

Criteria for Rating Basel III - Hybrid Capital Instruments issued by Banks [Issued in September 2020]

CARE has been rating various debt instruments of banks including fixed deposit (FD) programmes, certificate of deposit (CD), infrastructure bonds and subordinated bonds (including Lower Tier II bonds) issued by banks. CARE has a rating methodology for rating of banks which is available on our website www.careratings.com.

Background

The Reserve Bank of India (RBI) has been prescribing the capital adequacy framework for scheduled commercial banks in India and has allowed banks to raise capital by way of several debt instruments, some of which are hybrid in nature having certain features of both equity and debt. Each instrument has unique features, which affect its quality as capital. While some of these instruments act similar to equity, with loss-absorption features on an ongoing basis without triggering liquidation, they may be included in Tier I or Tier II capital for the purpose of capital adequacy calculations of a bank.

CARE Ratings rates various debt instruments having unique features that differentiate its loss-absorption capacity, severity of loss and probability of default from others. CARE reviews and accounts for these critical features which are important parameters in arriving at the final rating of such instruments. Some of the key features of the non-equity capital instruments under **Basel III** are mentioned below:

Additional Tier 1 (AT1) debt instrument: These instruments have several unique features, which make them very different from other types of debt instruments. Compared with Tier I instruments under Basel II, these instruments have higher loss-absorption capacity and are designed to absorb losses on a going-concern basis. These instruments do not have a maturity date and no step-ups or other incentives to redeem. Coupons may 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. The issuing bank has full discretion over coupon payments at any time; dividend pushers are not permitted. These instruments also have 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% upto September 2020 and 6.125% beyond September 2020 or at the point of non-viability (PONV) and seniority of claim superior to only the claims of investors in equity shares and perpetual non-cumulative preference shares. While there are no put options, these bonds come with a call option after a minimum of five years which the issuer bank can exercise subject to RBI approval.

Tier II Instruments (under Basel III)

Basel III-compliant Tier II capital instruments have an additional feature that is meant to be invoked/ at the PONV, and **therefore**, provide an additional layer of protection to depositors and senior creditors. These bonds do not have any interest deferral clause, but they are expected to absorb losses when the PONV trigger is invoked. On the invocation of the PONV trigger, these instruments at the option of the RBI, are either to be written off or converted into common equity.

CARE's criteria on the rating of various debt instruments under Basel III are as under:

Rating of Additional Tier 1 debt instrument (under Basel III)

CARE Ratings considers the following key features while assigning rating to these instruments:

- The bank has full discretion to cancel coupon payments anytime.
- The coupon is to be paid out of current year profits. However, if the current year's profits are not sufficient, i.e., payment of such coupon is likely to result in losses during the current year, the balance of coupon payment may be made out of reserves representing appropriation of net profits, including statutory reserves and excluding share premium, revaluation reserve, foreign currency translation reserve, investment reserve and reserves created on amalgamation provided the bank meets the minimum regulatory requirements for Common Equity Tier I [CET I], Tier I and Total Capital Ratios and capital buffer frameworks as prescribed by the RBI.
- The instrument may be written-down upon CET I breaching the pre-specified trigger of 5.5% up to September 30, 2020 and 6.125% (as per extant guidelines) after that, or written-off on occurrence of the point of non-viability (PONV) trigger event. The PONV trigger shall be determined by the RBI.

To factor in the additional risk in these instruments, the rating is notched down by one to several notches below the Tier II Bond rating depending on the expected adequacy of eligible reserves after capital conservation buffer, cushion over minimum regulatory capital and other credit risk assessment parameters of the individual bank. Similarly, AT1 instruments may also be rated lower as compared to Innovative instruments (IPDI) under Basel II based upon the credit profile of the bank. Under Basel III, severity of loss is likely to be significantly higher and permanent as PONV trigger could lead to write-off/conversion to equity capital unlike IPDI under Basel II where there is no impact on principal. The notching of AT1 instruments would also be dependent on the rating of the bank's senior instruments, where stronger banks with higher rating may see lower notching, whereas notching could increase for lower rated banks. While this relationship will generally hold, the rating of the senior instruments of the bank will be looked in conjunction with the other factors mentioned earlier for determining the notching for AT1.

