

Criteria | Financial Institutions | Banks:
**Bank Hybrid Capital Methodology
And Assumptions**

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RELATED CRITERIA AND RESEARCH

Bank Hybrid Capital Methodology And Assumptions

(Editor's Note: This article supersedes "Assumptions: Implications Of The December 2009 Basel III Proposals For Our Bank Hybrid Criteria," published Feb. 9, 2010, "Methodology For Rating Bank Nondeferrable Subordinated Debt (Lower Tier 2 Regulatory Capital)," published Aug. 4, 2009, "Equity Content Of U.S. Capital Assistance Program Convertible Preferred Stock," published March 17, 2009, "Equity Content Assessment Of TARP Preferred Stock Issues Revised Following Changes Under The Stimulus Act," published Feb. 20, 2009, "Standard & Poor's Ratings Services Criteria Regarding Contingent Capital Securities," published Oct. 26, 2009, and "Methodology: Treatment Of B Shares And Asset Protection Scheme Fees In Standard & Poor's Capital Ratios For U.K. Financial Institutions," published April 9, 2010. This article partly supersedes "Hybrid Capital Handbook: September 2008 Edition," published Sept. 15, 2008, "Criteria Assumptions Regarding Coupon Step-Ups In Equity Hybrids Issued By Banks And Insurers," published Sept. 16, 2009, "Criteria Clarification On Replacement Provisions In Hybrid Securities," published Dec. 12, 2008, and "Franchise Stability, Confidence Sensitivity, And The Treatment Of Hybrid Securities In A Downturn," published Dec. 1, 2008.)

1. Standard & Poor's Ratings Services is updating its methodology and assumptions for identifying, categorizing, and rating bank hybrid capital. This criteria update follows the publication of "Request for Comment: Bank Hybrid Capital Criteria: Methodology And Assumptions," on Dec. 6, 2010. This update is intended to provide additional clarity regarding the determination and classification of the equity content of bank hybrid capital instruments and to explain the criteria for assigning ratings to such instruments. This article also incorporates information derived from the 2008-2010 banking downturn, particularly regarding the observed performance of bank hybrid capital instruments during that period of stress. The updated criteria are intended to reflect banks' high sensitivity to market confidence and the impact of changing regulatory standards on hybrid instruments.
2. The criteria comprise standards for: (i) determining whether a hybrid capital instrument is eligible for inclusion in the calculation of a bank's total adjusted capital or of a finance company's capital, (ii) classifying a bank or finance company hybrid capital instrument based on its degree of equity content, and (iii) assigning a rating to a bank or finance company hybrid capital instrument. Total adjusted capital is the numerator of Standard & Poor's risk-adjusted capital (RAC) ratio for banks. The RAC ratio provides the starting point for assessing the strength of a bank's capitalization under the criteria for rating banks. Bank hybrid capital instruments that can qualify for inclusion in total adjusted capital include so-called "contingent capital" instruments and those with write-down features.
3. The "Principles Of Credit Ratings," published Feb. 16, 2011, form the basis of these criteria.
4. This article supersedes:
 - "Assumptions: Implications Of The December 2009 Basel III Proposals For Our Bank Hybrid Criteria," published Feb. 9, 2010, on RatingsDirect on the Global Credit Portal;
 - "Methodology For Rating Bank Nondeferrable Subordinated Debt (Lower Tier 2 Regulatory Capital)," published Aug. 4, 2009;
 - "Equity Content Of U.S. Capital Assistance Program Convertible Preferred Stock," published March 17, 2009;

- "Equity Content Assessment Of TARP Preferred Stock Issues Revised Following Changes Under The Stimulus Act," published Feb. 20, 2009;
 - "Standard & Poor's Ratings Services Criteria Regarding Contingent Capital Securities," published Oct. 26, 2009; and
 - "Methodology: Treatment Of B Shares And Asset Protection Scheme Fees In Standard & Poor's Capital Ratios For U.K. Financial Institutions," published April 9, 2010.
5. This article partly supersedes:
- "Hybrid Capital Handbook: September 2008 Edition," published Sept. 15, 2008 (superseding various references to banks, including the section titled "Applying Hybrid Capital Equity Content Analysis in Credit Analysis: Nonbank Financial Institutions Methodology");
 - "Criteria Assumptions Regarding Coupon Step-Ups In Equity Hybrids Issued By Banks And Insurers," published Sept. 16, 2009 (This article still applies to insurers, but no longer applies to banks.);
 - "Criteria Clarification On Replacement Provisions In Hybrid Securities," published Dec. 12, 2008 (This article still applies to issuers other than banks.); and
 - "Franchise Stability, Confidence Sensitivity, And The Treatment Of Hybrid Securities In A Downturn," published Dec. 1, 2008 (superseding the section titled "Payment deferral risk of financial institutions' hybrid securities").

I. SCOPE OF THE CRITERIA

6. These criteria apply to all existing and future hybrid capital instruments issued by banks and other deposit-taking institutions that Standard & Poor's rates. The term "banks" includes finance companies and bank nonoperating holding companies. The term "other deposit-taking institutions" includes entities such as building societies and banks that are subsidiaries of insurance or corporate groups.
7. These criteria do not apply to hybrid capital instruments issued by stock exchanges and clearing houses, asset managers, insurance companies, corporate issuers, or insurance companies that are subsidiaries of banks. For these issuers, the applicable criteria are in "Hybrid Capital Handbook: September 2008 Edition," published Sept. 15, 2008, and related articles.

II. SUMMARY OF THE CRITERIA

8. Hybrid capital instruments include--but are not limited to--preferred stock, deferrable subordinated notes, trust preferred securities, and mandatory convertible securities (see subpart VI.A). The equity content of a hybrid capital instrument (or hybrid) can affect the rating on a bank by influencing the measurement of the bank's capitalization. Equity content refers to the extent to which a bank hybrid capital instrument can function as equity and therefore--via features such as coupon nonpayment or deferral, a principal write-down, or conversion into common equity--absorb a portion of a bank's losses. The criteria classify the equity content of bank hybrids into one of three categories: (i) high, (ii) intermediate, or (iii) minimal.
9. To qualify for inclusion in total adjusted capital (TAC), subject to certain limits, a bank hybrid capital instrument must qualify for inclusion in regulatory capital and contain features consistent with the criteria for classification in either the high equity content category or the intermediate equity content category (see table 1). The definition of TAC is specified in "Bank Capital Methodology And Assumptions," published Dec. 6, 2010. A bank hybrid with

minimal equity content is not eligible for TAC.

