinary support sometimes inflates the Long-Term Issuer rating of a bank, Ind-Ra does not factor extraordinary state or institutional support into the ratings of hybrid securities with going-concern loss-absorption features. This recognises that extraordinary government support cannot be relied upon to extend to such instruments during a crisis as it could be prioritised for depositors. As a result, the anchor rating from which such securities are notched down is usually the issuer's unsupported rating.

However, Ind-Ra believes that for bank securities with gone-concern loss-absorption features, the likelihood of government support in India remains sufficiently strong. The notching down of hybrids with gone-concern loss-absorption features will therefore usually start from the bank's Long-Term Issuer Rating.

Notching for Non-Performance Risk

Ind-Ra considers coupon omissions, write-downs or conversions into equity to be non-performance from a rating's perspective, regardless of contractual treatment. The probability of non-performance relative to hitting the point of non-viability is a major rating variable for all Basel III compliant securities, along with loss severity. In addition, for securities with going concern loss-absorption features, the probability of a coupon omission, an equity conversion or a write-down is an important variable to determine the extent of notching from the anchor rating. Activation of a going-concern loss-absorption feature does not mean that the issuing bank has failed, but is treated as ‘non-performance’ at a security-level rating.

Ind-Ra will add between zero and three notches for incremental non-performance risk, dependent on whether it is minimal, moderate or high. Ind-Ra’s assessment of whether the incremental risk is minimal, moderate or high depends on a number of variables, e.g. volatility of a bank’s earnings, the degree of flexibility in managing risk-weighted assets and the projected capital cushion above the pre-determined trigger. Another reason for lesser notching might be where non-performance risk is cushioned by the existence of a sufficient layer of junior securities with sufficiently higher triggers.

For the Basel III going concern instruments in their current form, Ind-Ra will have three components to its notching for non-performance risk – a mandatory notching for the issuer discretion on coupon payments and two other notching components to capture the write-down risk and coupon omission risk. Ind-Ra’s assessment of write-down risk depends primarily on the ability of a bank/FI to manage its projected capital cushion above the pre-determined trigger. This could be measured through the relative quantum of capital requirement to meet the minimum mandated Basel-III capital ratios including provisions for capital conservation buffer (CCB), systemically important bank buffer (D-SIB) and countercyclical buffer (CCCB). The assessment would take into account parameters such as required dilution on existing net-worth, promoter headroom for dilution and capital market reach, and Ind-Ra’s opinion on the ability of a bank to monetise its non-core assets in a timely manner and others. Ind-Ra’s assessment of coupon omission risk would consider the bank/FI’s relative ability to service their coupon payments through earnings and/or free reserves (revenue reserve and P&L balances).

For securities with gone-concern loss-absorption features, Ind-Ra regards the non-performance risk inherent in a pure non-viability trigger to be the same as that expressed by the Long-Term Issuer Rating. As such, no incremental notching for non-performance is required because of the existence of a non-viability trigger unless the unsupported rating is low.

Indian banks whose standalone credit profiles justify an unsupported rating at the top end of the long-term scale (‘IND AAA’, ‘IND AA’ and the higher end of the ‘IND A’ category) typically have a history of above-average core capitalisation and reasonable operating performance. Various stress tests also indicate that these banks are less impacted during a credit crisis. The ratings of Tier II instruments for these banks will usually not be notched down from their unsupported rating level for incremental non-performance risk.

Lower rated banks with unsupported ratings, typically in the ‘IND BBB’ category or lower, have historically shown greater volatility in profits, which could stem from regional and sector concentrations, together with more limited funding and equity franchises. The ratings of Tier II instruments of these banks could therefore be rated at least one notch lower for incremental non-performance risk relative to higher rated banks.

Notching for Loss Severity

Loss-severity notching arises because of lower recovery expectations for subordinated and hybrid securities than for a senior unsecured instrument in a failing unsupported entity. In an extremely adverse scenario (for example, outright liquidation), both subordinated and hybrid creditors of a bank would almost certainly be completely wiped out. However, Ind-Ra believes it is reasonable and appropriate to maintain a degree of flexibility in the notching assigned at the initial rating for different types of regulatory capital securities to reflect their differing subordination and nature of contractual write-downs.

Ind-Ra will decide on the appropriate notching for loss severity on a case-to-case basis. Factors that could – but will not necessarily – give rise to wider notching include: quality/sophistication of insolvency or resolution legislation specific to banks, contractual write-off language, greater vulnerability to outright liquidation, or thin layers of more junior non-equity capital, particularly if several of them are relevant for an issuer. The most deeply subordinated classes of securities with permanent write-down features will receive additional notches for loss severity, reflecting their more junior status and higher risk of poor recoveries in an adverse scenario.

Event of Non-Performance

In the event of an actual or imminent non-performance 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 the form and expected duration of loss absorption. In event of a full write-down or conversion into equity, the rating on these instruments will be withdrawn.