Any delay/omission in payment of interest/principal (as the case may be) due to invocation of any of the features mentioned above would constitute as an event of default as per CARE's definition of default and as such these instruments may exhibit a somewhat sharper migration of the rating compared with other subordinated debt instruments.

Basel III Hybrid Instruments issued by Banks

For public sector banks (PSB), the current rating factors in government support. The restriction on coupon payment in the event of loss or through distributable reserve may pose challenge in coupon servicing for weaker banks. However, in the past, the GoI, as a shareholder, has provided support to PSBs to not only make the coupon payments but also to call back the bonds. In case of PSBs, it is likely that the GoI would provide capital support well in advance so that the coupon payment trigger is not breached.

For private sector banks (PVBs), their intrinsic strength is reflected in the rating of their conventional debt instruments. As such, the notching may be lower for higher rated PVBs, whereas the notching could be wider for lower rated PVBs.

A brief comparison of Tier I instruments under Basel II and Basel III is presented below:

| Clause | Under Basel II | Under Basel III | Credit Risk Impact |
|--|--|--|---|
| | Innovative Perpetual Debt Instruments (IPDI) | AT 1 Instruments | |
| Lock-in clause on payment of coupon | <p>Non-payment of coupon if CAR is below 9% or goes below 9% on payment of coupon</p> <p>Prior RBI approval is required if coupon results in net loss or increases the net loss, provided CAR above minimum requirement.</p> | <p>If a bank does not have positive earnings and has a Common Equity Tier I ratio < 8%, the bank will not be able to make coupon payments on the AT1 bonds.</p> | <p>The trigger in Basel II instrument is based on overall CAR, while in Basel III it is based on CET 1. Thus, the default event has shifted from breach of overall capital adequacy of 9% (under Basel II) to Common Equity Tier I of 8% (for non-payment of coupon).</p> |
| Loss Absorption Features | No such clause | <p>Can be permanently written-off or converted into common equity in case of two events:</p> <ol style="list-style-type: none"> Breach of CET 1 ratio of 5.5% till September 30, 2020 & Breach of CE Tier I ratio of 6.125% after September 30, 2020 (as per current guidelines) Upon declaration of non viability by RBI on reaching the PONV trigger | <p>The credit loss is higher under Basel III as compared to Basel II in a going concern scenario resulting in conversion or write-off.</p> |
| Coupon Discretion | Bank shall not be liable to pay interest if its CRAR falls below the minimum requirement or interest payment results in bank's CRAR falling below the minimum regulatory requirement. | The bank has full discretion at all times to cancel distributions/payments. The interest shall not be cumulative. | Makes the credit quality of the perpetual bonds under Basel III framework weaker in relation to the perpetual bonds under Basel II framework. |

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| Clause | Under Basel II | Under Basel III | Credit Risk Impact |
|-------------------------|--|---|---|
| | Innovative Perpetual Debt Instruments (IPDI) | AT 1 Instruments | |
| Coupon Payment | Payment of coupon with the prior approval of RBI is allowed even when the impact of such payment may result in net loss or increase the net loss, provided the CAR remains above the regulatory norms. | While earlier regulations allowed banks to pay coupon only out of the current year's profit and revenue reserves, the RBI regulations of February 2017 allow other reserves, including statutory reserves, for coupon payment. However, payment is subject to the issuing bank meeting minimum regulatory requirements for CET1, Tier 1 and Total Capital ratios at all times and subject to the requirements of capital buffer frameworks. | |
| Severity of loss | Non-cumulative coupon/dividend | Non-cumulative coupon. High severity of loss upon CET1 declining below the pre-specified trigger levels and RBI opting for conversion of AT I bonds to equity or upon invocation of PONV by RBI. | While Basel II provisions could have led to a permanent loss on interest/coupon payments, there was no impact on principal. However, under Basel III, severity of loss is likely to be significantly higher and permanent as PONV trigger could lead to write-off/conversion to equity capital. |

Rating of Tier II Bonds (under Basel III)