Table 1 Bank Hybrid Capital Instruments: Equity Content And Eligibility For TAC*		
Equity content category	Maximum amount eligible for inclusion in total adjusted capital (TAC)§	Qualifying instruments
High	An amount equivalent to up to 50% of adjusted common equity (ACE)	<p>1. Short-dated mandatory convertible securities (MCS) that convert into common equity at a price that is not lower than the common share price of the issuer on the date it issued the MCS†:</p> <ul style="list-style-type: none"> • In less than three years if the bank's stand-alone credit profile‡ (SACP) is at 'bbb-' or higher, • Within two years if the issuer's SACP is in the 'bb' category, and • Within one year if the issuer's SACP is in the 'b' category. <p>2. Certain government-owned hybrids are included in TAC, without a limit (see paragraphs 50-51).</p>
Intermediate	An amount equivalent to up to 33% of ACE. However, if hybrid capital instruments with high equity content exhaust the 50% limit, those with intermediate content are unable to be included in TAC	<p>Subordinated instruments, preferred stock, trust preferred securities, or contingent capital instruments that meet all of the following conditions:</p> <ul style="list-style-type: none"> • Can suspend coupons, write down principal, or convert into common equity, without causing a default or wind-up of the bank; • Have no material restriction on the ability to defer or otherwise absorb losses while the bank is a going concern**; • Are perpetual or have a residual life of at least 20 years if the bank's SACP is at 'bbb-' or higher, at least 15 years if the SACP category is 'bb', at least 10 years if the SACP category is 'b', or a shorter residual life if they are going-concern contingent capital instruments (see paragraph 53); • Do not contain a step-up clause, or an alternative incentive to redeem, associated with a call date during the residual life periods described above (see paragraph 45). If a step-up clause applies during the residual life period, the instrument still qualifies for this equity content category if it also contains a contingency feature that can be activated on a going-concern basis and is consistent with the features outlined in paragraph 53; and • Coupons can be cumulative or noncumulative.
Minimal	Not included in TAC	Issues that do not have features consistent with high or intermediate equity content.

*This table replaces Table 2a in "Hybrid Capital Handbook: September 2008 Edition," published Sept. 15, 2008. In addition to meeting the features outlined in the table, the instruments must be included in regulatory capital to qualify for the high or intermediate content categories (see paragraph 38). §The word "amount" refers to the par amount, or the par amount adjusted for any write-downs of the instrument. This is unless an eligible instrument is subject to regulatory amortization, in which case, inclusion in TAC refers to the amortized amount. Inclusion in TAC occurs until the aggregate amount of eligible instruments exceeds the TAC limits shown in this table. †See "Intermediate Equity Content For Certain Mandatory Convertible Preferred Stock Hybrids," published Nov. 26, 2008, for the criteria for mandatory convertible preferred stock issued by rated Australian banks. ‡The methodology for determining a bank's stand-alone credit profile or SACP is specified in the criteria for rating banks. **See "Assumptions: Clarification Of The Equity Content Categories Used For Bank And Insurance Hybrid Instruments With Restricted Ability To Defer Payments," published Feb. 9, 2010. © Standard & Poor's 2011.

10. Qualifying for inclusion in a bank's regulatory capital is a necessary condition, but does not automatically qualify a bank hybrid capital instrument for inclusion in TAC. Inclusion in the calculation of TAC also depends on an instrument's specific features. A hybrid capital instrument's regulatory classification (for example, Tier 1 or Tier 2) does not, in isolation, affect the determination of equity content (see part VI "Methodology", section A.1). A hybrid capital instrument that has been "grandfathered" by regulators is eligible for inclusion in the TAC calculation until the regulator removes it from regulatory capital. This is provided that it otherwise qualifies for classification in either the high equity content category or the intermediate equity content category under these criteria.

11. The only types of hybrid capital instruments that can qualify for the high equity content category are: (i) mandatory convertible securities that meet the conditions specified in Table 1, and (ii) qualifying government-owned hybrids (see part VI "Methodology", subsection B.3.b). This treatment is more restrictive than the corresponding treatment of hybrid capital instruments issued by insurance companies and nonfinancial corporations. The reason for the difference is that banks' sensitivity to market confidence is generally higher than that of other issuers.
12. A government-owned hybrid capital instrument qualifies for the high equity content category, without limits, if: (i) it is issued to rescue or provide long-term support to a bank, (ii) the support appears likely to continue, (iii) the instrument is perpetual or only redeemable from the bank's retained earnings, (iv) the bank's stand-alone credit profile (SACP) is in the 'bbb-' category or higher after the redemption, (v) we believe the government is unlikely to sell the instrument until the bank has stabilized, (vi) dividends are discretionary, and (vii) the instrument is distinguishable from the bank's other hybrid capital instruments.
13. To qualify for the intermediate equity content category, a hybrid capital instrument must be able to absorb losses while the bank is a going concern. A so-called "going-concern contingent capital" instrument can qualify for the intermediate equity content category if it can absorb losses upon satisfaction of its contingency clause while the bank is a going concern. The method of absorbing losses may be conversion into common equity or a write-down of principal (see part VI "Methodology", section B.4). The criteria classify a contingent capital instrument that cannot absorb losses on a going-concern basis into the minimal equity content category.
14. A hybrid capital instrument with minimal equity content, such as one that can absorb losses only in a "nonviability" situation, is ineligible for inclusion in TAC. Nonviability refers to when a bank is in breach of, or about to breach, regulatory requirements for its license (see subpart VI.A). Such instruments include nonviability contingent capital (NVCC). The market sometimes refers to NVCC instruments as "bail-in" capital if these instruments share the cost of a government's rescue of a bank (see paragraphs 54-55).
15. However, even though an instrument is called an NVCC instrument, it can qualify for inclusion in the TAC calculation if it can also absorb losses on a going-concern basis and meet the other conditions for classification in the high equity content category or the intermediate equity content category.
16. The criteria for rating a bank hybrid capital instrument apply to all bank hybrid capital instruments, even those classified as having minimal equity content.
17. The methodology for assigning an issue rating to a bank hybrid capital instrument is to notch down from the bank's SACP, except in the situations described in the next paragraph or if the issuer credit rating (ICR) on the bank is lower than its SACP. For these exceptions, the notching is from the ICR. These criteria only assign a rating of 'C' or 'D' to an instrument that has stopped paying (see table 2). The minimum notching for a bank hybrid capital instrument ranges from two notches below the SACP (if the bank's SACP is assessed at 'bbb-' or higher) to three notches below the SACP (if the bank's SACP is 'bb+' or lower). An issue rating is a forward-looking opinion that reflects the risk of nontimely or partial payment on a bank hybrid capital instrument and the subordination of the instrument. If an instrument shows a higher risk of nontimely or partial payment than the SACP assessment indicates, additional notching from the SACP applies (see part VI "Methodology", section C.2).
18. If a bank is a subsidiary and benefits from group support because of its strategic importance, the approach is to notch down from the ICR on the subsidiary if the support covers the subsidiary's hybrid capital instruments. Conversely, if the support excludes the hybrid capital instruments, the notching is from the subsidiary's SACP (see

paragraphs 58 and 59). We do not expect government support to cover a bank's hybrid capital instruments unless the bank is a government-related entity and, even then, only in rare circumstances (see paragraph 60).

19. The rating on an NVCC instrument would be one notch lower than that on an equivalent hybrid capital instrument that does not contain a contingency clause.
20. A bank's proximity to a mandatory contingency trigger determines the additional notching on a going-concern contingent capital instrument. A rating cap applies when a trigger relates to maintenance of a specific regulatory capital ratio, depending on both the bank's SACP and its proximity to the trigger (see tables 3a and 3b in part VI "Methodology", section C.2). The rating cap is 'CCC' if the trigger is exceptionally sensitive or linked to rating transitions, or if its activation is independent of a deterioration of the SACP (see paragraph 72 for examples).
21. The methodology for rating a bank's nondeferrable subordinated debt instrument that qualifies as a hybrid capital instrument is to notch down from the SACP: one notch, if the bank's SACP is 'bbb-' or higher; or two notches if the SACP is 'bb+' or lower (see part VI "Methodology", section C.3). The criteria treat nondeferrable subordinated bank debt as hybrid capital if the relevant legal or regulatory framework insulates senior debt from defaults on the subordinated debt. An example of such a framework is a resolution regime that allows a bank's subordinated debt to absorb losses (such as via the write-down of principal) without causing the bank's liquidation.

III. CHANGES FROM REQUEST FOR COMMENT

22. On Dec. 6, 2010, Standard & Poor's published "Request for Comment: Bank Hybrid Capital Criteria: Methodology And Assumptions." Some market participants provided comments on parts of the text that could be further elaborated. Our review of these comments and refinement of the analytics have led to the following changes from the RfC:
 - A bank's contingent capital instrument is eligible for classification in the intermediate equity content category if it contains a contingency clause that can operate while the bank is a going concern (see paragraphs 36 and 53). By contrast, the RfC proposed that a contingent capital instrument would not achieve classification in the intermediate equity content category if it were a senior bond or a nondeferrable subordinated instrument before activation of the contingency trigger. This change seeks to reflect an instrument's ability to absorb losses, rather than focus only on its initial form.
 - The RfC proposal excluded from TAC any hybrid capital instrument with a step-up on a call date sooner than the minimum residual life, or equivalent features that provide an incentive to redeem early (see paragraph 44). The exclusion would have applied even though the instrument's other features might be consistent with classification in the intermediate equity content category. Under these criteria, such an instrument is now eligible for classification in the intermediate equity content category if it contains a contingency clause enabling conversion into common equity or a principal write-down feature that can take effect while the bank is a going concern (see paragraph 53). This change seeks to reflect the capacity of a going-concern contingent capital instrument to absorb losses.
 - A going-concern contingent capital instrument is eligible for TAC if it has a remaining life of at least 15 years, compared with the RfC proposal of more than 20 years (see paragraph 53). This eligibility applies for the hybrid capital instruments of banks with SACPs at 'bbb-' or higher. Shorter residual maturities meet the eligibility standard if the SACP is at a lower level. This change also seeks to reflect a going-concern contingent capital instrument's ability to absorb losses.

- To increase transparency, there is more information on what constitutes a nonviability situation and a going-concern basis under the criteria (see paragraphs 34-37).
- The criteria specify issue ratings that are lower than a bank's SACP for nondeferrable subordinated debt in countries whose legal or regulatory frameworks may not support this type of debt in a stress scenario. The RfC proposal was to rate a bank's nondeferrable subordinated debt two notches below the bank's SACP if the SACP is at 'bbb-' or higher, or three notches if the SACP is at 'bb+' or lower. This has changed to one and two notches, respectively, to maintain consistency with the approach for nondeferrable subordinated debt in other sectors (see part VI "Methodology", section C.3).
- These criteria do not adopt the RfC proposal to deduct an additional notch from the issue rating on a bank hybrid capital instrument if the bank has stopped paying its ordinary dividend. The reason for the change is that the SACP assessment is intended to capture the factors that result in the nonpayment.
- The criteria contain more details on the approach for rating an instrument with mandatory nonpayment triggers, including going-concern contingent capital instruments, based on a bank's proximity to the trigger situation or event (see tables 3a and 3b in subpart VI.C). This is in response to requests for more information on the methodology for assigning issue ratings to such instruments.
- The criteria include more information on the situations that lead to a rating of 'CCC' on a contingent capital instrument (see paragraph 72).

IV. IMPACT ON OUTSTANDING RATINGS

23. In some cases, a change in the classification of the equity content of bank hybrid capital instruments may lead to a reevaluation of a bank's capital strength, a downward revision of the SACP assessment, or a lower ICR. This is because these criteria reclassify the equity content of a number of bank hybrid capital instruments to minimal from intermediate, removing their eligibility for inclusion in TAC (total adjusted capital). TAC is the numerator for the risk-adjusted capital ratio, which is one component of the assessment of bank capital. Consequently, the risk-adjusted capital ratios of some banks would likely fall after reclassification of the equity content of hybrid capital instruments as minimal.
24. This criteria update could lead to lower issue ratings on some bank hybrid capital instruments, depending on the instruments' features and the assessment of the bank's SACP.

V. EFFECTIVE DATE AND TRANSITION

25. These criteria are effective immediately. We intend to complete our review of the equity content of existing bank hybrid capital instruments and the relevant issue ratings within the next six months.

VI. METHODOLOGY

26. The methodology for bank hybrid capital instruments (hybrids) incorporates:
 - A. Identifying which instruments constitute bank hybrid capital,
 - B. Determining the equity content classification of bank hybrid capital instruments, and
 - C. Assigning issue ratings to bank hybrid capital instruments.

27. Subpart A describes the features that identify bank capital instruments as hybrid capital.
28. Subpart B describes the criteria for classifying the equity content of bank hybrid capital instruments into one of three categories, "high", "intermediate", and "minimal", and the reasons why these criteria differ from the criteria for similar instruments issued by insurance companies and nonfinancial firms. Hybrid capital instruments classified in the high equity content category or the intermediate equity content category count toward the calculation of total adjusted capital (TAC). TAC is the numerator of the risk-adjusted capital ratio, Standard & Poor's measure of the adequacy of bank capital.
29. Subpart C describes the criteria for assigning ratings to all bank hybrid capital instruments, even those classified in the minimal equity content category and therefore not included in the TAC calculation.
30. The methodology takes account of information derived from the 2008-2010 banking downturn. In particular, it reflects our views on the performance of bank hybrid capital instruments during that period of bank stress, banks' high confidence sensitivity, and the impact of changing regulatory standards on hybrid capital instruments.