Tier II Bonds under Basel III are characterized by a 'Point of Non-Viability' (PONV) trigger due to which the investor may suffer a loss of principal. PONV will be determined by the Reserve Bank of India (RBI) and is a point at which the bank may no longer remain a going concern on its own unless appropriate measures are taken to revive its operations and thus, enable it to continue as a going concern. In addition, the difficulties faced by a bank should be such that these are likely to result in financial losses and raising the Common Equity Tier I capital of the bank should be considered as the most appropriate way to prevent the bank from turning non-viable. The inherent risk associated with the PONV feature is adequately factored in the bank's Lower Tier II bonds (under Basel II). Therefore, the rating of Tier II bonds (under Basel III) for higher rated banks could be closer to those of Lower Tier II bonds (under Basel II). However, rating of these instruments for lower rated banks may be notched down accordingly. The government has been supporting the PSU banks through capital infusion from time to time given their role in economic

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growth and development as well as policy implementation. In our view, it is likely that the GoI would infuse equity in PSBs well in advance so that their capital remains well above the PONV triggers.

On a going concern basis, the parameters considered to assess whether a bank will reach the PONV are similar to the parameters considered to assess rating of Tier II instruments even under Basel II. Therefore, the rating of Tier II instruments under Basel III will be similar to the rating of Lower Tier II instruments under Basel II.

A brief comparison of Tier II Bonds under Basel II and Basel III has been presented below:

| Clause | Upper Tier II (Under Basel II) | Lower Tier II (Under Basel II) | Tier II (Under Basel III) | Credit Risk Impact |
|--|--|--------------------------------|--|---|
| Lock-in clause on payment of coupon/principal in going concern scenario | Non-payment of coupon if CAR is below 9% or goes below 9% on payment of coupon. Prior RBI approval is required if coupon results in net loss or increase net loss, provided CRAR>9%. | Not applicable | Not applicable | Probability of default on Upper Tier II (under Basel II) is higher than Tier II (under Basel III) as probability of PONV trigger invocation is likely to be much lower than the probability of a bank breaching the capital adequacy threshold. |
| Loss Absorption Features | Not applicable | Not applicable | These instruments can be written off or converted into common equity upon declaration of point of non viability (PONV) by RBI. | Under Basel III, loss absorption is likely to be significantly higher as a PONV trigger could lead to write off/conversion prior to any public sector injection of capital. |

CARE Ratings Limited

4th Floor, Godrej Coliseum, Somaiya Hospital Road,
Off Eastern Express Highway, Sion (East), Mumbai - 400 022.
Tel: +91-22-6754 3456, Fax: +91-22- 6754 3457, E-mail: care@careratings.com

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Basel III Hybrid Instruments issued by Banks

Appendix 1: A brief comparison of the key features of Tier I and II bonds under Basel III is as under:

| Clause | Tier I bonds | Tier II bonds | Credit Risk Impact |
|--|---|---|---|
| Coupon Discretion | The bank must have full discretion at all times to cancel distributions/payments. The interest shall not be cumulative. | No such clause | Coupon cancellation may lead to economic loss to investors and hence an event of default. |
| Lock-in clause on payment of coupon/principal in going concern scenario | If a bank does not have positive earnings and has a common Equity Tier I ratio less than 8%, the bank will not be able to make coupon payments on the perpetual bonds | No constraint for coupon or redemption until the occurrence of PONV. | Probability of default on AT1 bonds is higher than Tier 2, as the trigger is CET1 in case of AT1 bonds. |
| Loss Absorption Features | Can be permanently written-off or converted into common equity in case of two events: 1. Breach of CE Tier I ratio of 5.5% till September 30, 2020 & Breach of CE Tier I ratio of 6.125% after September 30, 2020 (as per current guidelines) 2. Upon declaration of non viability by RBI on reaching the trigger of PONV | These instruments can be written off or converted into common equity upon declaration of point of non viability (PONV) by RBI | Under Basel III, loss absorption is likely to be significantly higher as a PONV trigger could lead to write off/conversion prior to any injection of capital. Further, Tier I bonds carry a loss absorption feature in case of breach of minimum CET I trigger. |