A. Identifying Hybrid Capital

31. A hybrid capital instrument displays features of both debt and equity and can absorb losses via nonpayment of the coupon, a write-down of principal, or conversion into common equity, without causing a legal default or wind-up of the issuer.
32. Hybrid capital instruments include--but are not limited to--preferred stock, preference shares, deferrable subordinated notes, trust preferred securities, and mandatory convertible securities (mandatory convertibles). A mandatory convertible is a hybrid capital instrument, irrespective of whether it is senior or subordinated before conversion into common equity. The criteria treat noncumulative and cumulative deferrable subordinated debt securities as hybrid capital instruments.
33. Nondeferrable subordinated debt securities are not usually hybrid capital instruments, except in certain jurisdictions. The reason for this is that they cannot absorb losses before the bank's liquidation, or without causing a default on senior obligations. However, such instruments qualify as hybrid capital instruments if the regulatory and legal frameworks insulate senior debt from a default on subordinated debt. An example of such a framework is a bank resolution regime that allows a bank's subordinated debt to absorb losses without causing the bank's liquidation.
34. A nonviability hybrid capital instrument has features that allow it to absorb losses only when the bank is at or close to the point of "nonviability". The criteria define a nonviability situation as one in which a bank is in breach of or about to breach regulatory requirements for its license, and regulatory intervention may therefore be imminent. An example of a nonviability feature is a clause that requires coupon payments or prevents a principal write-down if a bank meets minimum regulatory capital requirements. Another example is a feature that allows coupon nonpayment or a principal write-down only after a bank has breached the minimum regulatory capital requirements. Other nonviability features may limit a bank's ability to suspend coupons or write down principal, even though it is in distress. A nonviability hybrid capital instrument typically absorbs losses no sooner than when a bank's SACP is at 'ccc' or lower. However, the timing of the bank's or regulator's conclusion that the entity is nonviable may lead to a different scenario. If the loss absorption can only occur after a bank defaults, such as when the share capital value is zero, then the instrument is not a nonviability hybrid capital instrument under these criteria.

35. Market participants sometimes refer to nonviability hybrid capital instruments as "bail-in" instruments if their mechanisms mean that creditors bear losses--for example, via a principal write-down--in the event that the issuer receives government support.
36. A "going-concern" hybrid capital instrument contains features that allow it to absorb losses when a bank is not at, or close to, the point of nonviability; in other words, when the bank is still a going concern. If the bank's SACP were 'bbb-' or higher at the time of issuance, these hybrid capital instruments would absorb losses early enough for the bank to maintain an SACP of at least 'b+'.
37. A contingent-capital trigger activates the mandatory conversion of contingent capital into common equity or a mandatory write-down of principal. A bank can set these triggers to activate while it is still a going concern, that is, on a "going-concern basis". An instrument with such a trigger is a going-concern contingent capital instrument. If a trigger activates in a nonviability situation, the instrument is a nonviability contingent capital (NVCC) instrument.

A.1. Regulatory classifications of hybrid capital instruments, and hybrid capital instruments subject to regulatory "grandfathering"

38. To qualify for inclusion in the calculation of TAC, a bank hybrid capital instrument must: (i) form part of regulatory capital or count as regulatory capital due to "grandfathering" by the regulator and (ii) satisfy all other conditions for inclusion in TAC, as specified in this criteria article and the related criteria articles listed at the end of this document. If the regulator amortizes an instrument, the TAC calculation uses the amount that the regulator includes in regulatory capital, regardless of the instrument's principal value.

B. Equity Content Classification

39. The criteria for classifying bank hybrid capital instruments in either the high, intermediate, or minimal equity content categories differ from the criteria for hybrid capital instruments in other sectors. This is because banks are highly sensitive to market and investor confidence and often need ongoing access to wholesale debt markets. The equity content classifications reflect the relative likelihood that a bank hybrid capital instrument can absorb losses when required.
40. The criteria in this subpart describe:
 - Equity content categories (see section B.1);
 - The effect of residual maturity standards and step-ups on bank hybrid capital instruments (section B.2);
 - Bank hybrid capital instruments with high equity content, including government-owned hybrid capital instruments that form part of a bank rescue or support package (section B.3); and
 - Contingent capital structures and hybrid capital instruments with write-down features (section B.4).

B.1. Equity content categories

41. This section shows how hybrid capital instruments count toward bank capital, depending on the classification of equity content into one of three categories: (i) high, (ii) intermediate, or (iii) minimal. The classification determines the degree to which a hybrid capital instrument is eligible for inclusion in TAC, depending on the features of the instrument (see chart 1).

a) High equity content:

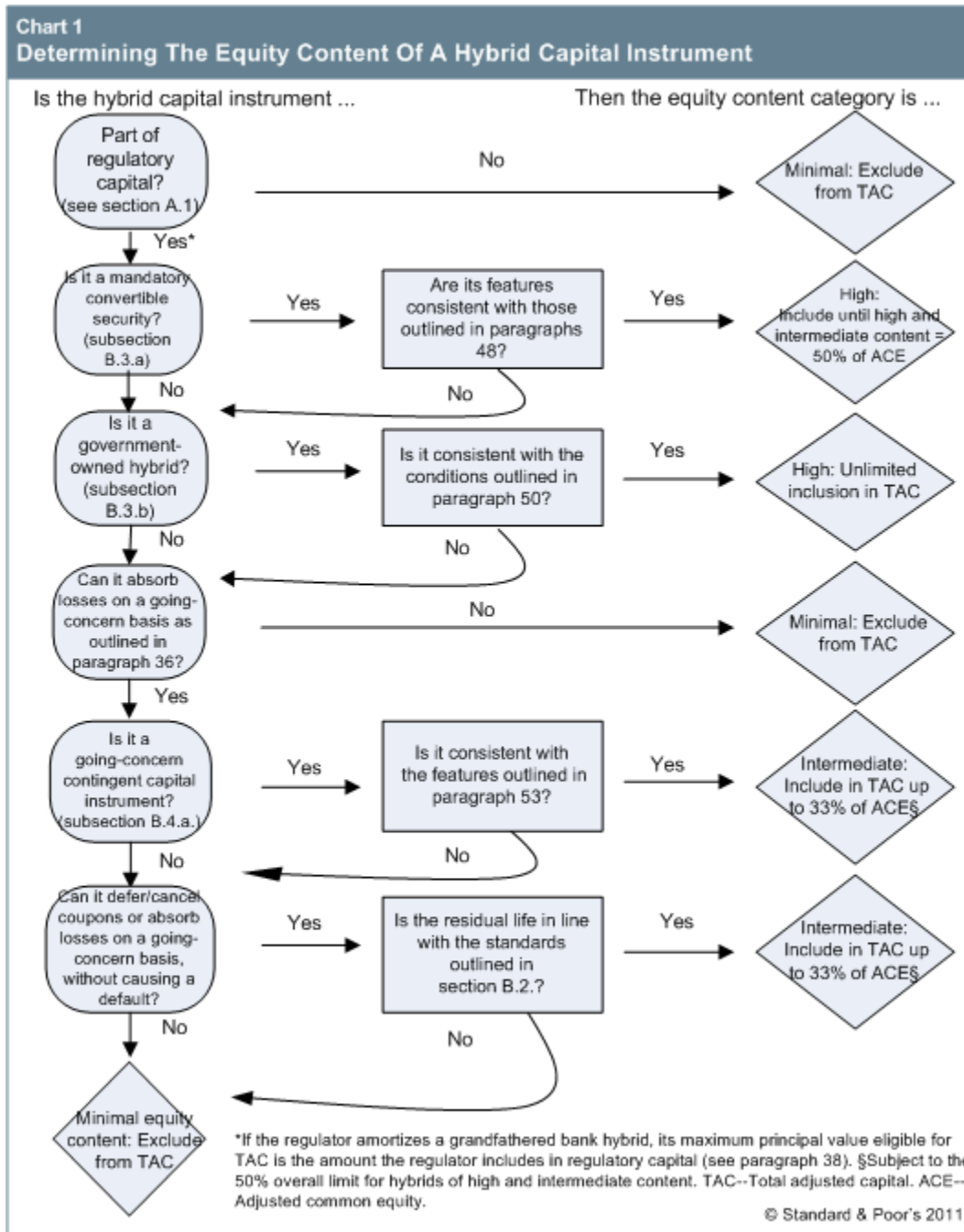
- Qualifying short-dated mandatory convertibles and certain government-owned hybrid capital instruments (see section B.3).
- A hybrid capital instrument with high equity content is eligible for TAC until the aggregate amount of hybrids is equivalent to 50% of the bank's adjusted common equity (ACE).

b) Intermediate equity content

- Qualifying subordinated instruments, preferred stock, or contingent capital instruments that allow nonpayment of coupon, principal write-downs, or conversion into equity on a going-concern basis, without causing a default (see sections B.2 and B.4).
- A hybrid capital instrument with intermediate equity content is eligible for the TAC calculation until the aggregate amount is equivalent to 33% of the bank's ACE.
- A sublimit applies for hybrid capital instruments with intermediate equity content, in that the aggregate amount of hybrid capital instruments with high and intermediate equity content cannot exceed 50% of ACE. This means that if hybrid capital instruments with high equity content are equivalent to 50% of ACE, then the overall limit is exhausted and hybrid capital instruments with intermediate equity content are not included in the calculation of TAC.
- The subcategory of "intermediate: strong" that was previously used for U.S. enhanced trust preferred securities is now part of the "intermediate" category.

c) Minimal equity content

- A hybrid capital instrument with minimal equity content is not eligible for inclusion in TAC.



*If the regulator amortizes a grandfathered bank hybrid, its maximum principal value eligible for TAC is the amount the regulator includes in regulatory capital (see paragraph 38). §Subject to the 50% overall limit for hybrids of high and intermediate content. TAC--Total adjusted capital. ACE--Adjusted common equity.

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42. An instrument qualifies for the calculation of TAC at its par amount, or the par amount adjusted for any write-down of the instrument, unless it is subject to regulatory amortization, in which case the amortized amount applies. The following sections--B.2 to B.4--provide more detail on the equity content classifications of specific types of hybrid capital instruments.

B.2. Effect of residual maturity standards and step-ups on bank hybrid capital instruments

43. TAC includes a bank hybrid capital instrument only when its effective residual maturity reflects:

- A residual life of at least 20 years if the bank's SACP is at 'bbb-' or higher,
 - A residual life of at least 15 years if the SACP is in the 'bb' category, or
 - A residual life of at least 10 years if the SACP is in the 'b' category.
44. The calculation of TAC excludes bank hybrid capital instruments with coupon step-ups on an optional call date, or with features equivalent to step-ups, that may provide an incentive to redeem sooner than the residual life standards in the previous paragraph. Such instruments qualify for the minimal equity content category, regardless of their regulatory classification, unless the step-up date is beyond the minimum residual life periods in paragraph 43.
45. If a step-up date falls within the minimum residual life standards, the intermediate equity content category applies if a hybrid capital instrument also qualifies as a contingent capital instrument. It does so if it has a mandatory common-equity conversion clause or principal write-down feature that can be activated on a going-concern basis and it meets the residual life standards in paragraph 53. A hybrid capital instrument with a step-up on a call date that falls outside the residual life standards remains eligible for the intermediate equity content category if its other features are in line with this category.
46. Given the criteria in paragraphs 43-45, Table 6 "Provisions In Hybrid Instruments Viewed As The Equivalent Of Maturity," in "Hybrid Capital Handbook: September 2008 Edition," published Sept. 15, 2008, no longer applies to regulated banks and finance companies. There is no change to the criteria relating to step-up hybrid capital instruments of regulated insurance companies and corporate issuers.

B.3. Bank hybrid capital instruments with high equity content

47. The only bank hybrid capital instruments that qualify for the high equity content category are: (i) instruments that convert mandatorily to common equity within a fairly short time frame, and (ii) eligible government-owned hybrid capital instruments.

a) Mandatory convertible securities

48. A mandatory convertible instrument may convert into common equity on a predetermined date, instead of due to a deterioration of a bank's position. In such cases, if the conversion is at an equity price that is not lower than the common share price of the bank on the date the instrument was issued, certain time horizons to conversion qualify these instruments for the high equity content category (see "Intermediate Equity Content For Certain Mandatory Convertible Preferred Stock Hybrids," published Nov. 26, 2008, for details of the criteria for mandatory convertible preferred stock issued by rated Australian banks). Specifically, the instrument must convert:
- Within three years if the bank's SACP is at 'bbb-' or higher,
 - Within two years if the SACP is in the 'bb' category, and
 - Within one year if the SACP is in the 'b' category.
49. Certain attributes of bank hybrid capital instruments are inconsistent with high equity content because of the high sensitivity of banks and finance companies to investor confidence. The first is a coupon or dividend that varies directly with changes in a bank's common stock dividend or earnings. The second attribute is that coupon deferral or principal write-down is mandatory on the activation of financial or rating triggers. Bank hybrid capital instruments that display such features include contingent capital structures and instruments with principal write-down features. However, such an instrument may qualify for the intermediate equity content category if its features operate on a going-concern basis. If such an instrument is also a mandatory convertible that converts into equity within the time periods outlined in the previous paragraph, then it is eligible for the high equity content

category.

b) Government-owned hybrid capital instruments as part of a bank rescue or support package

50. In addition to the mandatory convertibles described in subsection B.3.a, government-owned bank hybrid capital instruments also qualify for the high equity content category under certain circumstances. The word "government" includes national, regional, and local governments. For a government-owned hybrid capital instrument to qualify for the high equity content category, all of the following conditions must apply:
- The government has invested in the instrument to rescue or provide extraordinary support to a bank or as part of a long-term support arrangement for a bank;
 - The government appears likely to continue the support if the bank does not strengthen quickly. Examples of ongoing support include conversion of a bank hybrid capital instrument into common equity and the waiver of coupons or fees;
 - The instrument is either: (i) permanent, with no principal repayment dates, and will only be replaced by a similar government-owned hybrid capital instrument or common equity; or (ii) not permanent, but government's statements suggest that redemption will only come from the bank's retained earnings. After such a redemption, the SACP must be at 'bbb-' or higher;
 - We don't expect the government to sell the hybrid capital instrument to a market investor until the bank has stabilized;
 - Dividends are fully discretionary; and
 - There is a distinction between the government-owned hybrid capital instrument and other hybrid capital instruments in the public market. One example is when a payment suspension on a government-owned hybrid capital instrument can occur, even if other hybrid capital instruments continue to make payments.
51. A government-owned hybrid capital instrument that qualifies for the high equity content category under the criteria in the previous paragraph is eligible for unlimited inclusion in TAC. Examples of such instruments are the Class B shares issued by The Royal Bank of Scotland Group PLC to the U.K. government in 2009.

B.4. Contingent capital structures and hybrids with write-down features have intermediate or minimal equity content

52. A contingent capital instrument with features that could lead to mandatory conversion into common equity or a write-down of principal does not have high equity content if issued by a bank or finance company. This is because the activation of the loss-absorption trigger could cause a loss of investor confidence, restricting the bank's funding flexibility. Such an instrument can count as a hybrid with intermediate equity content if it satisfies the other relevant conditions for that category.

a) Going-concern contingent capital

53. A contingent capital instrument qualifies for the intermediate equity content category--regardless of its initial form--if it can absorb losses on a going-concern basis. The criteria treat such instruments as "going-concern contingent capital". An eligible instrument has:
- A residual life of at least 10 years, if the bank's SACP is at 'bb+' or lower, or at least 15 years if the SACP is at 'bbb-' or higher. These residual periods are shorter than the residual life standards for all other hybrid capital instruments with intermediate equity content;
 - Documentation stipulating that it may only be replaced by common equity or by an equivalent or stronger instrument (such a replacement would take place before the redemption of the instrument); and

- A conversion feature that transforms it into common equity or a feature allowing a permanent write-down of at least 25% of the principal. The triggers for these features would kick in mandatorily and on a going-concern basis.

b) Nonviability contingent capital (NVCC) and bail-in hybrids

54. The calculation of TAC excludes bank hybrid capital instruments that can only absorb losses on a nonviability basis. Such instruments are sometimes referred to as bail-in capital if the investors share the cost of a government's rescue of a bank. Only an instrument that can absorb losses on a going-concern basis qualifies for inclusion in TAC.
55. If a bank hybrid instrument can act like capital only at the point of nonviability, then it cannot support the bank's SACP until the bank has received government support or has collapsed. In these circumstances, the instrument does not contribute to the capital buffer that supports the SACP before the point of nonviability. Such instruments include those that form part of regulatory capital and may have to share the burden of a bank rescue, but cannot absorb losses before nonviability. Bank nondeferrable subordinated debt and NVCC instruments are examples. If an NVCC instrument can also absorb losses on a going-concern basis, such as via a coupon nonpayment or deferral, it is eligible for inclusion in TAC if the going-concern features are consistent with the criteria for intermediate equity content.

C. Assigning Issue Ratings To Bank Hybrid Capital Instruments

56. The criteria for rating a bank hybrid capital instrument apply to all such instruments, regardless of their equity content classification.
57. The criteria assign issue ratings to a bank hybrid capital instrument by notching down from the assessment of a bank's SACP, except in the cases described in paragraphs 58-61, when notching is from the issuer credit rating (ICR). The reason for this is that the ICR can incorporate government support that does not accrue to hybrid capital instruments, which often form part of a bank's regulatory capital. The gap between the issue ratings on senior bank debt and those on bank hybrid capital instruments widens if more government support is included in the ICR and the senior debt ratings.
58. If a bank subsidiary benefits from group support because of its classification as either core or strategically important under our "Group Methodology" criteria, published April 22, 2009, the following rating approach applies:
 - The issue rating results from notching down from the ICR on the subsidiary if group support is also for the subsidiary's hybrid capital instruments.
 - If group support is not expected to maintain payments on a hybrid capital instrument, then the issue rating on that instrument results from notching down from the SACP assessment of the subsidiary.
 - The criteria cap the issue rating on a subsidiary's hybrid instrument at no higher than, but potentially lower than, the issue rating on the parent bank's hybrid instruments. This is unless the ICR on the subsidiary is higher than that on the parent. The cap applies unless the parent entity's hybrid instrument has a mandatory going-concern nonpayment trigger set for an earlier point of credit deterioration than any triggers in the subsidiary's hybrid documentation. In this case, it would be possible for a subsidiary's hybrid capital instrument to have a higher rating than the parent's hybrid capital instrument.
 - The criteria cap the issue rating on a nonoperating holding company's hybrid instrument at one notch lower than the rating the instrument would have received if it had been issued by the operating bank.

59. The issue rating on a nonoperating holding company's hybrid capital instrument results from notching down from the ICR on the holding company, unless the holding company is also a government-related entity (GRE).
60. To rate a hybrid capital instrument of a bank that is a GRE, the notching is from the SACP assessment of the bank. However, in relatively rare instances, the government may support a GRE's hybrid capital instruments, and the notching would then be from the ICR. This approach applies only if the likelihood of government support under our GRE criteria is "almost certain", "extremely high", or "very high", and we consider that the state would likely provide sufficient financial support to prevent activation of a nonpayment trigger on the hybrid capital instrument (see "Rating Government-Related Entities: Methodology And Assumptions," published Dec. 9, 2010).
61. If the ICR on a bank is lower than the SACP, which can occur if the sovereign rating is lower than the SACP, then the rating approach is to notch down from the ICR.
62. The rating of a bank hybrid capital instrument occurs in five main stages (see table 2). A nondeferrable subordinated debt security is not a hybrid capital instrument unless certain conditions apply. The steps to assign issue ratings to nondeferrable subordinated debt are in section C.4.

Table 2

Assigning Issue Ratings To Bank Hybrid Capital Instruments*		
Instrument features	Rating approach§	Criteria reference
Step 1		
Apply the minimum notching for a bank hybrid capital instrument. †	For an SACP in the 'bbb-' category or higher, the rating is two notches below the SACP. For an SACP at 'bb+' or lower, it is three notches below the SACP.	Paragraphs 63-64
Step 2		
Step 2a: Identify whether the instrument contains a clause stating that it mandatorily absorbs losses on a going-concern basis, but in a situation that is not otherwise reflected in the SACP. The loss absorption can be via coupon nonpayment, principal write-down, or a trigger-based conversion into common equity.	If so, deduct one more notch for a mandatory earnings clause or go to Table 3a or 3b if there is a going-concern capital-based trigger that identifies the capital ratio as a specific number.	Paragraph 69 and Tables 3a and 3b
Step 2b: Identify whether the instrument contains a nonviability contingency clause leading to common equity conversion and/or a principal write-down.	If so, deduct one more notch, unless Table 3a or 3b applies.	Paragraph 69
Step 2c: Identify whether the instrument contains a contingency clause leading to common equity conversion and/or a principal write-down, but the contingency trigger is either based on rating transitions or is exceptionally sensitive or vulnerable.	If so, the issue rating is no higher than 'CCC'.	Paragraphs 71 and 72
Step 3		
Identify whether the issuer has announced the suspension of interest payments on the hybrid capital instrument, a write-down of the principal, conversion into equity, or default on the due date.	If so, assign an issue rating of 'CC'.	See existing criteria‡
Step 4		
Identify whether the issuer has announced a distressed exchange offer on the instrument.	If so, assign an issue rating of 'CC'.	See existing criteria‡
Step 5		
Identify whether there has been a coupon suspension on the hybrid capital instrument, a write-down of principal, trigger-based conversion into common equity, or a distressed exchange.	If so, assign an issue rating of 'C'.	See existing criteria‡

Table 2**Assigning Issue Ratings To Bank Hybrid Capital Instruments* (cont.)**

*This table replaces Table 9a from "Hybrid Capital Handbook: September 2008 Edition," published Sept. 15, 2008. §Not all notches are used if that would lead to a rating of 'C' or 'D' on a hybrid capital instrument that is being fully serviced. In these cases, the hybrid capital instrument receives an issue rating of 'CC', which is the lowest rating for a hybrid capital instrument that is still being serviced. †The deduction of notches is from the SACP except for some circumstances for which the starting point is the ICR, as discussed in paragraphs 58-61. ‡"General Criteria: How Standard & Poor's Uses Its 'CCC' Rating," published Dec. 12, 2008, and "Rating Implications Of Exchange Offers And Similar Restructurings, Update," published May 12, 2009, show the criteria for assigning issue ratings of 'CC' and 'C'. SACP--Stand-alone credit profile. ICR--Issuer credit rating.

C.1. Minimum notching

63. The rating methodology for all bank hybrid capital instruments starts with minimum notching. However, depending on an instrument's features, additional notching may apply (see section C.2). The minimum notching for a bank hybrid capital instrument is:
- One or two notches to reflect subordination risk, depending on the SACP assessment, and
 - A one-notch deduction to reflect the risk of partial or untimely payment.
64. Debt subordination results in a one-notch deduction from a bank's SACP if the SACP is at 'bbb-' or higher. An additional notch for subordination applies if the SACP is in the 'bb+' category or lower.
65. There is no additional deduction from the issue rating to reflect different subcategories of subordination if a bank were in liquidation. This is because the issue ratings mainly aim to reflect the heightened risk of untimely or partial payment.
66. If notching is from the ICR, the minimum deduction is two notches if the ICR is 'BBB-' or higher, or three notches if the ICR is 'BB+' or lower.
67. The minimum notching principle also applies for rating mandatory convertibles with triggers that activate conversion, regardless of the instrument's form before conversion.
68. A one-notch deduction for partial or untimely payment risk still applies even if a bank hybrid capital instrument has an ineffectual coupon nonpayment clause. An example of such a clause is one that prevents coupon suspension because of interactions between coupon payment dates. In these situations, there is still a one-notch deduction to reflect nonpayment risk because these instruments offer a bank the legal right to stop paying coupons.

C.2. Additional notches to reflect the risk of partial or untimely payment

69. The deduction of additional notches indicates higher relative risk and also reflect the likelihood of a principal write-down, trigger-based conversion into common equity, or distressed exchange of a bank hybrid capital instrument (see table 2). For example, additional notches apply if an instrument has a mandatory nonpayment trigger that operates independently of a bank's collapse or nonviability, a situation that the SACP analysis would not capture. A deduction of additional notches applies in the following cases:
- If a bank's reporting of a loss in a particular accounting period leads to mandatory nonpayment on an instrument and the bank is therefore unable to use its reserves to offset this loss, the deduction is at least one additional notch.
 - The criteria also apply an additional notch if a bank hybrid capital instrument contains a contingency clause that requires mandatory conversion into common equity or a write-down of principal on the activation of a nonviability trigger. If a principal write-down can only occur after the bank's share capital has been written down to zero, then the additional notch does not apply. This is because the SACP assessment captures the trend in share

capital.

- If activation of a capital-based trigger--expressed as a specific number--leads to mandatory loss absorption on a going-concern basis, the issue rating depends on the bank's proximity to the trigger (see tables 3a and 3b). The issue rating is therefore the lower of the outcome using Table 2 or the rating cap indicated in Table 3a or Table 3b. Tables 3a and 3b do not show the issue rating on hybrid capital instruments of banks whose SACPs are in categories lower than 'bb-' because the outcome using Table 2 is sufficient. For such banks, the rating approach in Table 2 is: (i) to deduct four notches from the SACP if an instrument contains a mandatory write-down or conversion clause, or (ii) to deduct three notches if an instrument contains a mandatory coupon-nonpayment clause.
 - If a mandatory capital trigger relates to compliance with a minimum regulatory capital requirement to maintain a banking license, it is a nonviability trigger, so Tables 3a and 3b do not apply. Tables 3a and 3b do not apply if a capital-based trigger does not identify a regulatory ratio as a specific number.
70. If a going-concern hybrid capital instrument has a mandatory trigger linked to a regulatory ratio expressed as a specific number, then it receives an issue rating based on: (i) the bank's SACP, (ii) Standard & Poor's projections of the specified regulatory ratio, and (iii) an estimate of the regulatory ratio that the bank can maintain if it uses its financial flexibility. The projected regulatory ratios look forward 18-24 months, in line with the time frame for the rating outlook, and can differ from the bank's forecasts. The rating outcomes in Table 3a are one notch lower than those in Table 3b. The reason for this is that the matrix in Table 3a is for bank hybrid capital instruments with features that cause a mandatory principal write-down or mandatory conversion into common equity.
71. If a bank's data do not facilitate the monitoring of the specific regulatory ratio referenced in a mandatory trigger, the hybrid capital instrument receives an issue rating of 'CCC'. To monitor a regulatory ratio included in a trigger and expressed as a specific number: (i) the definition of the ratio must be publicly available, (ii) the rules for calculating the ratio are publicly available, (iii) the bank publishes the ratio at least twice yearly and within three months of the calculation date, and (iv) the bank publishes a minimum target for the regulatory ratio.

Table 3a

Rating Caps For Hybrid Capital Instruments With A Going-Concern Capital Trigger

Leading To A Mandatory Write-Down Or Conversion Into Equity*

Projected buffer above capital-based trigger	--Stand-alone credit profile (SACP)--									
	aa- or higher	a+	a	a-	bbb+	bbb	bbb-	bb+	bb	bb-
Capital ratio projected to remain greater than or equal to 401 bps from the trigger	BBB+	BBB+	BBB	BBB-	BB+	BB	BB-	B	B-	CCC+
Capital ratio projected to remain 301-400 bps from the trigger	BBB	BBB	BBB-	BB+	BB	BB-	B+	B-	CCC+	CCC+
Capital ratio projected to remain 201-300 bps from the trigger	BBB-	BB+	BB+	BB	BB-	B+	B	CCC+	CCC+	CCC+
Capital ratio projected to remain 101-200 bps from the trigger	BB	B	B	B	B-	B-	B-	CCC+	CCC+	CCC+
Capital ratio projected to remain 0-100 bps from the trigger	CCC§	CCC	CCC	CCC	CCC	CCC	CCC	CCC	CCC	CCC

*This refers to a regulatory capital-based trigger that operates on a going-concern basis. This trigger identifies a specific capital ratio--expressed as a number--and leads to a mandatory principal write-down or mandatory conversion into common equity. A hybrid capital instrument receives a rating of 'CC' or 'C' if the conditions in Table 2 apply. If the issuer has an SACP of 'b+' or lower, instead of Table 3a, Table 2 applies. §This combination is unlikely to be used because the SACP assessment of the issuer would likely have been lowered to reflect the deterioration in the capital position. bps--Basis points.

Table 3b

Rating Caps For Hybrid Capital Instruments With A Going-Concern Capital Trigger										
Leading To Mandatory Coupon Nonpayment*										
Projected buffer above capital-based trigger	--Stand-alone credit profile (SACP)--									
	aa- or higher	a+	a	a-	bbb+	bbb	bbb-	bb+	bb	bb-
Capital ratio projected to remain greater than or equal to 401 bps from the trigger	A-	A-	BBB+	BBB	BBB-	BB+	BB	B+	B	B-
Capital ratio projected to remain 301-400 bps from the trigger	BBB+	BBB+	BBB	BBB-	BB+	BB	BB-	B	B-	CCC+
Capital ratio projected to remain 201-300 bps from the trigger	BBB	BBB-	BBB-	BB+	BB	BB-	B+	B-	CCC+	CCC+
Capital ratio projected to remain 101-200 bps from the trigger	BB+	B+	B+	B+	B	B	B	CCC+	CCC+	CCC+
Capital ratio projected to remain 0-100 bps from the trigger	CCC§	CCC	CCC	CCC	CCC	CCC	CCC	CCC	CCC	CCC

*The trigger is linked to maintenance of a specific regulatory capital ratio. The trigger can operate on a going-concern basis and identifies a specific capital ratio expressed as a number. A hybrid capital instrument receives a rating of 'CC' or 'C' if the conditions in Table 2 apply. If the issuer has an SACP of 'b+' or lower, Table 2 applies instead of Table 3b. §This combination is unlikely to be used because the SACP assessment of the issuer would likely have been lowered to reflect the deterioration of the capital position. bps--Basis points.

72. The criteria cap the issue rating on a bank hybrid capital instrument with a contingent capital trigger linked to a specific rating at 'CCC'. Likewise, the highest issue rating is 'CCC' if a contingent capital instrument has an exceptionally sensitive or vulnerable trigger that can be activated although the SACP has not deteriorated significantly. Examples of such triggers include those linked to market capitalization or share price because these factors do not always correlate with changes in creditworthiness. Other triggers may relate to regulators' concerns about financial stability in the broader market and to events or situations that are not observable using public information. This includes situations in which a regulator has full discretion to activate the trigger on a going-concern basis. If the regulator's discretion only extends to deciding whether a bank is about to breach a defined and observable regulatory ratio and the capital-based trigger clearly states this ratio as a specific number, then Tables 3a or 3b apply if the trigger is a going-concern trigger. If the regulator's discretion only extends to deciding whether a bank is nonviable, then the instrument is an NVCC instrument and paragraph 69 applies.

C.3. Nondeferrable subordinated bank debt

73. The issue ratings on a bank's conventional nondeferrable subordinated debt are one notch below the ICR on investment-grade issuers (i.e. banks rated 'BBB-' or higher). The issue ratings are two notches below the ICR if the ICR is 'BB+' or lower. The criteria only assign an issue rating of 'D' to an instrument that has stopped paying, however. This notching reflects that the default risk for the subordinated instrument is similar to that on senior debt. The issue rating also reflects such an instrument's subordinated position in an administration, insolvency, or similar proceedings.
74. The criteria take a different approach if a nondeferrable subordinated debt instrument constitutes part of a bank's regulatory capital and represents higher default risk than the senior debt. This occurs in countries where the regulatory and legal frameworks, including bank resolution regimes, could lead to the conversion of nondeferrable subordinated debt into bail-in capital or to untimely or partial payment of coupon or principal, without provoking a legal default or the bank's liquidation.
75. In a country where the features in the previous paragraph apply, the approach to rating nondeferrable subordinated

bank debt is to notch down from the SACP, using the minimum notching for subordination. In such jurisdictions, the government is unlikely to support the payment of nondeferrable subordinated debt, even though it may support senior debt. This makes the SACP on the bank the appropriate starting point. Such instruments receive issue ratings that are one notch below the SACP if the SACP is at 'bbb-' or higher, or two notches below the SACP if the SACP is in the 'bb+' category or lower. The criteria only assign an issue rating of 'D' to an instrument that has stopped paying, however.

76. Identification of the jurisdictions in which this notching applies relies on whether the legal and regulatory frameworks allow the authorities to instigate restructuring of a failing bank, to the detriment of nondeferrable subordinated debt. An example of such an action is if the authorities order the write-down of principal or transfer a nondeferrable subordinated instrument to a different legal entity from that carrying the senior debt, but also provide protection for the senior creditors. Such flexibility may form part of legislation, past regulatory actions, or the statements of those authorities.
77. In some jurisdictions, the authorities may have power to force a default on nondeferrable subordinated debt to protect senior creditors, but use of this option is uncertain. In rare circumstances, a government may indicate its intention to prevent losses on nondeferrable subordinated debt. The rating methodology in such a situation is to notch down from the ICR instead of from the SACP.
78. If regulatory actions support a bank's senior debt, but allow a default on nondeferrable subordinated debt, the affected subordinated debt instrument receives a rating of 'D' on default, or 'C' if the nonpayment were in accordance with the instrument's terms and conditions.
79. For nondeferrable subordinated debt of a banking subsidiary of an operating bank parent, or nondeferrable subordinated debt of a nonoperating holding company, the criteria in paragraphs 58-61 also apply.

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